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Clients&FriendsMemo

Executive Compensation and Corporate Governance Provisions Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*

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I. Introduction

The focus of this Memorandum is Title IX – Subtitle E "Accountability and Executive Compensation" and Title IX – Subtitle G "Strengthening Corporate Governance" of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Act**"). We note that the Act requires the Securities and Exchange Commission ("**SEC**"), or other specified federal regulator, to develop rules in order to fully implement many of these compensation and corporate governance provisions. Accordingly, the ultimate impact of such provisions will in large part depend on how such rules are implemented.

In short, the Act:

- Requires a non-binding shareholder vote to approve a publicly traded company's executive compensation packages for its named executive officers.
- Requires another non-binding shareholder vote to determine whether the non-binding shareholder vote approving executive compensation packages will occur every 1, 2 or 3 years.
- Requires a non-binding shareholder vote to approve golden parachute arrangements in connection with certain corporate transactions.
- Requires compensation committee and compensation adviser independence and disclosure of compensation consultants retained, including any conflict of interest that arises.

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* Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act's application to specific industries, entities and transactions. To see these other memoranda please see a *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Appendix A links to the various topic-focused memoranda) or visit our website at http://www.cadwalader.com/list_client_friend.php.

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- Requires disclosure of the relationship between executive compensation paid to executive officers and the issuer's financial performance (in addition to any compensation disclosure required under Item 402 of Regulation S-K).

- Requires disclosure of the median annual employee compensation (excluding CEO compensation), the annual CEO compensation and the ratio of the median annual employee compensation (excluding CEO compensation) to the annual CEO compensation.

- Requires publicly traded companies to implement a "clawback" policy that would allow companies to reclaim compensation paid to current or former executive officers during the 3-year period prior to any accounting restatement due to the company's material noncompliance with financial reporting requirements.

- Requires disclosure of whether any employee or board member of a publicly traded company can purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities granted as part of their compensation, or held, directly or indirectly, by the employee or board member.

- Requires "appropriate federal regulators" to prescribe regulations requiring each "covered financial institution" to disclose incentive-based compensation arrangements and to prohibit the arrangements that provide an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits, or that could lead to material financial loss.

- Prohibits non-beneficial owners from voting a security with respect to a board member election, executive compensation or any other significant matter that the SEC determines, unless instructed by the beneficial owner.

- Permits the SEC to prescribe rules requiring that a company's proxy solicitation, consent or authorization include a nominee submitted by a shareholder to serve on the board of directors.

- Requires disclosure to investors in publicly traded companies the reasons that the company has chosen the same person to serve as chairman of the board and CEO (or equivalent positions), or different individuals to serve in those positions.

The balance of this memorandum is divided into two parts: Part II discusses the executive compensation provisions of the Act, and Part III discusses the corporate governance provisions of the Act.

II. Executive Compensation

A. Shareholder Vote on Executive Compensation and Golden Parachute Disclosures

The Act requires publicly traded companies to provide for non-binding shareholder votes on executive compensation ("**say on pay**") and golden parachute packages ("**say on golden parachutes**") of named executive officers. Non-binding "say on pay" votes are already mandatory for companies that received government assistance through the Troubled Asset Relief Program ("**TARP**").[1]

The executive compensation provisions of the Act will subject executive pay to greater shareholder scrutiny. Accordingly, public companies should undertake a proactive and comprehensive review of their executive compensation and golden parachute packages and policies, analyzing whether it is likely shareholders will approve such packages and how best to avoid a negative reaction from institutional investors and proxy advisors.

Even without the mandate of the Act, in recent years, executive compensation packages at public companies have been subject to increased scrutiny by shareholders. For example, certain companies have voluntarily given shareholders a "say on pay" in their proxy statements in recent years.[2] This year, for the first time, shareholders for Motorola, Inc., Occidental Petroleum Corporation and KeyCorp rejected executive compensation proposals in non-binding "say on pay" votes.[3]

"Say on Pay". The Act requires publicly traded companies to provide for a non-binding shareholder vote to approve executive compensation packages at least

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[1] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111(e) (2008) (as amended by the American Recovery and Reinvestment Act of 2009); 31 C.F.R. § 30.13 (2009). *See* also 17 C.F.R. Part 240 (2010) for SEC amendments to the proxy rules under the Securities Exchange Act of 1934 requiring TARP recipients to include a "say on pay" vote in their proxies.

[2] *See* American Federation of State, County and Municipal Employees, AFL-CIO, "More Than 50 Companies Voluntarily Adopt "Say on Pay" as Institutional Investors Continue to Press for an Advisory Vote", Mar. 2, 2010, available at http://www.afscme.org/press/27802.cfm.

