

DODD-FRANK PROVISIONS ADDRESS EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). Although much of the focus on the Dodd-Frank Act has been placed on its provisions relating to consumer protection and the regulation of financial institutions, the statute also contains a number of key provisions relating to the disclosure of executive compensation and corporate governance.

Executive Compensation Disclosure

Under the Dodd-Frank Act, the SEC is required to expand its disclosure requirements for proxy statements as follows:

- Pay Versus Performance. The annual compensation disclosure will be required to include information illustrating the relationship between compensation paid to the issuer’s named executive officers and the financial performance of the issuer, taking into account any share price changes and dividends and distributions.
- Internal Pay Equity. In all proxy statements, companies will be required to disclose the median total annual compensation of all employees other than the chief executive officer, the total annual compensation of the chief executive officer and the ratio of those two amounts.
- Hedging by Employees and Directors. Companies will be required to disclose in their annual proxy statements whether employees or directors are permitted to purchase financial instruments designed to hedge any decrease in the market value of equity securities they hold.
- Chairman and CEO. Companies will also be required to discuss in their annual proxy statements why they have, or have not, separated the positions of chairman of the board and chief executive officer. Note that, in December 2009, the SEC issued final regulations requiring each issuer to “briefly describe the leadership structure of [its] board,” including whether the same individual serves as both the issuer’s chairman and chief executive officer. It is not clear whether this disclosure requirement imposed by the Dodd-Frank Act will result in an expansion of the existing SEC disclosure requirement.

The Dodd-Frank Act also directs federal regulators to issue regulations requiring disclosure by “covered financial institutions” of all incentive-based compensation arrangements they offer, sufficient to determine whether the compensation structure (i) provides executive officers, employees, directors or principal shareholders with excessive compensation, fees or benefits, or (ii) could lead to material financial loss to the covered financial institution. In addition, federal

regulators must issue regulations that prohibit any type of incentive-based payment arrangement that is determined to encourage inappropriate risk-taking by covered financial institutions. For purposes of the Dodd-Frank Act, “covered financial institutions” include (i) depository institutions or depository holding companies, (ii) registered broker-dealers, (iii) credit unions, (iv) investment advisers, (v) the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation, and (vi) any other financial institutions that federal regulators determine should be included. Covered financial institutions with assets of less than \$1 billion will be exempt from these regulations.

Corporate Governance

- Say on Pay Vote. Beginning six months following the enactment of the Dodd-Frank Act (*i.e.*, beginning in the 2011 proxy season), an issuer’s first proxy statement that requires compensation disclosure must also include a resolution for a non-binding shareholder vote with respect to the compensation of the named executive officers. In addition, that first proxy statement must include a resolution for a non-binding vote on whether the non-binding “say on pay” vote will occur every one, two or three years. Subsequently, the “say on pay” vote must be presented at least every three years, and the vote on the frequency of the “say on pay” vote must be presented at least every six years.
- Golden Parachute Compensation. In any proxy statement for a shareholder meeting occurring at least six months following enactment of the Dodd-Frank Act, at which shareholders are asked to approve an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all assets, issuers must include (i) a clear and simple disclosure of any agreements or understandings with named executive officers that provide for compensation based on or relating to the transaction, as well as the total amount of such compensation that may become payable to the named executive officers, and (ii) a non-binding shareholder vote to approve such agreements, unless the agreements have previously been subject to a “say on pay” vote.
- Broker Voting. The statute requires national securities exchanges to prohibit their members from voting on an election of directors (other than in the case of uncontested elections at registered investment companies), executive compensation or any other significant matter (as determined by the SEC) unless the beneficial owner of the issuer’s shares has given the broker instructions on how to vote on such matters. This provision is very similar in substance to New York Stock Exchange Rule 452, in effect since the beginning of 2010, and therefore should not lead to further significant changes in broker voting.
- Proxy Access. The SEC is expressly permitted to adopt rules pursuant to which shareholders may nominate directors using an issuer’s proxy solicitation materials. This statutory authorization should dispel concerns that the SEC’s pending rulemaking on “proxy access” could be successfully challenged on the ground that it exceeds the SEC’s authority.

- Compensation Committee and Advisor Independence. Stock exchanges must enhance their requirements for determining compensation committee members' independence, taking into account fees paid to directors and their affiliates. All members of a compensation committee will be required to be independent, as determined under this new standard. Compensation committees will also be required to have the authority to engage compensation consultants and other advisors. In selecting such consultants and advisors, an issuer must take into consideration certain factors relating to independence, which factors will be determined by the SEC.
- Clawback of "Erroneously Awarded" Compensation. Stock exchanges are also required to adopt new rules providing for the clawback of incentive compensation paid within a three-year period to any of an issuer's current or former executive officers, where the issuer is required to prepare an accounting restatement due to material non-compliance with any financial reporting requirements. The amount of the clawback is equal to any excess consideration paid as a result of the material non-compliance (*i.e.*, amounts that would not have been paid had the financials been materially accurate at the outset). This provision is broader than a similar clawback introduced in the Sarbanes-Oxley Act because it does not require any misconduct and it targets executive officers beyond the chief executive officer and chief financial officer.

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If you have any questions concerning the foregoing or would like additional information, please contact Jeffrey S. Hochman (212-728-8592, jhochman@willkie.com), David E. Rubinsky (212-728-8635, drubinsky@willkie.com), Michael A. Schwartz (212-728-8267, mschwartz@willkie.com), Katie M. Calabrese (212-728-8865, kcalabrese@willkie.com), or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000, and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

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