On June 30, 2010, and July 15, 2010, the House of Representatives and the Senate, respectively, passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. The bill was signed into law by President Obama on July 21, 2010. Below is a list of events that led to the bill’s enactment.

- **December 2009:** The House passed its version of a financial regulatory reform package, the Wall Street Reform and Corporate Protection Act of 2009
- **May 2010:** The Senate passed its version of a financial regulatory reform bill, the Restoring American Financial Stability Act of 2010
- **June 2010:** The Senate and House reconciled the two bills, creating the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Although the majority of the voluminous Dodd-Frank Act focuses on the regulation of financial institutions, there are also sections that address executive compensation and corporate governance provisions, which apply to a majority of U.S. publicly traded companies. (Smaller companies may be exempt from some provisions.) The Dodd-Frank Act may have a significant effect on how management and compensation committees design executive compensation programs and allow shareholders to provide input on executive compensation arrangements. The legislation also has implications for companies’ corporate governance policies, including committee structures and the amount of influence that shareholders may have in director elections.

Numerous provisions in the Dodd-Frank Act require rulemaking by the U.S. Securities and Exchange Commission (SEC). As a result, the SEC has expanded its normal public comment process. Specifically, the SEC has established e-mail boxes, organized by topics in the legislation, so the public can immediately provide its views before any official comment period opens. (The mailbox for executive compensation matters is accessible under “Title IX- Investor Protection and Improvements to the Regulation of Securities.”)

**Description of Executive Compensation and Corporate Governance Implications for U.S. Publicly Traded Companies**

A summary of the executive compensation and corporate governance provisions of the Dodd-Frank Act and Deloitte’s observations regarding the provisions are as follows:
Shareholder Approval of Executive Compensation

Shareholder Advisory Vote (Say-on-Pay) on Executive Compensation

The legislation requires companies to submit a nonbinding shareholder vote on compensation for named executive officers (NEOs) at least once every three years. Additionally, companies are required to submit a nonbinding shareholder vote to determine whether such advisory vote, or say-on-pay, will occur every one, two, or three years. This shareholder say-on-pay “frequency” vote must occur once every six years.

Say-on-Pay on Golden Parachutes

Companies are also required to submit a nonbinding vote to shareholders to approve agreements or understandings the company has with its NEOs regarding any type of compensation paid in connection with “an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all the assets of the company,” unless such agreements or understandings have been subject to a shareholder vote under the general say-on-pay provision.

Other Items

The legislation amends the Securities Exchange Act of 1934 to require the nonbinding say-on-pay votes. A company will be required to include a management say-on-pay on executive compensation proposal in its proxy statement or other shareholder solicitation material for any annual shareholder meeting that occurs on or after January 22, 2011—six months after the enactment of the Dodd-Frank Act.

Institutional investment managers are required to report, at least annually, how they voted on each say-on-pay proposal.

An advisory vote on executive compensation encourages transparency and accountability. It is already required in several markets outside the United States, including the United Kingdom, Australia, the Netherlands, and several Scandinavian countries.

Under the American Recovery and Reinvestment Act of 2009, financial institutions that received Troubled Asset Relief Program (TARP) funds are required to submit a nonbinding shareholder advisory vote on NEO compensation practices. However, a TARP say-on-pay vote is only required for the period the money is borrowed. The say-on-pay provision under the Dodd-Frank Act requires all U.S. publicly traded companies to submit a management say-on-pay proposal to shareholder vote. It is important to note that the shareholder vote is nonbinding and does not require companies to change their executive compensation program to the extent they receive a negative vote.

Companies may want to consider the steps outlined below to be prepare for the shareholder vote. While such steps should consider the SEC’s Regulation Fair Disclosure, they may afford companies the opportunity to better understand shareholder interests and views on its compensation programs.