[3] *See* Motorola, Inc., Current Report (Form 8-K), at 1 (May 5, 2010); Motorola, Inc., Proxy Statement (Form DEF 14A), at 19 (Mar. 12, 2010); Occidental Petroleum Corp., Current Report (Form 8-K), at 1 (May 11, 2010); Occidental Petroleum Corp., Proxy Statement (Form DEF 14A), at 40 (Mar. 23, 2010); KeyCorp, Current Report (Form 8-K), at 3 (May 24, 2010); KeyCorp, Proxy Statement (Form DEF 14A), at 49 (Apr. 2, 2010). KeyCorp was required to include a "say on pay" vote in its proxy because it is a TARP recipient.

once every 3 years (although more frequent voting may be required).[4] The voting must be provided for in any proxy or consent or authorization for an annual (or other) shareholder meeting for which SEC proxy solicitation rules require compensation disclosure.

The Act also requires a shareholder vote at least once every 6 years to determine whether non-binding votes to approve executive compensation packages will occur every 1, 2 or 3 years, the result of which is not binding on the company. The proxy or consent or authorization for the first annual (or other) shareholder meeting occurring at least 6 months after enactment of the Act must include a non-binding shareholder vote to approve executive compensation packages and a shareholder vote to determine the frequency of such non-binding voting.

"Say on Golden Parachutes". The Act requires disclosure in any proxy or consent solicitation material for a shareholder meeting occurring at least 6 months after enactment at which shareholders are asked to approve an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all of an issuer's assets, by the person making such solicitation of any agreements that such person has with any named executive officers of the issuer (or of the acquiring issuer, if such issuer is not the acquiring issuer) concerning (1) any type of compensation (whether present, deferred or contingent) that is based on or otherwise relates to the transaction, (2) the aggregate amount of such compensation, and (3) the conditions upon which the compensation may be paid. In addition, any proxy containing the disclosure will include a non-binding shareholder vote to approve the disclosed agreements and compensation, unless the agreements have been subject to a "say on pay" vote.

Disclosure. The Act requires every institutional investment manager subject to section 13(f) of the Securities Exchange Act of 1934 to disclose at least annually how it voted on "say on pay" or "say on golden parachute" resolutions, unless the SEC rule or regulation requires the vote to be otherwise publicly reported.

Exemptions. The Act permits the SEC to exempt an issuer or class of issuers from these requirements, and, in determining any exemption, requires the SEC to take into account whether these requirements disproportionately burden small issuers.

[4] Last year, Microsoft Corporation voluntarily adopted a non-binding advisory shareholder vote on the company's executive compensation plan every 3 years. See "Microsoft Board Authorizes "Say-on-Pay" Advisory Vote on Executive Compensation", available at http://www.microsoft.com/presspass/press/2009/sep09/09-18boardpr.mspx. Certain other companies have adopted "say on pay" voting every 2 years.

B. Compensation Committee Independence

Compensation Committee Independence. The Act directs the SEC to promulgate rules requiring that each compensation committee member be a board member and be "independent".[5] The Act also requires the SEC to direct the stock exchanges and FINRA[6] to prohibit the listing of issuer equity securities for any issuer that does not comply with the compensation committee independence requirements.[7] The Act further mandates that the SEC rules to determine independence include the following factors: (1) the board member's source of compensation, including any consulting, advisory or other compensatory fee paid by the issuer, and (2) whether the board member is affiliated with the issuer, an issuer subsidiary or an affiliate of an issuer subsidiary. Publicly traded companies will need to consider these rules alongside the "outside director" requirement of section 162(m) of the Internal Revenue Code of 1986, and the "non-employee director" requirement of SEC Rule 16b-3.[8]

Compensation Adviser Independence. The Act further provides that the compensation committee may select a compensation consultant, legal counsel or

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[5] SEC rules will permit an exchange or FINRA (as the exchange or FINRA deems appropriate, taking into consideration an issuer's size and other relevant factors) to exempt particular relationships from these requirements with respect to the compensation committee members.

[6] The Act refers to the national securities associations, of which the only one relevant is the Financial Industry Regulatory Authority, better known as "FINRA".

[7] This rule excludes controlled companies, limited partnerships, companies in bankruptcy proceedings, open-ended management investment companies registered under the Investment Company Act of 1940, and foreign private issuers that provide annual disclosures to shareholders of the reasons that they do not have independent compensation committees.

