

# *Financial Reform: How It Will Affect Your Company's Compensation Practices, Corporate Governance and Employee Benefit Plans*

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## **Executive Summary**

The recently passed Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act")<sup>1</sup> represents over a year of difficult compromise and overhauls the nation's financial regulatory system. Part of the sweeping reform includes significant changes to public companies that will affect their compensation disclosure and corporate governance practices as well as employee benefit plans governed by ERISA.<sup>2</sup> Although federal agencies, such as the SEC, will determine financial regulation's final form, the Act sets forth the general framework for reform. This advisory is not meant to be a comprehensive description of financial reform, but rather a description of those parts of the Act that will affect a broad spectrum of securities issuers. Topics covered include:

### **Executive Compensation Reforms**

- "Say on Pay"
- "Say on Golden Parachutes"
- Executive Compensation as Compared to Company Performance
- Median Employee Compensation as Compared to CEO Compensation
- Compensation Committee Advisors

- Mandatory Clawbacks

### **Corporate Governance Reforms**

- Proxy Access and Majority Voting
- Chairman and CEO Disclosures
- Limits on Broker Voting
- Employee and Director Hedging
- Permanent Exemption from SOX 404(b) Requirements for Smaller Issuers

### **Reforms Impacting ERISA Plans**

- Regulation of Swaps and Derivatives
- Stable Value Contracts
- Bureau of Consumer Financial Protection

## **Executive Compensation Reforms**

### **"Say on Pay"**

One of the Act's principal compensation reforms is that it mandates advisory votes on executive compensation. Under the Act, issuers must conduct periodic, non-binding shareholder votes on executive compensation packages. Informally deemed "Say on Pay,"<sup>3</sup> beginning next proxy

season, issuers must include in their proxy a separate resolution to determine how often the shareholder Say on Pay vote should occur.<sup>4</sup> Shareholders can voice their preference to hold a Say on Pay vote every year, every two years or every three years.<sup>5</sup> Shareholders will have the right to vote on the frequency of Say on Pay votes at least every six years. As non-binding and purely advisory votes,<sup>6</sup> issuers are required to conduct them, but are free to act on the results as they choose. However, although these votes are non-binding, shareholder disapproval can have a substantial impact on pay practices and the election of directors who serve on the compensation committee.

## **Practice Point**

- Recently, several companies instituting Say on Pay votes failed to obtain a majority vote for their proposed pay packages,<sup>7</sup> suggesting that Say on Pay will not operate as a rubber stamp for companies going forward. As a result, companies should consider increasing their dialogue with key stakeholders on pay issues and the frequency of votes so that stakeholders come to view the company's compensation policies as supporting its long term goals. Engaging stakeholders in a dialogue will also reduce reliance on proxy advisory services.
- Companies should review their proxy disclosures to ensure that their proxy is clearly communicating how their pay practices are compensating for performance.

## **“Say on Golden Parachutes”**

The Act also requires a nonbinding, advisory shareholder vote on so-called “Golden Parachute” packages in the event of a change in control. If an issuer is involved in a merger, combination, or sale of all or substantially all of the issuer's assets and the transaction requires shareholder approval, the issuer must circulate a separate resolution on compensation to be paid to executives in connection with the transaction. The resolution must detail any agreements or understandings relating to any type of compensation, including deferred or contingent compensation, that will be paid to the issuer's named executive officers

as a result of the transaction.<sup>8</sup> Like Say on Pay, the vote is purely advisory and the failure to win a majority of votes would not imply disapproval of the transaction, but only of the Golden Parachute compensation paid to the executives. If no vote is required of the shareholders to effectuate the transaction, then the issuer need not submit the Golden Parachute packages to an advisory vote.<sup>9</sup>

Issuers must comply with these rules at their first annual or other meeting six months after the Act's passage.<sup>10</sup> Thus, any issuer whose annual meeting or shareholder vote to approve a change of control transaction will occur approximately six months from now should be prepared to conduct these advisory votes. Notably, both Say on Pay and Golden Parachute votes only apply to the issuer's executives and not to persons who serve on an issuer's board of directors.

