

Meridian Client Update

July 16, 2010

Congress Passes Dodd-Frank Wall Street Reform and Consumer Protection Act

On July 15, 2010, the Senate passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) which now goes to the President for his expected signature. The legislation includes significant provisions relating to executive compensation and corporate governance. Many of these provisions require action by the Securities and Exchange Commission (SEC) to become effective. In that regard, SEC chair Mary Schapiro in a recent speech indicated that the SEC will move quickly to issue regulations required under the Dodd-Frank Act.

The executive compensation and corporate governance provisions of the Dodd-Frank Act cover the following matters:

- Say on Pay
- Compensation Committee Standards
- Proxy Disclosures
- Proxy Access
- Mandatory Recoupment (Clawback) Provision
- Ban on Non-Directed Broker Votes
- Financial Institution Pay Regulations

Say on Pay

The Dodd-Frank Act grants shareholders of a public company the right to a non-binding vote on the company’s executive pay disclosures and, in certain circumstances, the right to a non-binding vote on the company’s golden parachute agreements. In addition, shareholders are granted the right to determine the frequency of shareholder voting on executive pay disclosures. These say on pay provisions will impact calendar year-end companies which will be required to permit shareholder voting on executive pay disclosures and on the frequency of such shareholder voting in their **2011 proxy**.

- **Non-Binding Shareholder Vote on Executive Pay Disclosures.** At least once every three years, a public company’s shareholders must be allowed to make a non-binding advisory vote on the company’s executive compensation disclosures set forth in the company’s proxy materials. Public companies cannot defer the first shareholder vote on executive compensation disclosures to year three. The initial shareholder vote must occur at the first shareholder meeting occurring six months after the enactment of the Dodd-Frank Act.
- **Non-Binding Shareholder Vote on Frequency of Vote on Executive Pay Disclosures.** At least once every six years, a public company’s shareholders must be allowed to make a non-binding advisory vote on whether shareholder votes on the company’s executive compensation disclosures should occur every 1, 2 or 3 years. Public companies cannot defer the first shareholder vote on this matter until year six. The

initial shareholder vote must occur at the first shareholder meeting occurring six months after enactment of the Dodd-Frank Act.

- **Non-Binding Shareholder Vote on Golden Parachute Disclosures.** A public company's shareholders must be allowed to make a non-binding advisory vote on the company's golden parachute disclosures set forth in proxy or consent solicitation materials which seek shareholder approval of an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all the assets of the company ("Corporate Transaction"). The vote requirement is effective for shareholder meetings occurring six months after the enactment of the Dodd-Frank Act where shareholders are asked to approve a Corporate Transaction. The vote is not required if the golden parachute arrangement was previously included in the company's executive pay disclosure which was subject to a shareholder vote. The SEC is directed to issue new rules on required golden parachute disclosures (see discussion below under Proxy Disclosure).
- **Legal Effect of Shareholder Vote.** The Dodd-Frank Act explicitly provides that shareholder votes on executive pay disclosures, on the vote frequency of such shareholder votes and on golden parachute disclosures are not binding on a public company or its board of directors and may not be construed to:
 - Overrule a decision by the company or its board of directors;
 - Create or imply any change to the fiduciary duties of the company or its board of directors;
 - Create or imply any additional fiduciary duties for the company or its board of directors; or
 - Restrict or limit the ability of shareholders to make proposals for inclusion in proxy materials related to executive compensation.
- **Disclosure of Vote.** Every institutional investment manager subject to section 13(f) of the Securities and Exchange Act of 1934 is required to disclose at least annually how it voted on any of the above shareholder vote matters.
- **Exemption from Shareholder Vote Requirement.** The SEC is authorized to exempt a company or class of public companies from the above shareholder vote requirements taking into account, among other considerations, whether the shareholder vote requirements disproportionately burdens small business.

