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Executive Compensation Group Advisory

July 2010

DODD-FRANK ACT RAISES MAJOR EXECUTIVE COMPENSATION ISSUES

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). Although Dodd-Frank focuses primarily on the financial services industry, it contains a number of new requirements generally applicable to executive compensation paid by public companies:

- **SAY ON PAY:** At least every three years – or more frequently if determined by shareholders – public companies must solicit a non-binding shareholder vote to approve the compensation of their named executive officers. The first say-on-pay approvals (including a separate vote on the frequency of say-on-pay voting) are required beginning with shareholder annual meetings occurring on or after January 21, 2011. While this vote is "non-binding," we expect that shareholder sentiment and companies' desire to avoid a "no" vote will significantly impact future compensation practices. We also expect that the "frequency vote" (required next year and at least once every six years thereafter) will be a hot issue at some companies.

- **SHAREHOLDER VOTE ON "GOLDEN PARACHUTES":** Similarly, any merger proxy statement must include a non-binding shareholder vote to approve named executive officer compensation that is based on or otherwise related to the transaction, unless the compensation was previously subjected to a regular say-on-pay vote. This vote is required beginning with shareholder "merger" meetings occurring on or after January 21, 2011.

- **DISCLOSURE OF RELATIONSHIP OF PAY TO PERFORMANCE:** Information showing the relationship between executive compensation actually paid and the total shareholder return of the company for the applicable period must be included in the annual meeting proxy statement. This requirement may result in a shift back towards long-term compensation tied to company share price fluctuations, such as stock options or stock-settled SARs. This requirement will become effective in accordance with regulations to be issued by the SEC. No deadline is contained in Dodd-Frank.

- **DISCLOSURE OF CEO COMPENSATION PAY RATIO:** Dodd-Frank requires annual disclosure of (1) the median "total compensation" (determined by the SEC proxy disclosure rules under Item 402 of Regulation S-K as in effect on July 20, 2010) of all employees of the company, (2) the total compensation of the CEO, and (3) the ratio of the two numbers. Similar information has been frequently sought by groups via shareholder proposals. Beyond the data collection burden associated with determining this median, we anticipate this provision will have a profound effect on companies' reviews of their executive compensation philosophy and disclosures to explain the pay differential. This requirement will become effective when the SEC amends its executive compensation disclosure rules under Item 402. No deadline is contained in Dodd-Frank.

- **INDEPENDENCE OF COMPENSATION COMMITTEE MEMBERS:** Dodd-Frank now requires that all compensation committee members be "independent," applying similar standards to those currently applied to audit committee members. There are narrow exceptions for certain companies exempted by the SEC and for "controlled companies" having more than 50% of the voting power held by an individual, a group, or another issuer. This requirement will become effective after the SEC has issued rules (due by July 17, 2011) and such rules have become effective at the various listing exchanges.

- **INDEPENDENCE OF COMPENSATION COMMITTEE ADVISERS:** The compensation committee is authorized – but not required – to retain, direct and pay the committee's own legal counsel, compensation consultants and other advisers independent of those advisers retained by management. Companies must provide appropriate funding to pay those advisers, as determined by the compensation committee. When selecting advisers, compensation committees are required to consider adviser independence. Similar to updates to the proxy disclosure rules adopted by the SEC in December 2009, these factors include:

(continued on next page)

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- other services provided to the company by the advising firm;
- the amount of fees paid by the company to the advising firm compared to the advising firm's overall fees;
- policies and procedures of the advising firm that are designed to prevent conflicts of interest;
- any business or personal relationship of the individual adviser or advising firm with a member of the compensation committee; and
- any stock ownership of the company by the individual adviser or advising firm.

This requirement is intended to mitigate the risk or the appearance of conflicts of interest by professionals advising compensation committees on matters relating to executive compensation. This rule, along with the conflicts disclosure rule adopted by the SEC last December, has caused and is likely to continue to cause benefits administration and actuarial firms to divest their executive compensation practices to avoid these conflicts. In addition, it is likely that many compensation committees will rely less on in-house expertise. We also expect an increase in the use of multiple consultants weighing in on a company's executive compensation matters. This requirement will become effective after the SEC has issued rules (due by July 17, 2011) and such rules have become effective at the various listing exchanges.

- **CLAWBACKS:** Although initially fashioned as a requirement to simply disclose "clawback" policies, Dodd-Frank directs the SEC to issue rules requiring the national stock exchanges to mandate their listed companies to establish a policy to recover (i.e., clawback) incentive compensation from current or former executive officers in certain cases following a restatement of financial results. If a company files a restatement that discloses a material noncompliance with any financial reporting requirement, the clawback applies to incentive compensation that was based on the erroneous financial statements and was paid during the three-year period preceding the date the restatement is required. This provision is substantially similar to the clawback requirements applicable to financial institutions receiving government funds under the federal TARP program. No deadline is contained in Dodd-Frank stating when the SEC must issue its rules.

- **DISCLOSURE OF HEDGING POLICY:** Companies will also be required to disclose any company policy permitting employees or directors to purchase derivative financial instruments (e.g., swaps and collars) that are designed to hedge or offset any decrease in the market value of the company's equity securities granted to or otherwise held by the employee or director. This rule does not require companies to disclose, or to specifically monitor or regulate, actual hedging transactions. Companies with insider trading policies that are silent on this point will likely look to clarify their policies one way or the other. The rule will become effective when the SEC issues its rules. No deadline is contained in Dodd-Frank.

- **ENHANCED COMPENSATION STRUCTURE REPORTING:** By April 21, 2011, federal regulators must issue rules or guidance requiring "covered financial institutions" with at least $1 billion in assets to disclose to the appropriate federal regulator the structure of all incentive-based compensation arrangements offered at such institutions, for the regulator to determine if these arrangements provide executives, employees, directors and principal shareholders with excessive compensation, fees, or benefits, and/or could lead to material financial loss to the covered financial institution. Also by April 21, 2011, the regulators are required to issue guidelines or regulations that prohibit incentive arrangements or features that provide excessive compensation or could lead to material financial loss. This mandate has greater reach than the final guidance on sound incentive compensation jointly issued by the Fed, FDIC and OCC in June 2010. Covered financial institutions include banks, broker-dealers, investment advisers, credit unions and Fannie Mae and Freddie Mac.

- **DISCLOSURE OF SEPARATE CHAIRMAN CEO POLICY:** While not an executive compensation matter per se, Dodd-Frank requires the SEC to issue rules by January 17, 2011 requiring company disclosure of the reasons why the company has or has not separated or combined the positions of CEO and board chair. Presumably, the SEC will need to revisit and most likely revise Item 407(h) of Regulation S-K, which was adopted in December 2009 and which requires only why the company determined that the leadership structure is appropriate.

- **BROKER VOTE:** Dodd-Frank prohibits discretionary voting by brokers with respect to executive compensation, director elections, or any other significant matter as determined by the SEC. To vote, brokers must obtain direction from the beneficial owner of the shares.

- **PROXY ACCESS:** Dodd-Frank allows the SEC to move forward with its proxy access project, which will permit shareholders to submit nominees as directors, subject to a procedure established by the SEC.

If you have any questions regarding this Advisory, please contact any of the members of the Executive Compensation Group.