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Financial Reform Bill
Webcast Series

Financial Reform Bill:

Impact on Executive Compensation, Corporate Governance, and Disclosure

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Part I: August 4, 2010

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Part II: August 11, 2010

Background

- July 21, 2010 - Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) signed into law.
- Imposes significant new requirements affecting executive compensation applicable, in whole or in part, to <u>almost all</u> publicly traded companies, with additional restrictions applicable only to financial institutions.
- Requirements will materially affect proxies for the 2011 proxy season.
- Will have **immediate** ramifications with respect to compensation practices for senior executives.
- http://www.morganlewis.com/topics/financialregulatoryreform

Highlights

Part 1:

- Clawbacks
- Say on Pay/Golden Parachutes
- Voting by Brokers
- Executive Compensation Disclosures

Part 2:

- Independence of Compensation Committee and Consultants
- Disclosures Regarding Chairman and CEO Structures
- Disclosure Regarding Employee and Director Hedging
- Enhanced Compensation Reporting for Covered Financial Institutions

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Clawbacks

- Public companies will be delisted if they do not develop and implement a clawback policy with respect to incentive-based compensation.

- Policy must provide:
  - if the company is required to restate its financial statements because of material noncompliance with any financial reporting requirement under the securities laws,
  - 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.

Clawbacks

- Applies to anyone who served as an executive officer during the relevant three-year period.
- Requires recovery even in the absence of misconduct.
- Broader than Section 304 of the Sarbanes-Oxley Act
- Similar to TARP clawback requirements

Clawbacks

- Act only requires recovery of the “excess” portion of the incentive payout.
- 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.
- SEC will implement rules directing the exchanges to prohibit listing any security of any company that fails to comply with this requirement.

Shareholder Vote on Executive Compensation: “Say on Pay” and Golden Parachutes

- The Act requires separate nonbinding shareholder vote to approve the compensation of its executives as disclosed (“say on pay”).
- At least once every six years, shareholders must also vote on whether the say on pay vote will occur every one, two, or three years.
- At first shareholder meeting after January 21, 2011, shareholders must vote on both issues.

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

- The Act also requires non-binding shareholder vote on "golden parachute compensation."
  - At any shareholder meeting including approval of an acquisition, merger, consolidation, or proposed asset sale.
  - Must disclose, in clear and simple form, in accordance with new SEC rules, any agreements and understandings with any named executive officers concerning compensation related to the transaction.
  - Must address:
    - *any agreements with the seller or buyer,*
    - *present, deferred, or contingent compensation*
- Shareholder vote required unless such agreements or understandings have already been approved in a separate say on pay resolution.

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

- Interplay between "say on pay" approval and golden parachute vote not clear.
- Institutional investment managers subject to Section 13(f) of the Securities Exchange Act of 1934 must disclose at least annually how they voted on the new pay-related proposals, 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.

Voting by Brokers

- Effective as of July 21, 2010, unless specific instructions are provided by the beneficial owner, brokers cannot vote shares held in customer accounts on matters involving executive compensation, director elections, or “other significant matters” identified by the SEC.
- This provision will likely enhance the influence of institutional shareholders and other large shareholders with reference to compensation matters.

Executive Compensation Disclosures

Pay vs. Performance

- SEC to issue rules requiring:
  - "Clear description of any compensation required to be disclosed" under Item 402
  - Proxy disclosure of the relationship between executive compensation "actually paid" and the financial performance of the company, taking into account any change in the value of stocks and dividends and any distributions
  - Disclosure may include graphs.

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Executive Compensation Disclosures

Internal Pay Equity

- SEC must amend Item 402 to require companies to 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).

- Total compensation determined in accordance with proxy rules in effect on July 20, 2010.

Compensation Committee Independence

- The Act adds Section 10(C) to the Securities Exchange Act of 1934 to require the SEC to require stock exchanges to prohibit the listing of a public company that does not have compensation committee members who are independent board members.
  - The Act excludes from this requirement controlled companies, limited partnerships, companies in bankruptcy, registered open-end management investment companies and foreign private issuers that explain in annual disclosures to shareholders why they don't have independent compensation committees.
- SEC rules will require that the definition of independence 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.

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Compensation Committee Independence

- The exchanges will 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).

Compensation Committee Independence

- 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.
- These new rules may disqualify some directors who are deemed “independent” under the current rules.

Compensation Committee Advisor Independence

- The Act also requires that compensation committees have the authority to retain and oversee their own compensation consultants, independent counsel, and other advisors to assist them with compensation-related duties and obligations.
- The Act requires that the company provide adequate funding to allow the compensation committee to compensate any such retained independent compensation consultants, counsel, and other advisors.

Independence Factors:

- Before hiring any counsel, consultant, or advisor, the compensation committee must evaluate factors identified in a new SEC rule, 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 business or personal relationship between the advisor and any member of the compensation committee, and (v) any equity ownership that the advisor may have in the company.

Compensation Committees: Disclosure and Effective Date

- 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 (July 21, 2011) 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, subject to any stock exchange exemption for a category of issuers and subject to SEC rules providing an opportunity to cure any defect.
- The Act provides an exemption from new Section 10(c) of the Securities Exchange Act 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.

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 reasons why the company has chosen either the same person to serve as both CEO and chairman, or different people to serve in those positions.
- This disclosure is already required in proxies by Item 407(h) of Regulation S-K.

Disclosure Regarding Employee and Director Hedging

- The Act requires the SEC to issue rules requiring companies to disclose, in their proxy or consent statement, whether any employee or director is permitted to purchase any 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 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.

Enhanced 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 to the regulator 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.

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

- A “covered financial institution” is defined as an entity that has assets of $1 billion or more 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.”

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

- 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."

Summary of Effective Dates

Effective Date	Provision
•On enactment, subject to adoption of implementing rules for the performance, internal pay equity, and hedging disclosure	•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

Summary of Effective Dates

•First proxy or consent solicitation that includes compensation disclosure 6 months after enactment	•Say on pay and golden parachutes
•Federal regulators to issue rules within 9 months after enactment •Proxy or consent solicitation for annual meeting on or after July 21, 2011	•Disclosure about retention of compensation consultant in accordance with SEC rules
•Effective within 360 days of enactment	•Compensation committee and advisor independence

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Questions?

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