After several false legislative starts, say on pay will finally become law. Starting with the 2011 proxy season, shareholders will be able to give thumbs up or thumbs down on companies' executive compensation programs. If past voting results are a guide to future voting patterns, few companies will receive thumbs down. However, this proxy season shareholders have shown their assertiveness by voting down executive pay programs at several well-known companies: Motorola, Occidental Petroleum and KeyCorp (see Meridian's Client Update, Vol. 1, Issue 4 dated June 7, 2010). While we believe shareholders will approve the executive pay packages at the overwhelming majority of large public companies in a given proxy season, companies with poor financial results, low shareholder returns or outlier pay practices are at risk of receiving sizeable and even a majority of "AGAINST" votes on their executive pay arrangements. Also, the elimination of broker proxy voting on non-directed shares will likely have an adverse impact on vote results since these shares were typically cast in favor of management.

Large mutual funds, influential and activist state and union pension funds and major shareholder advisory firms (see Meridian's Client Update Vol. 1 Issue 4, dated June 7, 2010 regarding RiskMetrics Group's say on pay proxy voting policy) all will likely influence broad voting patterns on say on pay. The ability of a large public company to individually and effectively communicate the merits of its pay programs directly to these and other constituencies is problematic at best given the broad-based ownership of large public companies. Nonetheless, we do not advocate that companies as a general matter undertake expensive and complex communication and polling campaigns to enhance the likelihood of a positive vote outcome.

Public companies already have an effective means by which to communicate their message directly to shareholders at no incremental expense; the proxy statement. A public company can fully explain the nature of and rationale for its executive compensation programs through the Compensation Discussion & Analysis (CD&A) section of the proxy. The CD&A permits a company to make a compelling case for its executive pay programs. The CD&A also allows companies to highlight the prospective elimination or modification of controversial pay practices. Overall, the CD&A is the most cost-effective, far reaching communication tool available to persuade shareholders to support a public company's executive pay programs.

The real challenge begins if a company receives a majority (or substantial minority) of "AGAINST" votes on its executive pay programs. In responding to a negative vote, a company may either disregard the vote (which is non-binding) and do nothing or determine the source of shareholder discontent and take affirmative action, to the extent possible and appropriate. Given the spotlight on executive pay, doing nothing does not seem like a plausible or prudent approach. Over time, this approach may adversely impact the reputation of the company and its officers, impair share price, garner adverse attention from RiskMetrics and other shareholder advisory groups and ultimately lead to increasing votes against incumbent compensation committee members and perhaps all independent board members. Dealing directly with shareholder concerns can help diffuse these negative consequences. If Motorola, Occidental Petroleum and KeyCorp are illustrative of circumstances giving rise to shareholder disapproval of pay programs, corporate boards and management should be able to readily identify the sources of shareholder concern without extensive investigation or analysis.

Compensation Committee Standards

The SEC is directed to issue rules no later than 360 days after enactment of the Dodd-Frank Act to require national securities exchanges and national securities associations to **prohibit** the listing of any company (subject to certain limited exceptions) that does not comply with compensation committee independence standards to be promulgated by the SEC. Due to the lengthy time during which the SEC may issue these standards, independence standards may not be effective for the 2011 proxy season for calendar year-end companies.

- **Independent Compensation Committee Members.** A listed company must meet the following independent standards applicable to its compensation committees:
 - Each member of the company's compensation committee must be "independent." Rules to be issued by the SEC will require each national securities exchange and national securities association to determine the definition of "independent" applicable to their respective members, taking into account relevant factors including:
 - The source of compensation of a member of the board of directors, including any consulting, advisory or other compensatory fee paid by the issuer to such member of the board of directors; and
 - Whether a member of the board of directors of a company is affiliated with the company, subsidiary of the company or an affiliate of the company.
- **Selection of Independent Adviser.** The compensation committee may only select a compensation consultant, legal counsel or other adviser ("Adviser") after taking into account certain SEC identified independence factors. The SEC is directed to issue rules setting forth independence factors which are to be "competitively neutral" but must include the following:
 - The rendering of non-executive compensation services to the company by the Adviser;
 - The amount of fees received from the company by the Adviser, as a percentage of the Adviser's total revenue;
 - The policies and procedures of the Adviser that are designed to prevent conflicts of interest;
 - Any business or personal relationship of the Adviser with a member of the compensation committee; and

– Any stock of the company owned by the Adviser.