The SEC has the power to exempt issuers from the Say on Pay and Golden Parachute votes through order or rule.<sup>11</sup> Given that smaller reporting companies have less extensive disclosure requirements under Item 402 of Regulation S-K,<sup>12</sup> and given the Act's directive that the SEC consider whether these requirements would disproportionately burden small issuers, it is possible that the SEC will exempt smaller issuers at some later date.

## **Executive Compensation as Compared to Company Performance**

Central to the new legislation and certain to capture popular attention, are the new executive compensation disclosure requirements. Under the Act, the SEC must promulgate rules requiring issuers to disclose in their proxy statement the relationship between executive compensation, as disclosed under Item 402 of Regulation S-K, and the financial performance of the issuer.<sup>13</sup> While financial performance is not defined, the Act provides that it would include consideration of any changes in issuer stock price or dividends. The disclosure may include a graphic comparing issuer performance against executive compensation.<sup>14</sup>

## **Practice Point**

- When the SEC determines acceptable measures of financial performance, companies will need to

consider whether their current proxy disclosure concerning performance targets and thresholds that executives must meet in order to receive bonuses and incentive compensation adequately discusses the relationship between executive compensation and the company's financial performance. Companies that have discretionary compensation policies and therefore do not currently disclose specific performance targets and thresholds will need to include a discussion of compensation in relation to measures of financial performance.

## **Median Employee Compensation as Compared to CEO Compensation**

The Act will require issuers to disclose the ratio of the CEO's pay and the pay of the typical employee. Specifically, issuers must disclose the median of the total annual compensation of all employees of the issuer (excepting the CEO), the CEO's annual total compensation and the ratio between the two figures.<sup>15</sup> Total compensation is determined in accordance with the existing rules for calculating total compensation in the Summary Compensation Table under Item 402 of Regulation S-K,<sup>16</sup> which includes salary, bonus, stock and option awards and equity incentive plan compensation.

### **Practice Points**

- This provision will effectively compel companies to: (1) construct (but not disclose) their own Summary Compensation Table<sup>17</sup> that includes every employee, (2) determine the median among such employees and (3) compare that compensation figure against the CEO's compensation.
- Companies of all sizes should be prepared to articulate and potentially defend the ratio of the CEO's pay and the pay of the average employee.

## **Compensation Committee Advisors**

The SEC is required to prohibit the listing of issuers (with certain exceptions, such as controlled companies and limited partnerships) who do not have an independent compensation committee comprised solely of board members who are independent. In determining whether the members

are independent, the SEC is required to consider whether the member has received any consulting, advisory or other compensatory fee paid by the issuer and whether the member is affiliated with the issuer, a subsidiary of the issuer or an affiliate of the subsidiary of the issuer.

In addition, under the Act, compensation committees may only select compensation consultants, legal counsel or other advisors (a "Third Party Advisor") after considering a number of factors that may affect their independence.<sup>18</sup> Although the SEC is authorized to supplement the factors to be considered in determining a Third Party Advisor's independence, the main factors include:

- Services rendered by the Third Party Advisor to the issuer,
- Fees paid by the issuer to the Third Party Advisor as a percentage of the Third Party Advisor's total revenue,
- Issuer stock owned by the Third Party Advisor,
- Conflict of interest policies that the Third Party Advisor uses, and
- Personal relationships between a Third Party Advisor and the compensation committee.<sup>19</sup>

The Act requires issuers to disclose whether the compensation committee retained a compensation consultant and if so, whether such work raised any conflicts of interest.<sup>20</sup> Disclosure will be required in any proxy statement for an annual meeting of shareholders occurring on or after one year after the Act's passage. The Act also requires that the compensation committee determine the reasonable compensation to be paid to Third Party Advisors.<sup>21</sup>

### **Practice Points**

- Listed issuers may need to replace compensation committee members who are not independent board members and should consider whether their board has sufficient independent directors for the compensation committee and other standing or ad hoc committees requiring independent directors.