1. Creating an internal working team of representatives from investor relations, legal, finance, and human resources to develop a dialogue with major shareholders about the company’s compensation programs.
2. Developing an understanding of major shareholders’ voting practices and guidelines to determine if any company practices are not supported by shareholders.
3. Preparing talking points to address shareholder issues throughout the year in order to anticipate shareholder concerns and to defend the company’s practices or explain the steps being taken to address the practice or issue.
4. Creating a forum (e.g., online, in person, etc.) between the company and shareholders to review and receive feedback on the key executive compensation policies and practices.
5. Performing a say-on-pay readiness assessment to identify institutional investors’ and shareholder activists’ potential areas of concern.
6. Prospectively, eliminating certain policies or practices that have become “lightening rod” issues.
7. Articulating the company’s pay program, rationale for design considerations, alignment of executives’ long-term interests with those of shareholders, and justification for using specific performance metrics and goals, along with how the pay program relates to the overall business strategy in the Compensation Discussion & Analysis (CD&A) section of the proxy.
8. Including key messages about the company’s compensation practices and corporate governance measures in the supporting statement for management’s say-on-pay proposal.
Since brokers are prohibited from voting shares without instructions, as further discussed herein, it will be important for companies to get as many “for” votes as possible.

Further, as has been somewhat of a trend by some proxy voting services, companies that fail to adequately address a majority or significant minority of “against” votes on say-on-pay may receive an increased number of “against” votes for compensation committee members in future director elections.

It is also likely that many companies may opt for a biennial or triennial vote on executive pay, as major changes to plans or other compensation-related items are often difficult to accomplish in a single year. Such changes often require a reasonable period to demonstrate their effectiveness. Large institutional shareholders may not have the appropriate time and resources to conduct a detailed review of every company’s compensation plans in their portfolios to determine how they should vote on the compensation programs for NEOs and, thus, they may support a biennial or triennial vote. On the other hand, activist shareholders and proxy advisory firms may support the annual vote model, as more frequent elections are likely to increase their influence over the proxy process.

The say-on-pay golden parachute vote shines a light on changes in compensation arrangements that occur shortly before a change-in-control transaction, as existing arrangements would have already been voted on as part of the general say-on-pay vote. This could make it more difficult for boards to make last-minute changes to such arrangements.

**Compensation Committee Independence**

**Description of the Legislation**

This provision requires U.S. publicly traded companies to have compensation committees that include only independent directors. This requirement resembles the audit committee independence requirements of the Sarbanes-Oxley Act of 2002 and is not drastically different from existing listing standards related to compensation committee independence. Under the SEC’s direction, the legislation allows for the securities exchange and association listings to define independence, but offers several considerations for evaluating independence, such as the nature of the director’s compensation, as well as any relationships between the director and the issuer.

Further, the legislation provides for compensation committees to be responsible for the appointment, compensation, and oversight of independent compensation consultants and other advisers (collectively, advisers). These advisers must meet the SEC’s standards for independence, which include considerations such as the adviser’s company’s affiliations with the issuer, any relationships between the adviser and any of the compensation committee members, and any direct financial relationship between the issuer and the adviser, including stock ownership. These requirements expand on the SEC’s December 2009 enhanced proxy disclosure rules, which require companies to disclose services provided by advisers and the associated fees.

By July 16, 2011, the SEC must issue rules directing the national securities exchanges and associations to prohibit the listing of companies not in compliance with these provisions.

Further, companies will be required to include enhanced disclosure in proxy statements identifying whether the compensation committee retained the advice of an adviser during the year and if any conflicts of interest arose from such a relationship. Such disclosure will be required by companies as of July 21, 2011.

Compensation committees have long been an integral part of the board governance process, so it is interesting to note the increasing attention that the compensation committee is receiving, especially related to independence issues. This reform could be attributed to stakeholder desire to ensure that directors making these decisions are objective and will take actions that are in accordance with their fiduciary duties to act in the best interests of the company. Further, the extent to which this provision will affect current practice or differ from current listing standards will rest with the exchanges’ definition of the term “independence”; the exchanges are provided with latitude and discretion in the formation of the standards, with suggestions provided by the legislation.