- **Right to Retain Advisers.** The compensation committee must have the authority, in its sole discretion, to retain Advisers. In addition, the compensation committee must have the authority to compensate and oversee the work of Advisers. *However, the legislation explicitly provides that compensation committees are not required to implement or act consistently with the advice or recommendations of any retained Adviser.* A public company must provide for the appropriate funding, as determined by the compensation committee, for payment of reasonable compensation of any retained Adviser. The SEC is directed to issue rules requiring companies to make certain proxy disclosures regarding any retained compensation consultant (see discussion below under Proxy Disclosures). The SEC is required to submit a report to Congress within 2 years of the enactment of the Dodd-Frank Act reviewing the use of compensation consultants and the effects of such use.
- **Exemption from Compensation Committee Standards.** The SEC may issue rules that permit a national securities exchange or national securities association to exempt a category of companies from the compensation committee standards, as they determine appropriate. In making such determination, the national securities exchange or the national securities association must take into account the potential impact of the requirements on smaller reporting companies.

The compensation committee standards, to an extent, codify existing practices at many public companies and national security exchanges. The requirement that compensation committees be composed of “independent” members and be permitted to retain, oversee and compensate advisers is already reflected the New York Stock Exchange listing requirements. Unlike the NYSE, Nasdaq does not require a listed company to maintain a compensation committee but does require the determination of officer pay be made either by the company’s independent directors or a compensation committee composed of independent directors. In addition, the Nasdaq listing requirements do not mandate that boards have the ability to retain, oversee and compensate advisers, other than the audit committee. However, the boards of many Nasdaq companies already include compensation committees that have the authority to retain advisers.

Despite the existence of board member independence standards at the major securities exchanges, the SEC could issue rules that define independence in a more restrictive manner, perhaps akin to the fairly restrictive independence standards applicable to audit committee members.

The new standards also require that compensation committees may only retain advisers after taking into account six “independence” factors and any other factors to be promulgated by the SEC. For the most part, evaluating the six enumerated factors should require minimal due diligence to be performed by a compensation committee. Information regarding each factor should be easily obtained from the adviser. However, the SEC will need to clarify if the stock ownership factor is limited to stock of the company held by the individual employee or employees of the firm rendering services to the compensation committee or includes all employees of the firm. The latter case would prove particularly onerous, especially for large multi-service firms.

Proxy Disclosures

The SEC is directed to write rules to require public companies to disclose in their annual proxy statement the following matters (unless otherwise noted, the SEC is under no deadline as to when these rules must be issued):

- **Disclosure of Pay versus Performance.** A public company must disclose the relationship between executive compensation actually paid and the financial performance of the company, taking into account any change in the value of shares of stock and dividends of the company and any distributions. This disclosure may be made through a graphic representation.

The exact scope of this pay versus performance disclosure is unclear. The disclosure does not indicate whether it is applicable solely to CEOs or to all named executive officers. Further, the rule does not disclose the financial performance metrics against which to compare executive pay, the manner in which changes in share value should be taken into account, the time period of the comparison or the definition of the term “actually paid.” These open issues will need to be dealt with through future rulemaking by the SEC.

- **Disclosure of Ratio of CEO Pay to Median Pay.** A public company must disclose the following employee pay information:
 - The median annual “total compensation” of all employees of the company, except the chief executive officer;
 - The annual “total compensation” of the chief executive officer; and
 - The ratio of the median annual total compensation of all employees to the total compensation of the chief executive officer.

Total compensation is determined in accordance with the proxy disclosure rules for determining total compensation for a named executive officer.

Regulations will need to clarify a number of aspects of this disclosure including the treatment of part-time employees, seasonal employees and employees who are hired or terminate employment during the fiscal year and the method for converting into U.S. dollars compensation paid in foreign currencies, among others. As a practical matter, an organization with a large workforce covered under different payroll systems may find it particularly burdensome determining the median annual total compensation for its entire workforce, especially using the current SEC approach to the determination of total compensation. Disclosing the ratio of CEO pay to median employee pay could be a further source of irritation and misunderstanding for many public companies given the significant differential between CEO pay and pay for the broader employee population. Moreover, extremely high ratios will undoubtedly provide fodder for those decrying CEO pay levels, particularly for outliers in a specific industry.