- Compensation committee members should re-evaluate the independence of their consultants and determine whether the consultant receives other compensation from the issuer, the nature of any other services the consultant provides to the issuer and the consultant's personal relationships with members of the committee.
- To inform the determination of whether relationships with consultants raise conflicts of interests, issuers may look to the SEC's new proxy disclosure rules, effective this proxy season. The recently effective rules were adopted to address conflict of interest concerns about whether executive pay recommendations were influenced by compensation consultants who are paid significant fees for other services beyond executive compensation services. Generally, the current rules require disclosure of compensation consultant fees if the compensation consultant engaged to provide advice on executive compensation also provided non-executive compensation consulting services of more than \$120,000 during the last fiscal year.
- In light of the Act's more expansive list of factors to be considered in determining whether a conflict exists, issuers should be prepared to disclose whether these factors could raise conflicts.
- The clawback must be triggered if the issuer is required to prepare an accounting restatement due to the material noncompliance with any financial reporting requirement under securities laws.
- Once the clawback is triggered, the issuer must recover incentive-based compensation (including stock options) from any current or former executive officer who received such compensation during the three-year period preceding the date on which the issuer must restate in excess of what would have been paid under the restatement.
- There is no misconduct requirement, which means that executives will be subject to the clawback regardless of whether their actions led to a restatement.

### **Practice Point**

- Companies that have already adopted clawback policies may need to revise their policies to comply with the SEC's new rules. Because the Act provides for clawbacks of previously awarded compensation, the SEC will need to consider whether the rules it creates will apply retroactively or prospectively. Retroactive application may create enforcement issues for companies that have agreements in place that do not currently provide for clawbacks.

### **Mandatory Clawbacks**

The Act amends the Securities Exchange Act of 1934 (the "Exchange Act") by prohibiting the listing of any issuer that does not implement a mandatory clawback, to be effective upon dates prescribed in forthcoming SEC rules.<sup>22</sup> The details of the clawback requirement are sparse, and the SEC must develop rules for eventual implementation.

The Act does provide, however, certain guidelines that must be a part of the SEC's rules.

- Issuers must develop and disclose their policy regarding payment of incentive-based compensation that is based on financial information required to be reported under securities laws.

### **Corporate Governance Reforms**

#### **Proxy Access and Majority Voting**

The debate over proxy access goes back almost a decade and its inclusion in the Act faced heavy opposition from executives and strong support from unions and institutional investors. The Act gives the SEC the authority to issue shareholder proxy access rules and the ability to exempt an issuer or class of issuers from such rules.<sup>23</sup> Although the SEC proposed rules in June 2009 allowing shareholders to access the issuer's proxy in order to nominate directors,<sup>24</sup> given the number of comments on the proposed proxy access rules and the SEC's authority to exempt issuers (which was not in the original House or Senate Acts), the final

rules could vary considerably from the proposed rules in substance and scope. SEC Chairman Mary Schapiro stated in a June 2010 speech that she was committed to propose final rules so that they would be in effect for the 2011 proxy season.<sup>25</sup>

The Act does not require companies to implement a majority vote standard for uncontested director elections, as had been included in some prior versions of the legislation. However, the number of companies adopting majority voting procedures has increased in recent years, particularly for large cap companies.<sup>26</sup> Generally, smaller companies are more likely to keep the plurality standard.

### **Chairman and CEO Disclosures**

The Act directs the SEC to issue rules requiring an issuer to disclose in its proxy statements the reasons why the issuer has chosen either the same person to serve as chairman of the board and CEO or different persons to serve as chairman of the board and CEO.<sup>27</sup> In other words, Congress is seeking additional disclosure as to *why* the issuer chose to invest the chairman and CEO positions upon one person or split them up among two individuals.