When implemented, this provision is likely to affect not only the compensation committee, but also the nominating committee, because it will be the nominating committee’s task to determine whether to change director qualification policies and search criteria to comply with the independence standards. This will require a clear and open communication channel between the nominating and compensation committees to help ensure that the compensation committees’ views are incorporated into the board’s director retention policies and procedures, as implemented by the nominating committee. Nominating committees, specifically, and boards, in general, should think proactively about the effects of this provision on existing structures and how they may need to change practices to comply with the new standards.
Further, a required advisory vote on executive compensation, combined with the requirements for fully independent compensation committees as defined by listing standards, may create a trend that, over time, could result in director candidates with human resources and compensation experience.

The legislation encourages compensation committees to retain independent advisers and compensation consultants to provide insights and expertise regarding matters presented to the committee for consideration, including the implementation of many of the Dodd-Frank Act’s executive compensation provisions. The legislation is quite clear, however, that compensation committees must continue to exercise their own judgment and cannot rely solely on the advice of external advisers.

**Additional Disclosure of Executive Compensation in the Annual Proxy Statement**

**Description of the Legislation**

The legislation requires the SEC to amend the proxy statement rules to require companies to disclose the following in their annual proxy statements or any solicitation materials for an annual shareholder meeting:

- Information regarding the relationship between financial performance, which includes changes in total shareholder return, and executive compensation actually paid.
- The dollar amount of median annual total compensation for all employees of the organization, excluding the chief executive officer (CEO), and annual compensation for the CEO, along with the ratio of CEO total compensation to the employee median total compensation.

The act did not specify the timeline for the SEC’s rulemaking related to this provision.

This requirement will need to be clarified by the SEC, as it is unclear if financial performance is strictly based on total shareholder return, or if it includes other financial performance metrics. It is also unclear what “actually paid” means. For example, actually paid could refer to W-2 information or it could be based on the same standards used to report compensation in the Summary Compensation Table of the proxy.

The relationship of pay and performance may be different depending on the type of performance metrics and how pay is defined. Thus, companies may want or need to provide a detailed discussion in the proxy statement, under the CD&A section, on the relationship between pay and performance.

Since internal pay ratios are difficult to compare across companies due to differences in workforce composition, organization structure, and the like, companies may consider providing additional data illustrating how the CEO’s compensation compares to different employee groups. Companies may also want to add a discussion to the CD&A that explains how the company has created internal pay equity among various groups of employees.

The internal pay ratio is to be based on the CEO’s pay compared to the median total compensation for all employees, exclusive of the CEO, which will require companies to calculate every employee's total compensation using the Summary Compensation Table reporting requirements for the proxy statement. For many companies, especially those that are global or decentralized, the calculation of total compensation for every employee could require a significant amount of time and effort.
Recovery of Erroneously Awarded Compensation

Description of the Legislation

This legislation directs the SEC to establish rules requiring companies to develop a policy mandating the recovery of “excess” incentive compensation paid to executive officers in the event of an accounting restatement due to material noncompliance with financial reporting requirements, regardless of whether the executive officer was involved in misconduct that led to the restatement. Incentive compensation includes items such as stock options, but does not appear to include retirement benefits. Further, the policy would apply to any current or former executive officer.

The “clawback” policy must require a company to recover the amount of incentive compensation received during the three years preceding the restatement date in excess of the amount that would have been paid had the proper earnings figure been reported.

The act did not specify the timeline for the SEC’s rulemaking related to this provision.

The existing proxy statement rules require disclosure of clawback provisions in the CD&A to the extent a company has them. To date, there are a number of large companies that have voluntarily adopted a clawback policy to ensure any excess amounts paid prior to a restatement of earnings are recouped from participants. The new clawback legislation is much broader than the majority of clawback policies voluntarily adopted by companies and those required by the Sarbanes-Oxley Act of 2002, which required clawbacks only for CEOs and CFOs, since it applies to all executive officers, not just those who were engaged in misconduct that resulted in a financial restatement.

