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DODD-FRANK SUMMARY

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Initially proposed in December 2009, the Dodd-Frank Wall Street Reform and Consumer Protection Act became law on July 21, 2010. It is the most comprehensive and dramatic change to federal regulation of the financial services industry since the Great Depression.

The following is a summary of the Dodd-Frank Act (Dodd-Frank) as it relates to executive compensation and other significant corporate governance issues.

SAY-ON-PAY

Dodd-Frank requires a non-binding "Say-on-Pay" shareholder vote (SOP) to approve the compensation of the executives as disclosed in the proxy statement. A company must hold a SOP vote at least every three years. SOP is required at a company's first annual meeting following the 6-month anniversary of the date that Dodd-Frank is enacted, thus SOP will be mandatory for most companies in 2011.

Additionally, Dodd-Frank requires a separate shareholder vote (the "frequency vote") to determine whether the company's SOP vote should take place every one, two, or three years. While a company must hold the frequency vote in 2011, Dodd-Frank requires a company to hold a shareholder vote every six years to re-evaluate the vote frequency.

Dodd-Frank will further require that for any meeting where shareholders are being asked to approve an acquisition, merger, consolidation or sale, or other disposition of all or substantially all of the assets of a company (a change in control), a company hold a non-binding shareholder vote to approve merger related compensation ("golden parachute" SOP).

Lastly, SOP proposals under Dodd-Frank will now become non-routine items under NYSE Rule #452, which means the broker vote will not count for SOP proposals. Previously board supported SOP proposals had been routine items and benefitted from the broker discretionary vote.

❖ *While SOP has been a hot-button issue over the last few years, not all institutional investors have embraced the concept. As of early September 2010, many institutional investors have no formal SOP voting policy. Many institutions are in the process of formulating their SOP policies, though the majority are not expected to be available until late 2010 or early 2011. As companies begin their outreach programs and preparation for the 2011 proxy season they need to be mindful of this issue.*

❖ *Other institutions are likely to default to the recommendations of the proxy advisory firms such as ISS and Glass Lewis. It is important that companies understand the SOP policies of these firms and the impact of these firms' recommendations on the voting decisions of their shareholder base. Companies should watch for the 2011 policy updates (typically released in late 2010) of ISS and Glass Lewis.*

COMPENSATION COMMITTEE AND ADVISORS

Compensation Committee Independence

Under Dodd-Frank, compensation committees must be comprised entirely of independent directors. The definition of independence will be determined by the national exchanges, taking into effect:

- The sources of director compensation – whether via consulting, advisory, or any other fees received by the compensation committee member, and
- Whether the compensation committee member is affiliated with the company, a subsidiary of the company or an affiliate of any subsidiary.

- ❖ *For most companies, the impact of this provision should be minimal. For a company to have non-independent directors on the compensation committee is rare, primarily due to the fact that institutional shareholders and the proxy advisory firms have had (for a number of years) a stricter definition of independence than the exchanges*.

Consultants

Dodd-Frank requires that a compensation committee select a compensation consultant, legal counsel or other advisor *only after* taking into consideration independence factors identified by the SEC. Those independence factors must include:

- Whether the advisor's employer provides other services to the company,
- The amount of fees received by the advisor's employer (as a percentage of total revenue of the employer),
- Conflict of interest policies and procedures of the advisor's employer,
- Any relationship between the advisor and members of the compensation committee, and
- Any equity ownership that the advisor may have in the company.

Dodd-Frank further requires that a company provide adequate funding for the compensation committee to retain compensation consultants, legal counsel and other advisors.

In terms of related disclosure, Dodd-Frank stipulates that any proxy statement for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting) occurring on or after the 1-year anniversary of the date that Dodd-Frank is enacted will be required to disclose:

- Whether the compensation committee retained or obtained the advice of a compensation consultant, and
- Whether the consultant's services created any conflict of interest, and if so, the nature of the conflict of interest and how the conflict was addressed.

If a company fails to comply with these provisions within one year after Dodd-Frank is enacted, it will be prohibited from being publicly listed. For those that fail to comply, Dodd-Frank provides for a "reasonable opportunity to cure any defects" before their listings are banned.

Additional Executive Compensation Disclosures

Dodd-Frank will mandate SEC rulemaking to require disclosure of 1) executive compensation versus company performance and 2) a comparison of CEO compensation to the average employee's compensation (referred to as the "internal pay ratio" disclosure).

