

Dodd-Frank Financial Reform Act Signed into Law Includes Provisions Related to Executive Compensation and Corporate Governance

On July 21, 2010, President Barack Obama signed into law major financial reform legislation in the form of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The primary focus of this law is the restructuring of US financial system regulation. It also includes provisions related to executive compensation and corporate governance affecting publicly traded companies. This Cogent Alert highlights the relevant executive compensation and corporate governance provisions of the new law.

Say on Pay and Say on Golden Parachute Pay

The Act provides for *non-binding* shareholder votes on executive compensation and golden parachute arrangements.

Say on Pay of Named Executive Officer Compensation. Shareholders must be given the opportunity for a *non-binding* vote on executive compensation at least once every three years. Shareholders are also provided a second vote at least every six years on the frequency of the say on pay vote, which could occur every one, two or three years.

Say on Golden Parachute Pay. All agreements and total potential golden parachute pay must be clearly disclosed in a proxy or other solicitation for shareholder approval of a merger, acquisition or similar business transaction. Shareholders must be provided a non-binding vote on the golden parachute compensation, unless those arrangements have been included in a previous shareholder vote.

The first say on pay and related frequency vote must occur at the first annual or shareholder meeting held six months or more after the Act was signed into law. Likewise, the requirements for say on golden parachute pay apply to events occurring after the same six month period.

Compensation Committee Independence and Selection of Advisors

Within one year following enactment of the legislation, the SEC must issue rules directing the national securities exchanges and associations on considerations for compensation committee independence and outside advisor independence as a condition for listing on such an exchange.

Compensation Committee Independence. The requirement for compensation committee independence will take into account the source of any other compensation paid to the committee member (e.g., consulting, advisory, or other fees paid) and any affiliations of the committee member.

Outside Advisor Independence. Committees will be required to consider the independence of outside advisors including consultants and attorneys as part of the selection process. Factors that must be considered include other services the advisor's employer provides to the company, the amount of fees paid to the advisor's employer relative to employer's total revenue, the advisor's relationships with any committee member, the advisor's conflicts of interest policies and any company stock owned by the advisor.

The committee must also have the sole discretion to retain, oversee and approve payment to its advisors, while the company is required to provide funding for reasonable compensation for such advisors.

Within one year of enactment, the company's proxy or related filings must disclose the use of consultants, any conflicts of interests and remedies to any conflicts.

Proxy Disclosure and Policy Requirements

The SEC must issue rules for disclosure of the following items in the proxy. There is no specific deadline for the issue of the following rules.

Pay and Performance Disclosures. Companies' disclosure must include details demonstrating the relationship between compensation actually paid and the related financial performance. This disclosure should take into account shareholder returns and may include graphical representation.

Internal Pay Equity. Companies must calculate and report the median annual total compensation of all employees other than the CEO, the annual total compensation for the CEO, and the relationship between the two.

Clawback Policy Requirement. Companies must develop and implement a policy for "Recovery of Erroneously Awarded Compensation." The policy would cover the three year period leading up to any financial restatement due to material non-compliance of reporting

requirements. The policy would apply to incentive compensation, including stock options. Adoption of and reporting of such a policy will be a condition of listing on national securities exchanges and associations.

Corporate Governance

The Act includes various other corporate governance matters, as described below.

Elimination of Broker Discretionary Votes on Certain Matters. Brokers are prohibited from voting without instruction on director elections, executive compensation matters such as say on pay, and other significant items determined by SEC. This provision in the Act is effective immediately.

Chair and CEO Roles. Companies must disclose the reasoning behind why the company has chosen to either combine or separate the role of chairman and CEO. The SEC is required to issue the rules for this disclosure within 180 days after the Act was signed into law.

Hedging by Insiders. Companies must disclose whether any employee or board member is permitted to purchase financial instruments designed to hedge against decreases in the value of the company's equity securities. The SEC will issue the rule, but there is no specific deadline.

Proxy Access. The SEC may issue rules to allow shareholders to utilize company-provided proxy solicitation materials for the purpose of nominating directors. The details of implementation are left to SEC determination.

Cogent Observations

This new law captures many of the executive compensation and corporate governance legislative initiatives that have been discussed for the last several years. It is unclear what long term effects the legislation will have on actual pay practices and pay levels. It is likely that the legislation will immediately impact most executive compensation deliberations but will have some longer term macro effects such as:

- Downward pressure on severance and golden parachute arrangements
- Narrowing of pay practices whereby the "outliers" are pulled to the center
- Compensation committees will feel the pressure to align compensation results with reported shareholder return results.
- Enhanced communication between the company and their largest shareholders
- Improved disclosure and demonstration of the linkage between compensation rationale and a company's business strategy and results
- Increased influence of proxy advisory firms

Cogent suggests companies review their compensation arrangements and pay strategy in light of external perception, and consider sharpening their communications in preparation for a shareholder advisory vote on executive compensation. Companies should also work closely with their proxy solicitors in anticipation of the impact on shareholder votes by the elimination of broker discretionary votes on director elections and say on pay proposals.

The implementation of the new law requires the SEC to develop many new rules between now and the end of the year. Cogent Compensation Partners will continue to monitor progress and update our clients as new information is available.

The full text of the Act can be found at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf The executive compensation and corporate governance portions are in Subtitle E and Subtitle G of Title IX.

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About Cogent Compensation Partners

Cogent Compensation Partners is a leading provider of objective and independent advice on the subject of executive compensation, corporate governance, and the linkage between company performance and executive pay.

Our executive compensation consultants assist in driving together the various interests involved in the executive pay debate: employees, shareholders, institutions, and other stakeholders. Our services include compensation committee advisory, incentive plan design, compensation strategy development, board of director compensation analysis, executive compensation related shareholder proposal assistance and assistance with risk assessments.

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