“Executive officers” is not defined in the Dodd-Frank Act, therefore, further clarification is needed to determine if it applies to the NEOs or the Section 16 officers’ of a company. It is also not clear how excess stock option gains will be calculated. Presumably, this provision will apply only if the options vested based on the achievement of meeting certain financial results, rather than attempting to recapture an “excess gain” that was realized on exercise, due to inflated earnings. However, this is not certain at this point.

It is likely that most companies will need to modify their current clawback policies or adopt a new clawback policy to comply with the Dodd-Frank Act. It is expected that most companies will wait for the SEC guidance before doing so.

Disclosure Regarding Director and Employee Hedging

Description of the Legislation

The legislation calls for the SEC to issue rules requiring disclosure in the proxy materials of whether employees and directors are allowed to hedge the value of any equity securities granted to the director or employee or that are otherwise owned by the director or employee.

The act did not specify the timeline for the SEC’s rulemaking related to this provision.

This provision is important for investors and other stakeholders who are interested in understanding whether directors, executives, and other company employees are permitted to purchase financial instruments that serve to protect against downward changes in the company’s stock value. In some cases, executives and other parties own financial instruments whose values will likely change in the opposite direction of fluctuations in the company’s securities prices, so as to not change the individuals’ overall financial health. It is not clear whether the implementation of this disclosure requirement will cause modifications in company policy.

If this provision causes companies to forbid purchases of hedging instruments by directors and employees to counteract movement in the value of the company’s equity securities, it may cause companies to compensate these parties for loss of hedging abilities through other forms of compensation. Additionally, other methods may emerge for these parties to continue to avoid downsides in company stock prices.
**Incentive Plan Limitations to Minimize Risk (for Covered Financial Institutions)**

**Description of the Legislation**

The appropriate federal regulator (such as the Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve, and Comptroller of the Currency) is required to establish guidelines prohibiting incentive-based compensation that the regulators determine encourages inappropriate risks by covered institutions:

- By providing any executive officer, employee, director, or principal shareholder with “excessive” compensation, fees, or benefits, or
- That could lead to a material financial loss to the covered financial institution.

Additionally, financial institutions will be required to report to the federal regulator all incentive-based compensation arrangements offered to employees.

Financial institutions, as defined by the legislation, with less than $1 billion in assets will be exempt from this requirement.

The guidelines under the provision must be established by the appropriate authority by April 21, 2011, nine months after the enactment of this law.

Establishing a definition of “excessive” compensation, fees, and benefits will likely be difficult, as it is highly subjective and each company is unique.

On June 21, 2010, the Federal Reserve issued final guidance on “Sound Incentive Compensation Policies,” which requires banking organizations to regularly review and evaluate their incentive compensation arrangements for select groups of employees. In general, the provisions under this specific piece of the Dodd-Frank Act further support the Federal Reserve’s final guidance.

**Voting by Brokers**

**Description of the Legislation**

Effective immediately upon enactment, this provision allows the SEC to issue rules prohibiting brokers from voting shares for director elections, executive compensation, or other significant matters, as determined by the SEC, unless specific instructions are provided to the broker by the owner.

The act did not specify the timeline for the SEC’s rulemaking related to the determination of other significant matters, but allowed the SEC to create the rules immediately.

Prior to 2010, routine proxy voting matters included uncontested director elections, and brokers were allowed to vote on this issue for each share under their management, even if they did not receive voting instructions from the shareowner. This caused much debate in the investment community given that brokers tended to vote for and support management recommendations for director candidates. Accordingly, interested parties campaigned for an end to uninstructed voting by brokers in director elections in order to put this matter in the hands of actual shareowners. In response, effective January 1, 2010, the SEC changed rules relating to voting by brokers in director elections. The Dodd-Frank legislation expands on the SEC’s voting restrictions by further barring brokers from voting shares in executive compensation and other significant matter voting measures, without instruction from the owner.