In the pay versus company performance disclosure, Dodd-Frank requires that the SEC require a company to disclose in its proxy the relationship between executive compensation actually paid and the company's financial performance, taking into account any change in the value of a company's shares and any dividends or distributions paid by the company.

- ❖ *The median pay for all employees could involve a lot work for companies with a large employee base. Also, additional guidelines will be needed with respect to certain employees (part-time or hourly for example).*

CLAWBACK PROVISION

Under Dodd-Frank, companies will only be able to list on a national exchange if they adopt certain clawback policies with respect to incentive-based compensation. Specifically, a company's clawback policy must provide that in the event a company is required to restate its financial statements because of material noncompliance with any financial reporting requirement under securities laws, the company will recover from *any current or former executive officer* who received incentive-based compensation (including stock options) during the 3-year period preceding the date in which the company is required to restate its financial statements, any amount in excess of the amounts that would have been paid to the executive officer under the accounting restatement.

- ❖ *In the wake of Sarbanes-Oxley, some companies had put clawbacks in place for senior executives. Dodd-Frank will require all companies to adopt clawbacks, and these provisions will reach deeper in the executive base.*

Disclosure Regarding Employee and Director Hedging

Dodd-Frank requires the SEC to issue rules requiring companies to disclose in their annual meeting proxy statement whether any employee or director is permitted:

- To purchase any financial instrument (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) that are designed to hedge or offset an decrease in the market value of company equity securities, and
- That is granted by the company as compensation to such employee or director or otherwise held directly or indirectly by such employee or director.

Chairman and CEO Structures

Dodd-Frank also requires the SEC to issue rules mandating that companies disclose in their annual meeting proxy statement the rationale behind its chairperson and CEO structure. Each company must disclose the reason it has either chosen the same person to serve both as chairperson and CEO or has decided to split the positions between two people.

❖ *An explanation of Board structure was required for the 2010 proxy season, so the impact of this provision should be minimal. A combined CEO/Chairperson is not uncommon in the United States; however, most companies with a combined role have opted to appoint a lead independent director.*

Compensation Disclosure Requirements for Covered Financial Institutions

Within nine months after Dodd-Frank is enacted, covered financial institutions will be subject to new rules and regulations to be issued by the appropriate federal regulator. The new regulations would prohibit covered financial institutions from having excessive incentive compensation arrangements that encourage risk or could lead to material financial losses. Also, publicly traded nonbank financial institutions supervised by the Federal Reserve and bank holding companies with at least $10 billion in assets must establish a risk committee comprised of board members.

Proxy Access

Dodd-Frank gives the SEC authority to adopt proxy access rules; and on August 25, 2010 the SEC approved the new rule that will become effective 60 days after publication in the Federal Register. Under this new rule, shareholders (or a group of shareholders) who hold 3 percent of a company’s outstanding shares and have held them continuously for 3 years may nominate the greater of 25 percent of the Board or one director, and have those nominees included in the company’s proxy material

Again:

- 3% of the outstanding,
- Held continuously for 3 years, allows for
- 1 nominee or 25% of the board.

Companies can use the no action process to exclude nominees if they believe a nominee or a nominating shareholder does not satisfy these requirements. The shareholder, or group, with the *largest* number of shares will have access to the proxy.

❖ *Labor unions and other governance activists have been pushing proxy access for a number of years. The holding period and ownership thresholds are higher than many activists had hoped for, but they view the new rules as a win for shareholder rights nonetheless.*

❖ *Labor unions and their affiliates are projected to be the most aggressive patrons of proxy access and use it as means to push through their own agenda. By reducing the barriers to gaining Board representation, unions and special interest groups may gain disproportionate influence at the expense of other investors.*

❖ *Some traditional institutional investors have stated intent to utilize proxy access should they feel their concerns have not been addressed by the Board of Directors.*

BROKER VOTING

Effective as of the date of Dodd-Frank’s enactment, unless instructions are provided by the beneficial owner, brokers cannot vote shares held in a trust on matters involving executive compensation, director elections, or “other significant matters” recognized by the SEC.

- *The broker vote was removed for director elections in 2010, so the main impact of this will be on SOP. Companies where retail holders make up a sizable portion of the total shareholder base will be impacted the most by this change.*

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