#### **Practice Point**

- Under the disclosure requirements that became effective earlier this year, companies must describe in their proxy statements why the leadership structure it has chosen is appropriate in light of the company's circumstances.<sup>28</sup> This includes whether and why the company has chosen to separate or combine the CEO and board chair positions.<sup>29</sup> Unlike current disclosure, the disclosure under the Act will focus on the individual rather than the overall leadership structure of the company. Companies should revisit their discussion of leadership structure to determine whether any additional disclosure may be needed.

### **Limits on Broker Voting**

The Act limits the situations in which brokers can vote shares of stock in the absence of instructions from stockholders. This provision amends the Exchange Act to require national securities

exchanges to issue rules prohibiting brokers from voting on (1) the election of directors, (2) executive compensation, (3) or any other significant matter as determined by the SEC without the shareholder's approval.<sup>30</sup>

#### **Practice Point**

- Since the beginning of this year, NYSE rules allow brokers to vote only on "routine" matters, which excludes election of directors, without instruction by the beneficial holder.<sup>31</sup> The current prohibition on discretionary voting for brokers applies to all brokers registered with the NYSE and thus affects all public companies whether or not the company is listed on the NYSE. The Act will extend these restrictions to executive compensation matters and any other matters that the SEC considers too important to be made without shareholder instruction. Companies have already implemented procedures to deal with decreases in retail votes as a result of the NYSE changes in broker discretionary voting by including a non-routine matter on the agenda to obtain a quorum for the meeting. However, issuers should redouble their efforts to communicate with key stakeholders, including institutional investors (who do vote), since they will continue to have greater influence over not only the election of directors but Say on Pay votes and other issues the SEC determines to exclude from broker discretionary votes.

### **Employee and Director Hedging**

The Act requires the SEC to formulate rules mandating issuers to disclose in their proxy statement whether any employee or member of the board is permitted to purchase financial instruments which hedge or offset the decrease in the issuer's equity securities that are either granted to the employee or board member as part of their compensation package or are held by the employee or board member.<sup>32</sup> This provision will not restrict employees or board members from hedging their risk on an issuer's securities, but will clarify whether employees or board members are unquestionably "long" the company's equity. The disclosure does not require that the issuer identify the individuals

who hedged their risk and by how much, but rather whether employees and board members are permitted to hedge.<sup>33</sup>

## **Permanent Exemption from Auditor Attestation Requirements for Smaller Issuers**

One of the more controversial provisions of the Sarbanes-Oxley Act of 2002 (“SOX”) was section 404(b)’s auditor attestation requirement.<sup>34</sup> This provision, which forced all issuers to have an auditor attest to the effectiveness of the company’s controls over financial reporting, was seen as unduly expensive for smaller issuers, particularly those with less than \$75 million in market cap. Although regulatory authorities regularly exempted smaller issuers from complying with 404(b)’s requirements,<sup>35</sup> the Act permanently exempts issuers who are not “large accelerated filers” or “accelerated filers” from complying with 404(b).<sup>36</sup> Furthermore, the SEC must also conduct a study to determine whether the cost of SOX 404(b) compliance is prohibitive for filers with a market cap between \$75 and \$250 million.<sup>37</sup>

## **Retirement Plan Reforms**

### **Regulation of Swaps and Derivatives**

The Act provides new rules for the operation of the over-the-counter derivatives market, including swaps.<sup>38</sup> Swaps can generally be thought of as arrangements that transfer the risk of fluctuations in the value of an asset, such as securities. Employee benefit plans, such as pension plans, often make use of swaps to hedge risk.

