

## Legislative Update

■ By **Eric Hosken** and **Daniel Laddin**

The House and Senate have agreed on a final version of the financial reform legislation now named the “Dodd-Frank Wall Street Reform and Consumer Protection Act”. The Act is expected to be voted on this week in the House and the Senate with the goal of presenting it to President Obama by July 4th. While the focus of the new legislation is on reforming the financial services industry, the Act includes several provisions that will directly impact executive compensation, including:

- Non-binding advisory votes on Executive Pay and Golden Parachutes
- Independent Compensation Committees, with authority to hire advisors
- Compensation recoupment (“No Compensation for Lies”)
- Additional Disclosure Requirements of pay-for-performance, pay ratios, and employee and director equity hedging policies

Below is a brief description of each of the key provisions impacting executive compensation, along with considerations for companies as they begin to think of the implications of the legislation.

### Shareholder Vote on Executive Compensation Disclosures (Section 951)

#### Advisory Vote on Executive Compensation (i.e., “Say on Pay”)

*Description:* Companies must submit a resolution to shareholders to approve the compensation of named executive officers

- Vote must occur at least once every three years
- Shareholders must be provided with an opportunity to determine if the vote will take place every one, two, or three years and must be given the opportunity to vote on the frequency every 6 years
- The new requirement will be effective for the first annual shareholder meetings taking place six months after the enactment of the bill, which for calendar year companies means their 2011 shareholder meeting, assuming the bill is signed as expected

*Considerations:* Companies should examine their compensation programs to ensure program design features have a solid rationale from a shareholder perspective. Consider meeting with key shareholders well in advance of filing the annual proxy statement to explain the compensation program and gain insight on shareholder views of compensation. A recent *Compliance and Disclosure Interpretation* by the SEC has provided reassurance to companies that they can communicate directly with key shareholders about compensation.

#### Advisory Vote on Golden Parachutes

*Description:* In connection with a shareholder vote on a merger or acquisition, companies must submit a non-binding advisory vote to shareholders, including:

- A clear description of any agreements with Named Executive Officers that will be impacted by the

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merger or acquisition

- Non-binding shareholder advisory vote on any agreements, to the extent not previously subject to the general shareholder advisory vote on executive compensation

*Considerations: Vote may have narrow implications as it only covers new agreements or modified agreements in advance of a change in control that have not already been covered under a non-binding shareholder advisory vote. In addition, it does not cover the total change in control costs a company may incur, but only those that relate to the Named Executive Officers. However, as change in control agreements are a key area of focus, such agreements should be reviewed to ensure that agreements are in line with current and emerging practices.*

## Compensation Committee Independence (Section 952)

### Compensation Committee Independence

*Description:* The Act requires companies to ensure that all members of the Compensation Committee are independent (with limited exceptions), otherwise they cannot be listed by a national securities exchange. Independence will be assessed considering sources of compensation received by the director and affiliation with the company.

*Considerations: Companies that have directors not meeting these criteria will need to modify the Committee membership.*

### Independence of Compensation Consultants and Other Compensation Committee Advisors

*Description:* The Compensation Committee may only select an advisor after taking into consideration specific factors identified by the SEC. Factors to be considered will include the following:

- *Provision of other service to the Company by the advisor*
- *Amount of fees received from the Company relative to the firm's total revenue*
- *Policies and procedures of the advisor to resolve conflicts of interest*
- *Business or personal relationships between the advisor and Compensation Committee members*
- *Stock ownership in the Company by the Advisor*

*Considerations: Following guidance from the SEC, Compensation Committees will likely want to document that they have reviewed these factors prior to selecting outside advisors.*

### Compensation Committee Authority Relating to Compensation Consultants

*Description:* The Compensation Committee has the authority to retain the advice of a compensation consultant and the Company will provide appropriate funding. Compensation Committees are required to disclose the relationship and whether any conflicts of interest arose and how they are being addressed. However, Committees are not required to hire an advisor.

*Considerations: Many companies have already provided clear disclosure of the nature of the reporting relationship with the compensation consultant. They may need to enhance the disclosure slightly to clarify that they are in compliance with the new legislation.*

## Executive Compensation Disclosures (Section 953)

### Disclosure of Pay Versus Performance

*Description:* Companies are required to disclose the relationship between executive compensation and the

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financial performance of the company, possibly through a graphic presentation.

*Considerations: Compensation appears to be defined as compensation actually paid as disclosed in the Summary Compensation Table. For share-based compensation, this may be misleading, as the realized value of the compensation may be very different from the grant value of the compensation. Specific guidance from the SEC is needed to implement this proposal.*

#### **Disclosure of Pay Ratio**

*Description:* Companies are required to disclose the ratio of the median annual total compensation of all employees of the issuer (excluding the CEO) to the annual total compensation of the CEO.

*Considerations: SEC guidance is required to implement this provision, as for most companies it will be challenging to determine the median compensation of all employees on a comparable basis to the Summary Compensation Table compensation of the CEO.*

#### **Recovery of Erroneously Awarded Compensation (Section 954)**

*Description:* Companies will need to develop and implement a policy that provides for the recovery of compensation from current or former executive officers following a financial restatement due to material non-compliance with financial reporting requirements. Policy will apply to any incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date of the restatement.

*Considerations: The proposal is more stringent than most clawback policies currently in-effect as it does not require executive misconduct to trigger recoupment. The policy may be challenging to implement in practice for some forms of compensation (e.g., stock options) as it may be difficult to determine the value that needs to be recovered following a restatement.*

#### **Disclosure Regarding Employee and Director Hedging (Section 955)**

*Description:* Companies are required to disclose whether any executive or director is permitted to purchase financial instruments that are designed to hedge or offset a decrease in the market value of the company's stock.

*Considerations: Companies that have not already adopted an anti-hedging policy should consider doing so to ensure that they do not have to disclose that executives and directors are permitted to hedge positions in the company's stock.*

#### **Conclusion**

The Act will have a significant impact on executive compensation in the near-term as companies work to comply with the new requirements and prepare for "Say on Pay". Additional guidance from the SEC is expected to assist companies in complying with the new rules. However, given the mandatory "Say on Pay", a key area of focus for companies should be ensuring that shareholders understand and support the executive compensation program. Two actions that can assist in this are direct conversations with key shareholders and ensuring that the company's CD&A provides a clear rationale for the compensation program and an easily understandable description of compensation decisions.

***Please contact us at (212) 921-9350 if you have any questions about the issues discussed above or would like to discuss your own executive compensation issues. You can access our website at [www.capartners.com](http://www.capartners.com) for more information on executive compensation.***