Some question whether this provision will result in unintended consequences, such as decreased shareholder representation in director elections, executive compensation, and other voting matters — as many retail investors forego participation in such matters. Another possibility is that votes will not receive a quorum if shareowners do not vote their shares directly. For instance, if a company’s shareholder base is heavily retail (e.g., shareholders owning their shares through a broker), it may mean that companies would not receive many votes at all as shareholders forgo voting, and as brokers would be prohibited from casting votes on the owner’s behalf. Thus, some companies may not obtain a quorum for voting purposes, and votes require a quorum to stand. (Quorum rules are different for each company depending on bylaws.) Conversely, if shareholders of a company are largely institutional, then there may be more votes cast, disproportionately impacting retail voters.

Although brokers have been barred from voting uninstructed shares in director elections since January 2010, there was not a notable impact in the 2010 proxy season on director elections. It is difficult to predict, and there is debate regarding the effect that the expanded prohibition on uninstructed broker-voting may have on executive compensation and other significant voting matters.
**Proxy Access**

### Description of the Legislation

This provision allows for the SEC to issue requirements that, if met, permit shareholders to nominate directors to be included in the company’s proxy materials. The SEC is allowed to determine the applicable ownership thresholds (e.g., requirements of share ownership percentages to be able to gain access to the proxy to include a shareholder-nominated candidate). The SEC may also exempt smaller companies from proxy access rules if it chooses.

Under the SEC’s current proposed proxy access rule, shareholders seeking to nominate a director for inclusion in the proxy must have held a minimum percentage of the market value of the voting securities of the company (or net assets if an investment company) for at least one year. The percentage requirement is based on company size and corresponds with other thresholds in the securities laws. Shareholders can aggregate holdings to meet the following thresholds:

- 1 percent of voting securities if the company’s market cap is more than $700 million (large accelerated filer)
- 3 percent of voting securities if the company’s market cap is between $75 million and $700 million (accelerated filer)
- 5 percent of voting securities if the company’s market cap is under $75 million (non-accelerated filer).

The act permits the SEC to establish proxy access rules immediately. In a July 27, 2010, speech, SEC Chairman Mary Schapiro reiterated the Commission’s intent to finalize proxy access rules in time for the 2011 proxy season.

Access to nominate directors or put other matters to a vote in the company’s proxy materials is not a new concept, but rather one that has been sought by members of the investment community for some time. The impact of this provision will not be known until the SEC adopts rules for its implementation.

On one extreme, shareholder access may mean competing slates of board candidates at annual meetings. Some fear that this could result in corporate elections that begin to resemble political elections, with campaigns for shareholder support of candidates, public debates, and discussions about corporate strategy and financial policy in the context of an election. On the other hand, depending on the final thresholds and rules related to share aggregation that the SEC ultimately adopts, the provision could have relatively little impact. Specifically, ownership threshold requirements could be set high enough that not many shareholders would meet them, even if allowed to aggregate holdings amongst shareholders.

Further, even if a shareholder candidate is included in the proxy materials for voting, he or she must still receive more votes than the incumbent or management-backed director candidate to secure a position on the board of directors. Some may also assert that proxy access may undermine the effectiveness of the nominating committee, whose responsibility it is to consider and vet the qualifications and experience of candidates seeking board positions.

### Disclosures Regarding Chairman and CEO Structures

### Description of the Legislation

The legislation requires the SEC to establish rules regarding proxy disclosure about the reasons why companies have selected to either separate or combine the roles of the chairman and the CEO.

The SEC rules are required by mid-January 2011, within 180 days of the legislation’s enactment.