The Act regulates the conduct of “major swap participants.” The Act defines major swap participant broadly to include any person that is not a swap dealer that maintains a “substantial position” in certain major swap categories.<sup>39</sup> However, the Act excludes from this definition ERISA plans that use swaps for the primary purpose of hedging risks directly associated with the plans’ operations.<sup>40</sup> The Act contains a similar exclusion in the definition of “major security-based swap participant.”<sup>41</sup>

The Act also removed language contained in an earlier Senate bill that would have created a fiduciary relationship between swap dealers and

retirement plans that engage in swap transactions. The Act now provides that swap dealers have a fiduciary-like duty to ERISA plans only if they act as an advisor (which is not defined in the Act) to those plans. A swap dealer that does not act as an advisor would not be a fiduciary, but would be subject to several business conduct requirements, such as a duty to disclose material incentives or conflicts of interest and the duty to communicate in a fair and balanced manner.

### **Practice Point**

- The Act removed troubling language contained in earlier bills that could have made benefit plans with interests in swaps generally subject to regulation under the Act. However, employers with plans that make use of swaps may still want to pay attention to the new rules that will be created to govern swaps, because the new rules will undoubtedly change the way the swap market operates.

### **Stable Value Contracts**

Prior to the Act’s passage, it was unclear whether stable value contracts would be considered swaps. This was a concern for those retirement plan sponsors that make use of stable value funds in their 401(k) and other defined contribution plans. Under the Act, a stable value contract is essentially a contract, agreement or transaction, for the benefit of a retirement plan investment fund, issued by a bank, insurance company or other state or federally regulated financial institution, providing for a specified rate of return and assurances that principal amounts invested will be preserved.<sup>42</sup> Stable value contracts include stable value funds in participant-directed defined contribution plans.<sup>43</sup> The Act exempts stable value contracts from the definition of swaps, pending a joint study by the SEC and the Commodity Futures Trading Commission (“CFTC”) to determine whether stable value contracts fall within the definition of swaps.<sup>44</sup> The study must commence no later than 15 months after the enactment of the Act, and must include input from the Department of Labor, the Department of Treasury and the state entities that regulate the issuers of stable value contracts. If the SEC

and CFTC determine that stable value contracts are swaps, they must jointly decide whether an exemption for such contracts is appropriate and issue regulations to implement those findings.

## **Practice Point**

- Employers sponsoring retirement plans (such as participant-directed 401(k)s) that provide stable value funds as an investment option will want to pay attention to the results of the joint study. There is a potential that stable value funds may eventually be deemed to constitute swaps, thereby subjecting those funds to the Act's regulatory regime for swaps.

## **Bureau of Consumer Financial Protection**

The Act creates the Bureau of Consumer Financial Protection (the "Bureau") which is tasked to regulate the offering and provision of consumer financial products or services.<sup>45</sup> Prior to enactment

of the Act, there was concern that the Bureau would be able to regulate retirement plans. However, the Act does not give the Bureau broad power in this regard. Rather, it excludes "specified plans or arrangements," such as qualified retirement plans, from Bureau oversight.<sup>46</sup>

The Act does allow the Secretaries of Labor and Treasury to jointly issue a written request to the Bureau to implement appropriate consumer protection standards with respect to the provision of services to plans.<sup>47</sup> Furthermore, the Secretaries of Labor and Treasury may jointly grant or deny a Bureau request to implement recommended consumer protection with respect to services provided to plans. The Bureau can then implement rules that are based on such requests or grants from the Secretaries of Labor and Treasury. However, the Secretaries must provide the Bureau with proper information concerning the basis and scope of the rule that the Bureau will implement.

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## **Endnotes:**

1 H.R. 4173, 111th Cong. (2010).

2 Employee Retirement Income Security Act of 1974, as amended ("ERISA").

3 Note that the SEC instituted "Say on Pay" rules similar to the instant requirements for TARP recipients earlier this year. Shareholder Approval of Executive Compensation for TARP Recipients, Release No. 34-61335, Jan. 12, 2010 (*passim*).

4 Act § 951(a)(2).

5 *Id.*

6 *Id.* § 951(c).

