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Executive Compensation

Pay Policy Is Part of Financial Reform Bill Approved by House-Senate Conferees

The Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173) approved by House-Senate conferees June 25 contains in Title IX reforms giving shareholders the right to vote on the compensation of executives and mandates Securities and Exchange Commission action on standards of independence of public company compensation committees and their advisers.

The requirements generally would apply to any publicly traded company, with additional requirements applicable to financial institutions.

Although it ''wasn't any surprise'' that the final version contains a say-on-pay provision, Ted Allen, director of publications at ISS Governance Institute, told BNA June 28 that it was a surprise that the option to hold a vote every one, two, or three years was accepted by the full conference committee. Inclusion of the golden parachute provision was another surprise, Allen said, since initially the Senate had opposed it.

Allen said that from ISS's standpoint, it will be interesting to see investor reaction to the vote frequency provision. A ''fair number'' of companies may seek a three-year cycle, Allen said, but it is possible that larger companies, in keeping with best practices, will choose an annual vote.

Allen expects at least a tenfold increase in the workload for companies, institutional investors, and proxy advisers in 2011, because of say-on-pay and say-on-pay frequency voting.

Specifics of the Dodd-Frank Bill. **Say on Pay**—Section 951(a). At least once every three years, shareholders will vote to approve the compensation of executives as disclosed in the company's proxy. In addition, at least once every six years, shareholders will vote to determine whether say-on-pay votes will occur every one, two, or three years. This section will take effect six months after enactment of the legislation.

Compensation consultant Edward A. Hauder of Exequity LLP, Libertyville, Ill., told BNA June 28 that an interesting aspect of the say-on-pay provisions is that under Section 951 shareholder votes ''will not be binding on a company or its board of directors,'' and ''while a company needs to put the frequency of the say-on-pay vote to a separate shareholder vote at least once every six years, it will not be bound by the say-on-pay vote frequency endorsed by its shareholders.''

Hauder said, ''Companies could decide for business reasons to hold the vote on a frequency different from what shareholder endorse. As a practical matter, companies will not want to ignore shareholders' wishes and become a target of shareholder activism, Hauder said. Therefore, he expects ''most companies will abide by the wishes of their shareholders when it comes to the frequency of the say on pay vote.''

On the overall effect of the provision, Hauder said, ''Allowing for management say-on-pay votes less frequently than annually should lessen worries about proxy advisory firms' influence growing dramatically as a result.''

However, Hauder also noted that if annual votes become the majority practice, ''the influence of such advisers likely will grow, which would virtually guarantee that say-on-pay becomes another check-the-box compliance requirement and ends up falling significantly short of its proponents' expectations.''

Golden Parachutes—Section 951(b). A separate vote on golden parachutes is required when there is an acquisition, merger, consolidation, or proposed sale of the company. The disclosure of any compensation that may be paid to a named executive officer is to be made in ''clear and simple form.''

Investment Managers Disclosure—Section 951(d). This section requires disclosure of votes of institutional investment managers subject to Section 13(f) of the 1934 Exchange Act, unless their votes are otherwise reported.

The SEC has the authority to exempt small issuers from Section 951(a) or (b).

Compensation Committee Independence—Section 952(a). Compensation committees are to be independent, as determined in rules to be issued by Section

Adviser Independence—Section 952(b). Compensation committees are to select only independent advisers. SEC must identify factors that affect the independence of compensation consultants, legal counsel, and other compensation committee advisers.

Speaking to BNA June 28 of the effect of requiring compensation committees, after taking into consideration certain factors identified by SEC, to select only independent advisers, including legal counsel, Mark Poerio, a partner with Paul Hastings Janofsky & Walker, Washington, D.C., sees the legislation as having a significant impact because it intensifies the escalating governance—and accountability—pressures under which compensation committees are operating.

It gives ''a further push to utilizing independent consultants and legal advisers,'' he said, adding that the bill also mandates separate funding to engage independent legal counsel. By requiring SEC to identify factors that affect the independence of consultants, the bill will ''put a premium on carefully weighing and documenting the independence'' of legal counsel and other consultants, he said.

Poerio said SEC's emphasis on disclosure in its 2009 amendments (239 PBD, 12/17/09;36 BPR 2904, 12/29/09) pushed compensation committees to ask questions about the independence of advisers in order to assure that the committees receive objective advice. Even in cases where there seems to be no conflict, compensation committees may feel the safest course is to get independent advice, he said.

Subsections (c) and (d) of Section 952 cover giving compensation committees the authority to fund and retain independent compensation consultants, legal counsel, or other advisers.

Executive Pay Disclosure and Ratios—Section 953(a). This section requires proxy statement disclosure of the relationship between executive compensation actually paid and the financial performance of the issuer. The bill allows for graphic representation of the required disclosure.

In subsection (b), the bill requires disclosure of the median of the annual total compensation of all employees except the CEO, the annual total compensation of the CEO, and the ratio of the amount of the median of the annual total compensation of all employees to the amount of annual total compensation of the CEO.

Median Pay and Ratios. Commenting on this requirement, Hauder said that ''additional disclosures regarding executive compensation, specifically those involving the median of annual total compensation of all employees (excluding the CEO) and the total compensation of the CEO, along with the ratio of these amounts, is somewhat meaningless and doesn't give investors any significantly helpful information.'' The provision ''will require companies (at least those with a large employee base) to do a significant amount of work (and incur related expenses) to determine the total compensation for every employee so that they can then determine the median,'' Hauder said.

''The ratio isn't used today by any company that I know,'' Hauder said. He commented on potential problems with Section 953, including possible ''manipulation by outsourcing low-paying jobs in order to increase the median employee total compensation amount. Even without such manipulation, the ratio really doesn't say much about executive compensation or a company's pay structure, or even give shareholders an effective means of comparing compensation among companies,'' he said

A better approach, Hauder said, ''might have been to look separately at the compensation spent for employees and for executives (or just the CEO) as a percent of income or revenue to give a more meaningful point of reference to shareholders.''

Other Provisions. **Clawbacks**—Section 954 directs SEC to prohibit listing on national securities exchanges issuers that do not have compensation recovery policies. The section requires issuers to disclose clawback policies for incentive compensation that is based on financial information required to be reported under the securities laws. In the event of a financial restatement, the issuer is required to recover compensation from any current or former executive officer during the three-year period preceding the restatement. In contrast, under the Sarbanes-Oxley Act of 2002, clawback policies apply only to the chief executive officer and the chief financial officer.

Hedging Policies—Section 955 requires each issuer to disclose whether any employee or board member is permitted to hedge—attempt to offset losses—that may affect the value of the employee's or board member's equity awards.

Financial Institutions. Section 956 of Title IX also provides enhanced disclosure and reporting of compensation arrangements at covered financial institutions; prohibits certain risky incentive-compensation arrangements, as determined by the financial institutions' regulators; and directs the federal regulators to develop standards for compliance.

The final section of Title IX (Section 957) eliminates broker discretionary voting for the election of directors, except for companies registered under the 1940 Investment Company Act, similar to New York Stock Exchange Rule 452.

By Mary Hughes

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