This provision appears to be comparable to existing SEC rules requiring disclosure of a company’s leadership model and why it believes the model is appropriate for the company. Therefore, the impact of this provision will be unclear until it is known whether it will result in new SEC disclosure requirements or just reinforce existing practice. However, because the SEC’s rules were passed so late in 2009, most companies did not have time to consider changing their practice in this area before the disclosures were required. Therefore, there may be changes in the coming year, even absent new rules.

For companies that wish to keep the roles of the chairman and CEO combined, appointment of a lead or presiding director may be beneficial. The lead director helps to provide an external, independent voice on issues being considered by the board in which the combined chairman/CEO may have a personal stake. Existing SEC rules require detailed disclosure regarding the role of the lead director.
Risk Committees for Financial Institutions

Description of the Legislation

The legislation calls for each nonbank, public, financial company supervised by the Board of Governors of the Federal Reserve System to form a separate risk committee. It also requires each public bank-holding company with total assets in excess of $10 billion to establish a risk committee. The Board of Governors may also require public bank-holding companies that fall below the stated threshold to have a risk committee, if it determines that the establishment of such a committee would further encourage responsible risk management in the organization. Based on the legislation, risk committees will be:

- Held responsible for risk oversight in the organization
- Required to include the appropriate number of independent directors, as determined by the Board of Governors, based on a variety of factors, including nature and size of the organization
- Required to include at least one risk management expert, as defined by the bill.

The Board of Governors is required to issue its final ruling on the implementation of this section by July 21, 2012, and the rules must be effective no later than October 21, 2012. The legislation allows for these dates to extend by up to six months if the Treasury Secretary files for an extension within 270 days of July 21, 2010.

This provision may allow shareholders to better understand the board’s role with regard to risk oversight and the risk committee’s roles, actions, and responsibilities as disclosed within the proxy materials.

Companies that are required to have a separate risk committee should be careful to not “silo” risk into one committee because the full board is ultimately accountable for risk oversight. Other board committees may still need to play a significant role in risk oversight; for example, the audit committee should still oversee financial risks. Therefore, it may be useful for companies to revisit the board committee charter to ensure that responsibilities regarding risk are outlined clearly and concisely. The board of directors will need to consider how the addition of a risk committee will affect current board committees and the separation of roles. Additionally, nominating committees will likely need to consider what qualifications are necessary in a ‘risk expert’ and how the company will obtain such an expert. The board and nominating committee may leverage lessons learned in the process of identifying financial experts for the audit committee.

Concluding Thoughts

There are many provisions in the Dodd-Frank Act that may ultimately have a significant impact on executive compensation and corporate governance policies for U.S. publicly traded companies. Although a handful of the provisions seem to reinforce existing rules and policies, many of the provisions will require companies to consider changing existing practice. The bill’s provisions are likely to affect companies in different ways, depending largely on whether and how companies have already voluntarily adopted some of the new requirements as leading practices or in anticipation of the bill’s implementation. Boards and committees should view this upcoming period of implementation as a means of not only examining existing practices and identifying necessary changes to comply with the new requirements, but also as an opportunity to enhance their executive compensation and corporate governance policies and procedures.

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i The Securities and Exchange Act of 1934 requires directors, officers, and principal stakeholders to file certain statements related to ownership of company securities. A Section 16 officer refers to individuals such as the president, chief executive officer, chief financial officer, chief accounting officer, and the like.

ii “Financial Institutions” are defined as: (i) a depository institution or depository institution holding company, as such terms are defined in section 3 of the Federal Deposit Insurance Act; (ii) a broker-dealer registered under section 15 of the Securities Exchange Act of 1934; (iii) a credit union, as described in section 19(b)(1)(A)(iv) of the Federal Reserve Act; (iv) an investment adviser, as such term is defined in section 202(a)(11) of the Investment Advisers Act of 1940; (v) the Federal National Mortgage Association; (vi) the Federal Home Loan Mortgage Corporation; and (vii) any other financial institution that the appropriate federal regulators, jointly, by rule, determine should be treated as a covered financial institution for purposes of this provision.
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