

A Closer Look

The Dodd-Frank Wall Street Reform and Consumer Protection Act



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Part of an ongoing series

Impact On

Executive Compensation

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On July 21, 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank, or “the Act”), and in doing so ushered in a new era of financial regulation. Many questions remain, however, concerning exactly how the Act’s 2,300 pages of legislation will affect the way US companies do business in the months and years to come.

In addition to provisions addressing oversight of systemically important institutions, derivatives trading, and advisers to hedge funds and private equity funds, the Act will require some major changes in executive compensation arrangements at public companies. These new provisions, along with associated rulemaking that is forthcoming from regulators, will have a direct impact on the way corporate America seeks input from shareholders on the terms of executive compensation programs and discloses information about those programs. They may also have an impact on the way future compensation arrangements are structured.

In this *A Closer Look*, we focus on the Act’s requirements associated with executive compensation arrangements, and explore some of the strategic, operational, and financial reporting decisions companies will face as implementation of the Act gets underway in 2011.

What will your shareholders “say-on-pay”?

For some time, shareholder advocacy groups have been pushing for a greater voice in how boards and management establish compensation arrangements for executives. In Congress, legislation that would have required so-called shareholder “say-on-pay” for public companies was introduced in 2007, but was ultimately shelved. Then, in the midst of the credit meltdown, recipients of funds from the government’s Troubled Asset Relief Program (TARP) were required to incorporate say-on-pay resolutions during the time the TARP funds remained outstanding.

With the passage of Dodd-Frank, say-on-pay rules will now be required for all public companies in the United States. A section of the Act titled “Shareholder Vote on Executive Compensation Disclosures” amends the Securities Exchange Act of 1934 to include three new topics: shareholder vote on executive compensation (say-on-pay), frequency of votes on executive compensation, and disclosure of and shareholder votes on so-called golden parachute arrangements. As with many aspects of the new law, detailed rulemaking and implementation guidance has been assigned to the Securities and Exchange Commission (SEC).

In October 2010, the SEC issued proposed rules on the Act’s say-on-pay provisions, and sought comments on each of its proposed rules. The comment period ended November 18, 2010.

The Act provides that requirements regarding shareholder advisory say-on-pay votes (and votes on the frequency of such votes) are effective as of January 21, 2011. Companies will be required to include resolutions on these issues in any shareholder meeting occurring on or after that date, even if the SEC’s proposed rules have not yet been finalized and adopted. The Act similarly references January 21, 2011, regarding the new golden parachute disclosures; however, this date is conditional on final rulemaking by the SEC. Thus, these new disclosures will not be required until the effective date that is established in the SEC’s final rules.

Companies with annual meetings scheduled in early 2011 should consider how they will implement these new shareholder voting requirements, and what changes they will need to incorporate in annual proxy filings.

The SEC’s proposed rules would require issuers to hold a shareholder vote on executive compensation at least every three years, with the vote considered an “advisory vote” (i.e., non-binding on the company). The vote would cover the compensation of all named executive officers whose compensation is already required to be disclosed in the Compensation Discussion & Analysis (CD&A) and elsewhere in the company’s financial statements and proxy statement. Smaller reporting companies would also be subject to a shareholder advisory vote, though the new rules do not change the currently reduced level of compensation disclosure required of those entities.

Issuers are temporarily exempt from these new rules if they received financial assistance under TARP and are still operating under its 2009 rules, which require a separate annual shareholder vote to approve executive compensation.

The advisory vote on executive compensation applies only to the named executive officers, and thus does not apply to the company’s directors. Also, the vote does not apply to any disclosure the company makes regarding compensation policies and practices and alignment with risk management and risk-taking incentives under the SEC’s rules in Item 402(s), as these relate to employees generally. The vote does apply to the totality of disclosure under other aspects of Item 402, including policies and practices that relate to the compensation of the named executive officers.

While the proposed rules do not require specific language or specify the form of the resolution that will be voted upon, the SEC does emphasize that the vote should address all compensation of the named executive officer group.

The SEC’s proposed rules also require issuers to include new narrative in their CD&As describing how the shareholder advisory vote has impacted compensation policies and decisions. This rule goes beyond what is required under the Act, but the SEC believes this additional discussion will provide investors better insight into companies’ compensation decisions.

Current rules require issuers to disclose the results of shareholder votes within four business days following the end date of the shareholder meeting. The proposed new SEC rules would also require issuers to disclose all actions taken as a result of shareholder vote on the frequency of shareholder votes on executive compensation.

How often will we have these votes?

The SEC’s proposed rules would require issuers, at least once every six years, to provide a separate shareholder advisory vote in the proxy to determine how often the say-on-pay vote (described above) should

be held. The rules explicitly require that four options be provided to shareholders: to vote for the say-on-pay votes to be held every one, two, or three years, or to abstain from voting on the matter.