7 *E.g.* Erin White, *Investors Start to Make Their Voices Heard on Pay*, WALL ST. J. May 10, 2010 (reporting that Motorola and Occidental Petroleum failed to obtain majority support for their pay packages). *See also* KeyCorp, Current Report (Form 8-K) at 3 (May 20, 2010) (showing number of advisory Votes Against exceeding Votes For regarding issuer's Executive Compensation Program); Cari Tuna, *Investors Say 'Yes' on Pay at TARP Firms*, WALL ST. J. Sept. 2, 2009 (noting that shareholders approved executive pay packages at every TARP company).

8 Act § 951(b)(1)-(2).

9 *See id.* § 951(b)(1) ("In any proxy or consent solicitation material . . . at which shareholders are asked to approve an acquisition . . .") (emphasis added).

10 *Id.* § 951(a)(3), (b)(1).

11 *Id.* § 951(e).

12 17 C.F.R. § 229.402(n)-(o).

13 Act § 953(a)(i).

14 *Id.*

15 *Id.* § 953(b)(1)(A)-(C).

16 *Id.* § 953(b)(2).

17 *See* 17 C.F.R. § 229.402(c).

18 Act § 952(b)(1).

19 *Id.* § 952(b)(2)(A)-(E).

20 *Id.* § 952(c)(2)(A)-(B).

21 *Id.* § 952(e).

22 *Id.* § 954.

23 *Id.* § 971(a)-(c).

24 *See* Jerry J. Burgdoerfer et al., *SEC Publishes Proposed Rules on Stockholder Proxy Access*, Jenner & Block LLP Client

- Advisory (June 16, 2009) available at [http://www.jenner.com/files/tbl\\_s20Publications/RelatedDocumentsPDFs1252/2521/SEC%20Publishes%20Proposed%20Rules%20on%20Stockholder%20Proxy%20Access\\_0609.pdf](http://www.jenner.com/files/tbl_s20Publications/RelatedDocumentsPDFs1252/2521/SEC%20Publishes%20Proposed%20Rules%20on%20Stockholder%20Proxy%20Access_0609.pdf).
- 25 Mary Schapiro, Chairman, Sec. & Exch. Comm'n, Remarks at the CEO Quarterly Meeting of the Business Roundtable (Jun. 8, 2010).
- 26 William K. Sjostrom Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459 *passim* (2007).
- 27 Act § 972.
- 28 See Jerry J. Burgdoerfer et al., *SEC Adopts New Proxy Disclosure Rules for 2010 Proxy Season*, Jenner & Block LLP Client Advisory (Dec. 18, 2009) available at [http://www.jenner.com/files/tbl\\_s20Publications/RelatedDocumentsPDFs1252/2752/New\\_Proxy\\_Disclosure\\_Rules\\_for\\_2010\\_Proxy\\_Season.pdf](http://www.jenner.com/files/tbl_s20Publications/RelatedDocumentsPDFs1252/2752/New_Proxy_Disclosure_Rules_for_2010_Proxy_Season.pdf).
- 29 *Id.* at 2.
- 30 Act § 957.
- 31 See NYSE Rule 452.
- 32 Act § 955.
- 33 *Id.* ("The Commission shall . . . require each issuer to disclose in any proxy . . . whether any employee or member of the board of directors of the issuer . . . is permitted to purchase financial instruments . . . .")
- 34 15 U.S.C. § 7262(b).
- 35 *E.g.*, Press Release, Sec. & Exchange Comm'n, SEC Approves One-Year Extension for Small Businesses from Auditor Attestation Requirement in Sarbanes-Oxley Act (June 20, 2008).
- 36 Act § 989G(a).
- 37 *Id.* § 989G(b).
- 38 See generally Title VII of the Act.
- 39 Act § 721(a)(16).
- 40 *Id.*
- 41 *Id.* § 761(a)(6).
- 42 *Id.* § 719(d)(2).
- 43 *Id.*
- 44 *Id.* § 719(d)(1)(C).
- 45 Title X of the Act.
- 46 Act § 1027(g).
- 47 *Id.*

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