- **Disclosure of Hedging by Employees and Directors/Disclosure of Recoupment Policy.** A public company must disclose whether *any employee* or member of its board of directors, or any designee of such employee or board 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:
 - Granted to the employee or member of the board as compensation; or
 - Held, directly or indirectly, by the employee or member of the board.

In addition, a public company must disclose its policy for recouping erroneously awarded compensation (see discussion below regarding Mandatory Recoupment (Clawback) Provision).

*Under current rules, a public company is required to disclose hedging and recoupment policies if such policy or policies are **material** to an understanding of the company’s compensation programs. Subject to SEC rulemaking to the contrary, the new rule eliminates the materiality threshold for such disclosures and mandates the disclosure of hedging policies and recoupment policies. The new rule will not cause a change in reporting practice for the many public companies that already disclose their hedging and recoupment policies.*

- **Disclosure of Golden Parachutes.** In any proxy or consent solicitation materials which seek shareholder approval of an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all the assets of a public company (“Corporate Transaction”), the person making such solicitation must disclose the following matters:

- Any agreements or understandings that such person has with any named executive officers of such company concerning any type of compensation (whether present, deferred or contingent) that is based on or otherwise relates to the Corporate Transaction involving the company; and
- The aggregate total of all such compensation that may (and the conditions upon which it may) be paid or become payable to or on behalf of such executive officers.

This new disclosure requirement is separate from the shareholder vote requirement on golden parachute arrangements. The disclosure of golden parachute arrangements must be made in proxy or consent solicitation materials seeking shareholder approval of a Corporate Transaction irrespective of whether such arrangements are subject to a shareholder vote.

*Under current rules, solicitation materials must make certain disclosures regarding executive compensation. We anticipate the SEC will issue rules that will require **greater detail** around severance and change in control benefits than is required under the current rules.*

- **Disclosure Regarding Retained Compensation Consultant.** A public company must disclose whether its compensation committee retained or obtained the advice of a compensation consultant and whether 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. This disclosure requirement will not be in effect for the 2011 proxy season for calendar year-end companies. The disclosure must in proxies for annual shareholder meeting occurring on or after the 1-year anniversary of the enactment of the Dodd-Frank Act.

Existing rules already require public companies to disclose the identity of any retained compensation consultant. What is new under the Dodd-Frank Act is the requirement companies disclose the existence of any conflict raised by the work of the compensation consultant and the resolution of the conflict. Not specifically addressed is the manner in which companies determine if a conflict has arisen. Presumably, companies may determine if a conflict has arisen based on the independence factors enumerated in the Dodd-Frank Act and any other factors promulgated through SEC rulemaking. We anticipate companies will make every effort to avoid circumstances giving rise to a reportable conflict.

- **Disclosure of Chairman and CEO Structure.** A public company must disclose whether CEO and board chair roles are combined or separated and the rationale for separating or combining these roles.

Existing disclosure rules already require public companies to disclose whether CEO and board chair roles are combined or separated and the rationale for separating or combining these roles. Unless the SEC issues rules requiring additional disclosure around the chairman/CEO roles, the new rule does not expand upon the existing disclosure rules.

Proxy Access

The SEC is authorized but not required to write rules granting shareholders access to corporate proxy statements for purposes of nominating directors.

*Perhaps one of the most controversial aspects of the Dodd-Frank Act is proxy access. Many business organizations and associations have actively opposed the adoption of proxy access. The general complaint against proxy access is that it will not enhance corporate governance but will create undue administrative burdens on public companies, particularly small and mid-size companies. Further, many have questioned the SEC's authority to issue proxy access rules absent enabling legislation. The Dodd-Frank Act now provides the SEC with that authority. **We anticipate the SEC will act quickly to issue final proxy access rules.***

Mandatory Recoupment (Clawback) Provision

The SEC is directed to issue rules to require national securities exchanges and national securities associations to **prohibit** the listing of any company that does not comply with the following requirements for recoupment of erroneous incentive awards:

- In the event that a public company is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws, the company must recover any “excess” incentive-based compensation (including stock options awarded as compensation) paid to any current or former executive officers during the 3-year period preceding the date of such restatement. Excess incentive-based compensation is equal to the amount by which incentive compensation previously paid to the executive officer exceeds what would have been paid to the executive officer under the restated financial statements.
- The disclosure of the recoupment policy.

