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financial regulatory reform lawflash

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Financial Reform Bill Imposes Significant New Executive Compensation and Corporate Governance Requirements

Amendments to proxy disclosure rules and changes to executive compensation requirements will mean immediate changes for almost all publicly traded corporations.

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On July 15, Congress passed a final version of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), which is expected to be signed into law by President Obama in the near future. The Act imposes new disclosure requirements and significant new substantive and procedural executive compensation requirements, many of which are immediately applicable. **While the Act is primarily focused on reform of business practices of financial institutions, the executive compensation provisions of the Act will apply, in whole or in part, to almost all publicly traded companies, with additional restrictions applicable only to financial institutions.**

These requirements will affect next year's proxy disclosures (especially the Compensation Discussion and Analysis (CD&A) sections) in a material way, but will also have immediate ramifications with respect to compensation practices for senior executives. We discuss below some of the key provisions of the Act in the order in which the provisions become effective.

The Executive compensation and corporate governance provisions in the Act address the following issues:

- Recovery of Erroneously Awarded Compensation (Clawbacks)
- Executive Compensation Disclosures (Internal Pay Equity)
- Disclosure Regarding Employee and Director Hedging
- Voting by Brokers
- Disclosures Regarding Chairman and CEO Structures
- Shareholder Vote on Executive Compensation Disclosures ("Say on Pay")
- Enhanced Compensation Structure Reporting Applicable to Covered Financial Institutions
- Compensation Committee Independence

Clawbacks

The Act requires public companies to develop and implement a clawback policy with respect to incentive-based compensation. A company's clawback policy must provide that if the company is required to restate its financial statements because of material noncompliance with any financial reporting requirement under the securities laws, the company will recover from any current or former executive officer who received incentive-based compensation (including stock options) during the three-year period preceding the date on which the restatement is required any amount in excess of the amounts that would have been paid to the executive officer under the company's restated financial statements.

This provision in the Act is broader than Section 304 of the Sarbanes-Oxley Act and is similar to the Troubled Asset Relief Program (TARP) clawback requirements contained in the American Recovery and Reinvestment Act of 2009. The TARP clawback policy requires that a limited group of senior executive officers repay bonus or incentive compensation if the award is found to have been based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate. The provision in the Act goes further than the TARP requirements and applies the clawback policy to anyone who served as an executive officer during the relevant three-year period, and the new clawback provision requires recovery even in the absence of misconduct.

The Act requires recoupment of the "excess" portion of the incentive payout (i.e., the difference between the actual payout under the original financials and the amount payable using the restated financials.) Although many companies have adopted clawback policies, all clawback policies will have to be revised, as appropriate, to conform to the requirements of the Act.

The U.S. Securities and Exchange Commission (SEC) will implement rules to direct the exchanges to prohibit listing of any company that fails to comply with this requirement, which seems to be applicable on enactment.

Executive Compensation Disclosures and Internal Pay Equity

The Act requires the SEC to issue rules requiring proxy disclosure of the relationship between executive compensation and the financial performance of the company (taking into account the company's stock price and dividends). This disclosure may include a graphic presentation of the information.

In addition, the Act requires that companies disclose (i) the median total compensation of all employees (except its CEO or any equivalent position), (ii) the annual total compensation of the CEO (or any equivalent position), and (iii) the ratio of (i) to (ii). For purposes of this disclosure, companies must determine total compensation in accordance with the current proxy rules. This disclosure is intended to highlight significantly disproportionate CEO pay packages when compared to rank and file employees. This provision is effective as of the date of enactment of the Act.

Disclosure Regarding Employee and Director Hedging

The Act requires the SEC to issue rules requiring companies to disclose, in their proxy statement, whether any employee or director is permitted to purchase any financial instrument (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) that is designed to hedge or offset any decrease in market value of equity securities granted as compensation or held, directly or indirectly,

by the employee or director. As a practical matter, this provision may require boards to develop an anti-hedging policy, to the extent the board has not previously done so. This provision is effective as of the date of enactment of the Act.