Like the say-on-pay vote, a description of this vote would also need to be disclosed in the annual proxy, as well as the general effect of the vote, such as whether it is non-binding.

The proposed rules do not include guidance on how newly public issuers would apply the guidance. For example, if the issuer discloses it will hold a say-on-pay vote every two years, it is unclear whether it would be exempt from the vote for its first shareholder meeting as a public company. This is an area on which the SEC has specifically requested comment.

Yet more votes: golden parachute arrangements

Under current SEC rules, some disclosure related to payments that would be made to named executive officers in the event of a change in company control are disclosed in annual proxy statements and elsewhere. However, these rules don't include detailed disclosure requirements applicable to proxy or consent solicitations to approve an acquisition, merger, proposed sale, etc.

The proposed rules specifically require disclosure of golden parachute compensation arrangements in proxy or consent solicitations in connection with a transaction. Issuers would be required to disclose all golden parachute compensation arrangements relating to both the target and acquiring companies, as well as the named executive officers of each.

These golden parachute disclosures are required only in proxy and consent solicitations in connection with a transaction, and thus would not need to be included in annual proxy statements. However, the SEC would not object to including these disclosures in the annual proxies as well, and much of the required data is already included in existing Item 402(j).

Furthermore, the proposal provides that if disclosure that meets the new disclosure standards is provided in annual proxy statements and the agreements are subject to the shareholder say-on-pay vote described above, disclosure is not required at the time of the change of control. The proposed rules indicate that the SEC believes some issuers will now include such disclosures as part of the regular proxy disclosure.

This disclosure will need to be provided in narrative form as well as in a new table. The table, which would be titled "Golden Parachute Compensation," would include a row for each named executive officer and columns detailing the components of golden parachute compensation. These include cash, equity, pension, perquisites/benefits, tax reimbursement, and other. The total of these components of compensation would also be shown.

Some of the compensation elements of the new Golden Parachute Table (for example, stock options) may be based on company stock price. If the table is included in a proxy/consent solicitation related to a transaction, the price used to determine the compensation should be based on the most recent date practicable. If included in the annual proxy statement, the date used should be the end of the most recent fiscal year.

The table will include footnote disclosure indicating whether the parachute payments are "single-trigger" or "double-trigger." Under a double-trigger arrangement, payment is made only if the executive is terminated without cause or resigns for good reason within a limited period of time after the change in control. A single-trigger arrangement does not require a termination or resignation after the change in control in order for payment to be triggered. That is, the payment is automatic upon the change in control.

In addition to understanding the disclosure requirements around these single- and double-trigger parachute payments, both acquiring and target companies should understand the accounting and financial reporting treatment, which can be complex and often counterintuitive. For example, payments associated with a double-trigger arrangement will generally be reflected as an expense to the acquiring entity, even in cases where it is known prior to the acquisition that the executive will be terminated and will perform no service for the acquirer post-acquisition.

The compensation included in the table is only meant to encompass payments directly associated with and attributable to the acquisition, merger, etc. The table would not need to include amounts previously disclosed in, for example, the Pension Benefits Table or Nonqualified Deferred Compensation Table, nor would it need to disclose or quantify previously vested equity awards. Since these benefits are vested without regard to the transaction, they are not considered by the SEC to be golden parachute arrangements.

Finally, the proposed rules would require a shareholder advisory vote related to golden parachute arrangements. This non-binding vote would be solicited in the merger proxy, and shareholders would be asked to vote on the terms of the golden parachute arrangements of the named executive officers.

The “CEO pay ratio”

A topic that has received extensive focus in the “Wall Street versus Main Street” debate has been the relationship (or what some argue is often a lack of relationship) between executive compensation and the company’s financial performance. Likewise, there has been populist outcry that CEO pay levels have grown to multiples of the rank-and-file employee that are out of touch with shareholder (and Main Street) expectations. Regardless of your point of view on this issue, greater transparency will be coming courtesy of Dodd-Frank disclosure requirements focused on how executive pay measures up.

The Act directs the SEC to adopt rules requiring public companies to disclose the relationship between executive compensation actually paid and the company’s financial performance. Companies will also need to disclose internal pay equity, or the so-called “CEO pay ratio.” This disclosure will compare the total annual compensation of the CEO to the median total annual compensation of all employees. While the Act does not specify a date on which these requirements will take effect, the SEC has tentatively scheduled proposed rulemaking for Spring 2011.

Pay-for-performance disclosure. There are a number of questions related to the implementation of the pay-for-performance disclosure. For example, how will realized pay be defined? Should it include the change in value of executives’ unvested equity holdings? How will the exercise of stock options be considered? Is total shareholder return the only measure of performance that will be considered? What are the right time periods over which to evaluate pay and performance?