[8] Section 162(m) of the Internal Revenue Code generally provides for a $1 million deduction limitation on certain executive compensation, with specified exceptions including certain performance-based compensation. The performance-based compensation exception generally requires that the performance goals under which such compensation is paid be established by a compensation committee composed solely of two or more "outside directors." For purposes of section 162(m), a director is an "outside director" if the director (a) is not a current employee of the publicly held corporation, (b) is not a former employee of the corporation who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year, (c) has not been an officer of the publicly held corporation and (d) does not receive remuneration from the publicly held corporation, either directly or indirectly, in any capacity other than as a director.

SEC Rule 16b-3 exempts certain transactions between issuers of securities and their officers and directors from the provisions of Section 16(b) of the Exchange Act. This exemption applies if, among other things, the transaction is approved by the board of directors of the issuer, or a committee of such board that is composed solely of two or more "non-employee directors". SEC Rule 16b-3 defines a "non-employee director" to mean a director who (a) is not currently an officer of the issuer or a parent or subsidiary of the issuer, or otherwise currently employed by the issuer or a parent or subsidiary of the issuer, (b) does not receive compensation, either directly or indirectly, from the issuer or a parent or subsidiary of the issuer, for services rendered as a consultant or in any capacity other than as a director (except for an amount that does not exceed the dollar amount for which disclosure would be required pursuant to Item 404 of Regulation S-K) and (c) does not possess an interest in any other transaction for which disclosure would be required pursuant to Item 404 of Regulation S-K.

other adviser to the committee (each, an "**Adviser**") only after considering the independence factors the SEC identifies, which will be competitively neutral among categories of Advisers, including: (1) the other services provided to the issuer by the person that employs the Adviser; (2) the amount of fees received from the issuer by the person that employs the Adviser, as a percentage of the total revenue of the person that employs the Adviser; (3) the policies and procedures of the person who employs the Adviser that are designed to prevent conflicts of interest; (4) any business or personal relationship of the Adviser with a member of the compensation committee; and (5) any issuer stock owned by the Adviser.

Disclosure. The Act requires each issuer to disclose in any proxy or consent solicitation material for an annual shareholder meeting (or special meeting in lieu of the annual meeting) occurring at least 1 year after enactment in accordance with SEC regulations, whether (1) the compensation committee retained or obtained the advice of a compensation consultant, and (2) the work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.

SEC Rules. The Act mandates that, within 360 days following enactment, the SEC will direct the exchanges and FINRA to prohibit the listing of securities for issuers that are not in compliance with these compensation committee independence requirements. The SEC rules will provide appropriate procedures for an issuer to have a reasonable opportunity to cure any defects prior to delisting.

Exemptions. The compensation committee independence rules will not apply to an issuer (i) that is listed on an exchange or by FINRA, (ii) that holds an election for the board of directors, and (iii) in which an individual, group or another issuer holds more than 50% of the voting power. In addition, the SEC may permit exchanges and FINRA to exempt a particular relationship from the compensation committee independence requirements as the exchanges and FINRA determine is appropriate, taking into account the issuer's size and any other relevant factors.

Compensation Committee Authority. The Act permits a compensation committee to, in its sole discretion, retain or obtain the advice of an Adviser and, be directly responsible for the appointment, compensation, and oversight of such Adviser's work.

Adviser Compensation. The Act requires each issuer to provide appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to Advisers.

SEC Study and Report. The Act requires the SEC to conduct a study and review of the use of compensation consultants and the effects of such use and submit a report to Congress on the results of the study and review within 2 years of enactment.

C. Executive Compensation Disclosures – "Pay for Performance" and "Pay Disparity"

The Act directs the SEC to require each publicly traded issuer to disclose in any proxy or consent solicitation material for an annual shareholder meeting a clear description of any compensation required to be disclosed under Item 402 of Regulation S-K, including information that shows the relationship between executive compensation actually paid and the issuer's financial performance, taking into account any change in stock value and issuer dividends and any distributions.[9]

The Act also directs the SEC to amend Item 402 of Regulation S-K to require each publicly traded issuer to disclose: (1) the median annual total compensation of all employees, except the CEO (or equivalent); (2) the annual total compensation of the CEO (or equivalent); and (3) the ratio of the median annual total compensation of all employees (except the CEO) to the annual total compensation of the CEO.[10]

D. Recovery of Erroneously Awarded Compensation – "Clawbacks"

The Act directs the SEC to promulgate rules requiring each publicly traded issuer to develop and implement a policy providing: (1) for disclosure of the issuer's policy on incentive-based compensation that is based on financial information required to be reported under the securities laws; and (2) that, in the event that the issuer is required to prepare an accounting restatement due to the issuer's material noncompliance with any financial reporting requirement under the securities laws, any current or former executive officer who received incentive-based compensation (including stock options), based on the erroneous data, during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement to repay the issuer the excess of what would have been paid to the executive officer under the accounting restatement. The SEC will direct the exchanges and FINRA to prohibit the listing of securities for any issuer that does not comply with the clawback requirements.