Voting by Brokers

Effective as of the Act's date of enactment, brokers cannot vote shares held in trust on matters involving executive compensation, director elections, or "other significant matters" identified by the SEC unless specific instructions are provided by the beneficial owner. This provision will likely enhance the influence of institutional shareholders and other large shareholders with reference to compensation matters.

Disclosures Regarding Chairman and CEO Structures

Within 180 days after enactment of the Act, the SEC must issue rules requiring companies to disclose annually in the proxy the reason behind their chairman and CEO structure. Each company must disclose the reason it has either chosen the same person to serve as both CEO and chairman, or has chosen different people to serve in those positions. This disclosure is intended to highlight consideration of the benefits of a nonexecutive board chair.

Shareholder Vote on Executive Compensation: "Say on Pay" and Golden Parachutes

The Act requires a separate nonbinding vote (to be held at least every three years) of company shareholders to approve the compensation of its executives ("say on pay"). Shareholders are required to vote (at least once every six years) on whether the vote will occur every one, two, or three years. Shareholders must vote on both issues at the first shareholder meeting occurring six months after enactment of the Act, meaning that "say-on-pay" effective for many companies for the 2011 proxy season. "Say on pay" has been applicable for some time in Europe and for certain TARP companies in the United States, and may have a significant effect on disclosure practice and executive compensation structures.

In addition, the Act requires that shareholders approve "golden parachute compensation" at any shareholder meeting in which the shareholders are asked to approve an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all of the assets of the company. The company must provide its shareholders with proxy or consent solicitation material that includes, in clear and simple form, a summary of any agreements and understandings with any named executive officers concerning compensation related to the acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all of the assets of the company.

The disclosure must address any agreements with the seller or buyer, applies to present, deferred, or contingent compensation, and must disclose each type of compensation as well as the aggregate amount. The shareholders must approve such agreements or understandings unless they have already been approved in a separate "say on pay" resolution discussed above. Institutional investment managers subject to Section 13(f) of the Securities and Exchange Act of 1934 must disclose at least annually how they voted, unless such vote is otherwise required to be disclosed. The SEC may exempt issuers or classes of issuers, taking into account, among other factors, the impact on small business.

Enhanced Compensation Reporting of Incentive Compensation Arrangements of Covered Financial Institutions; Prohibition of Arrangements with Excessive Risk

The Act requires that, within nine months after its enactment, appropriate federal regulators issue rules requiring the disclosure of incentive-based compensation arrangements sufficient to determine whether a "covered financial institution's" compensation structure (i) provides an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits; or (ii) could lead to material loss to the "covered financial institution." This does not require the additional reporting of actual compensation of any individual, nor does it require disclosure by any "covered financial institution" that does not have an incentive-based compensation arrangement.

A "covered financial institution" is defined as an entity that has assets of greater than $1 billion and is either (i) a depository institution or depository institution holding company, (ii) a broker-dealer, (iii) a credit union, (iv) an investment advisor, (v) the Federal National Mortgage Association, (vi) the Federal Home Loan Mortgage Corporation, or (vii) any other financial institution that the appropriate federal regulators determine should be treated as a "covered financial institution."

An "appropriate federal regulator" includes (i) the board of governors of the Federal Reserve System, (ii) the Office of Comptroller of the Currency, (iii) the board of directors of the FDIC, (iv) the director of the Office of Thrift Supervision, (v) the National Credit Union Administration Board, (vi) the SEC, or (vii) the Federal Housing Finance Agency.

The Act also provides that, within nine months after its enactment, appropriate federal regulators must issue rules prohibiting any type of incentive-based compensation arrangement that (i) encourages inappropriate risk by providing excessive compensation, fees, or benefits, or (ii) could lead to material loss to the "covered financial institution."

Compensation Committee Independence

The Act requires that each member of a public company's compensation committee be independent under standards to be promulgated by the stock exchanges. To determine a member's independence, companies should take into account all relevant factors, including (i) the specific sources of compensation of a member, including any consulting, advisory, or other compensatory fees paid by the company to the member and (ii) whether the member is affiliated with the company, a subsidiary of the company, or an affiliate of a subsidiary of the company.

