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Recent Developments

Dodd-Frank Bill: Some Executive Compensation Action Items

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Washington's focus on changing the rules regarding executive compensation continues with the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act. Set forth below is a discussion of certain executive compensation provisions of the Act and some recommended action items.

Say-on-Pay. The Act requires that companies include in their annual proxy statement a non-binding resolution seeking shareholder approval of named executive officer compensation at shareholder meetings at least once every three years, and mandates a separate vote to determine how often the say-on-pay vote will be held (every one, two or three years), with such separate vote to be held at least once every six years. The frequency vote represents a welcome departure from earlier drafts of the bill, which required an annual say-on-pay vote. As discussed in our memo of September 30, 2009, triennial say-on-pay votes more closely align say-on-pay with the goal of avoiding short-termism in corporate governance and executive pay arrangements than do annual say-on-pay votes. We therefore recommend that most companies seek to implement a triennial approach. Targeted shareholder outreach, shareholder surveys regarding executive compensation and effective use of the compensation disclosure and analysis section of the proxy can be part of the arsenal of effective shareholder communication in connection with the say-on-pay vote and the frequency vote. Companies should be cognizant of (although not unduly deferential to) voting policies of institutional shareholders and proxy advisory services for say-on-pay, given that these groups may recommend withhold/against votes on the re-election of directors if concerns raised through say-on-pay votes are not adequately addressed.

Compensation Committee Adviser Independence. The Act provides that compensation committees may select a compensation consultant, legal counsel or other adviser only after taking into consideration competitively neutral independence factors determined by the SEC. These factors will include the nature of other services provided by the adviser, the amount of fees paid to the adviser, how much issuer stock the adviser holds and, notably, whether the adviser has a personal or business relationship with a member of the compensation committee. The adviser independence rules do not apply to controlled companies or foreign private issuers. We note that the Act does not require that advisers be independent, nor does the Act require that compensation committees hire outside advisers at all.

Compensation Committee Member Independence. The Act directs the SEC to adopt a rule instructing the securities exchanges to prohibit the listing of issuers that do not have independent compensation committees (except for controlled companies and foreign private issuers that disclose annually to shareholders why they do not have an independent compensation committee). The SEC must establish criteria for independence that will include a number of factors, such as the sources of any additional compensation paid to compensation committee members and whether any compensation committee members are affiliated with the company, its subsidiaries or affiliates. Companies will need to evaluate compensation committee members once the regulations for independence have been issued to determine if the members meet the independence standards, being mindful that such standards may differ from the requirements of Section 162(m) of the Internal Revenue Code, Section 16 of the Securities and Exchange Act and the current stock exchange rules. Private equity investors that have board representation at listed, non-controlled portfolio companies should pay particular attention

to whether their relationship to the portfolio company would disqualify their board representative from membership on the compensation committee.

Pay Disparity Disclosure. The Act directs the SEC to amend the proxy rules to require disclosure of the ratio of the median annual total compensation of a company's employees (excluding its chief executive officer) to the total annual compensation of its chief executive officer. It appears that this disclosure is required for all companies covered by the Securities Act of 1933 and the Securities Exchange Act of 1934, which includes, in addition to companies listed on a public exchange, companies with public debt and those that are not publicly traded (but does not include foreign private issuers). The determination of the median annual total compensation of a company's employees, which is generally based on the principles used for the summary compensation table, will necessitate the collection of substantial compensation data. For most companies, this project will be a significant undertaking. Systems specialists and payroll managers should begin coordinating with legal advisors to determine the realm of the possible. We are hopeful that the SEC will provide relief for some of the most administratively burdensome challenges of the new rule (e.g., application of the rule to non-U.S. employees, employees of non-wholly-owned subsidiaries). A practical interpretation of the statute would avoid significant administrative cost.

Pay vs. Performance. The Act directs the SEC to adopt rules requiring companies to include disclosure (graphic or otherwise) in annual proxy meeting materials showing the relationship between executive compensation and corporate financial performance. The statute does not specify in detail the method of presentation or the scope of the disclosure. Companies should monitor marketplace and SEC developments with respect to approaches to this disclosure.

Clawback. The Act requires that the SEC promulgate rules requiring listed companies to adopt policies that (i) provide for disclosure of a company's policy on incentive-based compensation that is based on financial information required to be reported under securities law, and (ii) mandate clawbacks of compensation that was paid to a current or former executive officer during the three-year period preceding the date on which the company is required to prepare an accounting restatement as a result of material non-compliance with the securities laws, if the compensation is determined to have been based on erroneous data. The SEC is further required to direct the securities exchanges to prohibit the listing of companies which do not comply with those rules. Companies (possibly including foreign private issuers) should review their existing clawback policies in light of the Act to ensure that the policies are sufficiently broad to cover the necessary executives, time period and acts. We anticipate that many companies will need to amend their policies to take into account the requirements of the Act. Companies also must determine how to effectively apply and enforce their clawback policy once adopted or amended.

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