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[9] The disclosure may include a graphic representation of this information.

[10] An employee's total compensation must be determined in accordance with the SEC's executive compensation disclosure rules.

We note that the Act's clawback provision is broader than section 304 of the Sarbanes-Oxley Act, which generally requires CEOs and CFOs to reimburse a company for any bonus or incentive-based compensation received and profits from stock sales realized during the 12-month period after publication of a misstated financial filing if a company is required to prepare an accounting restatement due to misconduct. By contrast, the Act's clawback provision does not require any misconduct as a basis for an accounting restatement and applies to any current or former executive officer who received incentive-based compensation during the 3-year period preceding the restatement. Companies should begin considering how their clawback policies will be implemented, including whether any existing employment agreements or incentive arrangements will need to be amended to comply with such a policy.

As further described in the memorandum titled Orderly Liquidation of Financial Companies, Including Executive Compensation Clawback, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, Title II of the Act also permits the Federal Deposit Insurance Corporation, as receiver of a "covered financial company," to clawback certain compensation from any current or former senior executive or director who is substantially responsible for the failed condition of the company.

E. Disclosure Regarding Employee and Director Hedging

The Act directs the SEC to issue rules requiring each publicly traded issuer to disclose, in any proxy or consent solicitation material for an annual shareholder meeting, whether any employee or board member, or any designee of the employee or member, is permitted to purchase financial instruments (including, prepaid variable forward contracts, equity swaps, collars, and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities (1) granted to the employee or board member as part of his or her compensation; or (2) held, directly or indirectly, by the employee or board member.

F. Enhanced Compensation Structure Reporting

The Act provides that, within 9 months of enactment, the "appropriate federal regulators"[11] jointly will prescribe regulations or guidelines that: (1) require each

[11] The Act defines the term "appropriate federal regulator" as the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Board of Directors of the Federal Deposit Insurance Corporation, the Director of the Office of Thrift Supervision, the National Credit Union Administration Board, the SEC, and the Federal Housing Finance Agency.

"covered financial institution"[12] (generally banking institutions) to disclose to the appropriate federal regulator the structures of all incentive-based compensation arrangements offered by such institutions sufficient to determine whether the compensation structure (a) provides an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits, or (b) could lead to material financial loss to the covered financial institution; and (2) prohibit any type of incentive-based payment arrangement, or any feature of any such arrangement, that the regulators determine encourages inappropriate risks (a) by providing excessive compensation, fees, or benefits, or (b) that could lead to a material financial loss to the covered financial institution. This provision will not apply to covered financial institutions with assets of less than $1 billion.

G. Voting by Brokers

The Act prohibits non-beneficial owners of a security registered under section 12 of the Securities Exchange Act of 1934 from granting a proxy to vote the security in connection with a shareholder vote for a board member election, executive compensation or any other significant matter as determined by the SEC (excluding a vote with respect to the uncontested board member election of any SEC-registered investment company), unless the beneficial owner has instructed the non-beneficial owner to vote the proxy in accordance with the beneficial owner's voting instructions.

III. Corporate Governance

A. Proxy Access

The Act permits the SEC to develop rules and regulations requiring: (1) a proxy solicitation, consent or authorization by (or on behalf of) an issuer to include a nominee submitted by a shareholder to serve on the board of directors; and (2) an issuer to follow a certain procedure in relation to the solicitation. The SEC may also issue rules permitting shareholders to use proxy solicitation materials supplied by an issuer to nominate individuals to the board, under such terms and conditions that the SEC determines are in the interests of shareholders and for the protection of investors. The SEC may exempt an issuer or class of issuers from the proxy access requirement and, in making such determination, will take into account whether the

[12] The Act defines the term "covered financial institution" as a depository institution or depository institution holding company, a broker-dealer registered under section 15 of the Securities Exchange Act of 1934, a credit union, an investment advisor, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and any other financial institution that the appropriate federal regulators jointly determine should be treated as a covered financial institution.

proxy access requirement disproportionately burdens small issuers, among other things.

B. Disclosures Regarding Chairman and CEO Structures

The Act directs the SEC to issue rules, within 180 days of enactment, requiring an issuer to disclose in the annual proxy sent to investors the reasons why the issuer has chosen (1) the same person to serve as chairman of the board and CEO (or equivalent positions); or (2) different individuals to serve as chairman of the board and CEO (or equivalent positions).

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If you have any questions regarding this memorandum, please contact the individuals listed below or any other member of the Cadwalader Tax Department.

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