The exchanges would have discretion to exempt certain relationships as they deem appropriate, based on relevant factors, including the company's size.

Although not mandated by the Sarbanes-Oxley Act, the corporate governance listing criteria for both the New York Stock Exchange and the NASDAQ Stock Market already require that executive compensation be reviewed and administered either by a compensation committee composed of independent directors (NYSE) or by an independent compensation committee or by a majority of the independent directors (NASDAQ).

The Act goes further to provide that consideration be given to the sources and nature (apart from the amount) of any compensation the director receives and to whether a director is "affiliated" with the

public company or its subsidiaries. Affiliate status (in this context, meaning share ownership) is currently not an "independence" criteria in either exchange's listing rules, although it is a criterion for eligibility to serve on an audit committee under the Sarbanes-Oxley Act and the related SEC rules.

This provision in the Act does not supersede the "outside director" requirement of Section 162(m) of the Internal Revenue Code or the "nonemployee director" requirement of SEC Rule 16b-3. As a result, companies may have to comply with up to three different sets of requirements regarding the composition of their compensation committees.

The Act requires that compensation committees have the authority to retain their own compensation consultants, independent counsel, and other advisors to assist them with compensation-related duties and obligations. Before hiring any counsel, consultant, or advisor, the compensation committee must evaluate factors such as (i) whether the advisor's employer provides other services to the company, (ii) the amount of fees received by the advisor's employer (as a percentage of the total revenue of the employer), (iii) conflict-of-interest policies and procedures of the advisor's employer, (iv) any relationship between the advisor and members of the compensation committee, and (v) any equity ownership that the advisor may have in the company. The Act requires that the company provide adequate funding to allow the compensation committee to retain independent compensation consultants, counsel, and other advisors.

Any proxy or consent solicitation material for an annual meeting of the shareholders (or a special meeting in lieu of the annual meeting) occurring on or after one year from the enactment of the Act will be required to disclose whether the compensation committee retained or obtained advice from a compensation consultant and whether the consultant's services created any conflict of interest, and if so, the nature of the conflict of interest and how the conflict is being addressed.

If a company does not comply with these provisions within 360 days after the enactment of the Act, the exchanges are to prohibit listing of the company. However, the Act provides an exemption for a "controlled company," which is a company that is listed on a national securities exchange and holds an election for its board of directors in which more than 50% of the voting power is held by an individual, a group, or another company.

Summary of Effective Dates

The Act's effective date provisions are somewhat unclear. Set forth below is a summary of what appear to be the effective date provisions, subject to modification by federal regulators as guidance is issued:

Effective Date	**Provision**
On enactment	• Clawback policies • Disclosures on pay for performance, internal pay equity and hedging • Voting by Brokers
SEC to issue rules within 180 days after enactment	• Disclosure of leadership structure

First shareholder meeting/vote 6 months after enactment	• "Say on pay" and golden parachutes
Federal regulators to issue rules within 9 months after enactment	• Rules for covered financial institutions
Effective within 360 days of enactment	• Compensation committee independence (**Note:** compensation consultant disclosure is effective for annual shareholder meetings held more than one year after enactment).

We will continue to monitor the ongoing developments of Financial Regulatory Reform. If you have any questions or would like more information on the issues discussed in this LawFlash, please contact the authors, **Joseph Ronan** (215.963.5793 or jronan@morganlewis.com), **Mims Maynard Zabriskie** (215.963.5036 or mzabriskie@morganlewis.com), and **Benjamin I. Delancy** (202.739.5608 or bdelancy@morganlewis.com), or any of the following Morgan Lewis attorneys:

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In addition, Morgan Lewis's multidisciplinary Financial Regulatory Reform resource team is available to assist with a wide range of issues and areas of concern related to the reform effort. You can access a complete collection of the firm's updates and alerts on the subject on our website's Financial Regulatory Reform page.

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