CEO pay ratio disclosure. The implementation of the CEO pay ratio disclosure will likely be difficult and complex, particularly for large multinational corporations. At issue are both the census of “all employees” and the definition of total annual compensation.

With regard to the census of employees: Who exactly will be considered an “employee” for purposes of the median income calculation? How will temporary workers be considered? Or contractors? Or part-time employees?

Total annual compensation, as defined in the Act, would include all components of employee income, including not only salary and bonus but also stock compensation, deferred compensation arrangements, pension and other post-retirement benefits, and other elements. Companies generally don’t maintain information on these various compensation components for all employees on an annual basis.

As a result of this complexity, development of this disclosure will likely require companies to establish new—and probably costly—administrative systems and controls. In recognition of these likely implementation difficulties, the SEC has asked for comments on these issues in advance of issuing proposed rules.

Expanding the use of compensation clawbacks

The Sarbanes-Oxley Act introduced clawback requirements for public companies. Those provisions generally required clawback of CEO/CFO awards earned in the year prior to a financial restatement issued as a result of misconduct. More stringent requirements issued as part of TARP expanded these clawback requirements to cover the twenty most highly paid executives, and eliminated the need to prove misconduct by the executive.

Dodd-Frank will expand significantly on these provisions by requiring clawback from all current or former executive officers of any erroneously awarded compensation in the three years prior to an accounting restatement, with no consideration regarding the presence or absence of misconduct.

As with most aspects of the Act subject to regulator rulemaking, many questions are still to be answered. For example, will the three-year look-back start from the date the accounting error was made, the date it was discovered, the date the restated financial statements were filed with the SEC, or some other date? Who will be considered an “executive” for purposes of this clawback provision? Will the clawback apply to both cash and share-based compensation? Will it apply to annual bonuses where the bonus pool is based on operating performance, or only to longer-term deferred compensation arrangements? As with so many aspects of the legislation, we’ll need to wait and see.

Again, while the Act mandated no specific date on which these requirements will take effect, the SEC has announced expected rulemaking in Spring 2011. After, this rulemaking, the securities exchanges will then need to establish rules for their listed companies.

Clawback provisions are subject to specific treatment for accounting and financial reporting purposes. Due to the complexity of accounting rules associated with stock compensation arrangements, it will be important for companies to consider the potential financial reporting implications before implementing any new clawback provision. For example, if new clawbacks are created that provide discretion to the company or compensation committee in determining when/if the provision has been triggered, this may lead to a conclusion that the executive who received the award doesn’t have “all the facts” necessary to understand how the award works. This could result in using the volatile “marking to market” accounting treatment to value the award each reporting period.

Also, some companies are wondering whether to implement new clawbacks now in anticipation of the new rules, which again, won’t be coming until at least mid-2011. While some companies may choose this route in an effort to improve corporate governance, the decision should be weighed against the reality that any provision established this year would likely need to be amended or updated next year to conform to final SEC and securities exchange rulemaking.

Is your compensation committee independent?

Similar to the Sarbanes-Oxley rules on audit committee independence introduced earlier this decade, Dodd-Frank’s executive compensation provisions will require companies to ensure independence of compensation committee members as well as the advisers to those committees. The Act requires the SEC to direct national securities exchanges to prohibit listing of any company that does not have an independent compensation committee.

In determining committee member independence, the securities exchanges are instructed to consider relevant factors including (i) any consulting, advisory, or other compensatory fees paid to the director by the company, and (ii) whether the director is otherwise affiliated with the company.

Compensation consultants, legal counsel, and other advisers to the compensation committee will likewise have their independence considered by the compensation committee, based on a wide range of factors that may include whether the adviser provides other services to the company, the amount of fees paid to the adviser as a percentage of the adviser's total revenue, the policies that the adviser has implemented to prevent conflicts of interest, any business or personal relationships between the adviser and members of the committee, and whether the adviser holds stock in the company. Disclosure will also be made regarding whether the compensation committee retained or obtained the advice of a compensation consultant, and whether the work of the compensation consultant has raised any conflict of interest. This disclosure is required in proxy statements for annual shareholders meetings occurring on or after July 21, 2011.

The Act requires the SEC to perform a study of the use of compensation consultants, and the effects of such use. A report to Congress is required within two years of the Act’s enactment—that is, by July 21, 2012.

While Dodd-Frank will have significant impact on the process of determining executive compensation arrangements at public companies, many implementation issues are currently unclear and are subject to federal agencies' rulemaking processes and various statutorily directed studies. PwC will continue to monitor those developments and provide you with updates, which will be available at www.pwcregulatory.com.

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