The prevalence of recoupment policies among major public companies continues to increase, although few policies mandate recoupment as is required under the Dodd-Frank Act. The mandatory recoupment policy appears to apply, at a minimum, to all named executive officers (future SEC rulemaking will need to clarify this point) and does not require misconduct in contrast to the recoupment provisions under Sarbanes-Oxley which is limited to a public company’s CEO and CFO and requires misconduct.

Regulations will need to clarify the method for determining “excess” incentive-based compensation, particularly as it relates to stock option awards and other equity-based awards. We expect most organizations will need to review existing clawback provisions, once the additional SEC guidance is developed.

Ban on Non-Directed Broker Votes

Unless a broker receives specific voting instructions from the beneficial owner of shares held by the broker, the broker is prohibited from voting such shares with respect to the election of board members, executive compensation or any other significant matters as determined by the SEC.

The ban on brokers voting non-directed shares on executive compensation matters presumably covers voting on say on pay proposals. The blanket ban on non-directed broker voting will directly impact voting results; generally to the detriment of management (typically, broker votes support management’s position).

Financial Institution Pay Regulations

The Dodd-Frank Act includes certain disclosure and pay prohibition rules applicable solely to “covered financial institutions.”

- **Disclosure of Incentive Compensation Arrangements.** Federal bank regulators are directed to issue rules no later than 9 months after enactment of the Dodd-Frank Act that require covered financial institutions to disclose to their appropriate regulator the structure of all incentive-based compensation arrangements. This disclosure must be sufficient to permit regulators to determine if a covered financial institution’s incentive compensation arrangements:
 - Provides an executive officer, employee, director or principal shareholder of the covered financial institution with “excessive” compensation, fees or benefits; or
 - Could lead to material financial loss to the covered financial institution.

The disclosure rule will not require covered financial institutions to report actual compensation of a particular individual.

- **Prohibition on Certain Incentive Compensation Arrangements.** Federal bank regulators are directed to issue rules no later than 9 months after the enactment of the Dodd-Frank Act that prohibit any types of incentive-based payment arrangement, or any feature of any such arrangement, that the regulators determine encourages inappropriate risks by covered financial institutions:
 - By providing an executive officer, employee, director or principal shareholder of the covered financial institution with “excessive” compensation, fees or benefits; or
 - That could lead to material financial loss to the covered financial institution.
- **Definition of “Covered Financial Institution.”** Covered financial institution includes depository institutions as defined in section 3 of the Federal Deposit Insurance Act; broker-dealers registered under section 15 of the Securities Exchange Act; credit unions described in section 19(b)(1)(A)(iv) of the Federal Reserve Act; investment advisors as defined in section 202(a)(11) of the Investment Advisers Act; Federal National Mortgage Association; Federal Home Loan Mortgage Corporation and any other financial institution federal bank regulators determine should be treated as a covered financial institution. However, financial institutions with assets of less than \$1 billion are exempt from the definition of covered financial institution and, therefore, are not subject to the foregoing disclosure and prohibition on “excessive” pay rules.
- **Compensation Standards.** Any standards for compensation developed by regulators with respect to the foregoing disclosure and prohibition rules must be comparable to the standards established under section of the Federal Deposit Insurance Act for insured depository institutions and must take into consideration the compensation standards described in section 39(c) of the Federal Deposit Insurance Act.

The Federal Reserve (joined by a number of other federal bank regulators) has already issued final comprehensive rules on financial institutions’ pay practices that are largely consistent with the foregoing provisions of the Dodd-Frank Act. However, additional rulemaking may be required for the Federal Reserve’s pay rules to fully comply with the Dodd-Frank Act.

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The **Client Update** is prepared by Meridian Compensation Partners’ Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.

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