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Dodd-Frank Targets your Bank's Compensation Practices

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Retention bonuses, extravagant office remodeling, and multi-million dollar bonuses at Wall Street banks led Congress and federal bank regulators to attempt to limit the risk in our financial system through increased compensation regulation. Rightly or wrongly, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") takes aim at compensation practices of banks of all shapes and sizes. Compensation is now a safety and soundness issue.

Say on Pay

Dodd-Frank amends the Securities Exchange Act of 1934 (the "Exchange Act") to require that "reporting companies" provide their shareholders a non-binding vote on executive compensation and on "golden parachutes." Securities Exchange Commission ("SEC") Release 33-9153 ("Release") sets forth proposed Rule 14a-21 to govern these new requirements.

Beginning with the first proxy statement after January 21, 2011, and then at least once every three years thereafter, proposed Rule 14a-21(a) requires reporting companies to provide a separate shareholder advisory vote on executive compensation. Importantly, this approval relates to all executive compensation matters disclosed in such proxy statement, including any Compensation Discussion and Analysis ("CD&A"), the tables and other narrative disclosures. The Release clarifies that 14a-21(a) does not require that "smaller reporting companies" include a CD&A.

The Release further requires inclusion of narrative disclosure about the separate say on pay vote, including any formal effect of the vote. Although not mandated, the Release proposes a new element of discussion in the CD&A addressing whether and, if so, how compensation policies and decisions take into account the results of prior say on pay votes.

Beginning with the first proxy statement after January 21, 2011, and then at least once every six years thereafter, Proposed Rule 14a-21(b) requires a separate shareholder advisory vote to determine if the say on pay vote should occur every 1, 2, or 3 years. The SEC proposes to amend forms 10-K and 10-Q to require disclosure of company action taken because of the shareholder vote on the frequency of say on pay voting. Companies with TARP CPP funds need not provide separate votes under Rules 14a-21(a) or (b).

Through new tabular and narrative disclosure, Item 402(t) of Reg S-K will require that any proxy statement to approve an acquisition, merger, consolidation, or proposed sale of all or substantially all assets of a company (a “Merger”) include a description of any golden parachute payment to an executive triggered by the Merger. “Golden parachutes” include any compensation to an executive from either the target or acquiring company.

Rule 14a-21(c) will require a separate shareholder advisory vote on golden parachutes disclosed in any proxy statement seeking shareholder approval of a Merger. However, no advisory vote is needed if the particular golden parachute was the subject of a prior say on pay vote.

Subject to further SEC rulemaking, Dodd-Frank requires new “pay vs. performance” disclosure in proxy statements showing the relationship between executive compensation and the company’s financial performance. The new disclosure likely will require both narrative text and graphical disclosure. In addition, Item 402 of Reg S-K will be amended to require disclosure showing the relative level of CEO compensation compared to the median of all employee compensation excluding the CEO.

All reporting companies must prepare themselves for the new disclosure requirements for 2011 proxy statements. Non-reporting companies should give careful consideration to whether they adopt these new SEC disclosures as a “best practices” standard. Any company subject to the say on pay and/or golden parachute vote requirements should give consideration to what, if any, impact on compensation practices the voting results will have. While statutorily “non-binding,” the practical effect of ignoring a majority or sizable “no” vote from shareholders may be daunting.

Compensation Committees and Clawbacks

Dodd-Frank also tinkers with compensation committees of “listed issuers” by requiring rules that effectively prohibit national exchanges from listing any company that does not comply with new sections 10C(a)(1) and (2) of the Exchange Act mandating a compensation committee that is made up of independent members. No definition of “independent” is provided, but Dodd-Frank suggests factors for exchanges to consider in developing definitions.

Apart from independence, Dodd-Frank requires that compensation committees have certain powers including the ability to retain consultants and counsel. Further, the SEC will adopt disclosure rules about the use and independence of consultants.

Dodd-Frank also requires that listing standards of national securities exchanges include a bonus “clawback” requiring recovery from executive officers of incentive-based compensation paid based on inaccurate financial statements. The clawback is not conditioned on adjudication of misconduct by the executive, and must cover a three-year lookback period.

Given the changes to compensation committee structure and the new clawback requirements, listed companies must review their compensation committee charters to ensure compliance. Non-listed companies should likewise consider their committees from a best practices standpoint, particularly if listing on a national exchange is planned.

Disclosure by Banks of Incentive Compensation Practices

In the first quarter of 2011, federal bank regulators are expected to issue regulations requiring that covered institutions disclose all incentive-based compensation to allow determination of whether such compensation: (1) provides an executive officer, employee, director or principal shareholder excessive compensation, fees or benefits; or (2) could lead to material financial loss. In addition, the regulations must prohibit any incentive-based compensation arrangement determined to encourage "inappropriate" risks. By statute, financial institutions of less than $1 billion in assets are exempted from the forthcoming rule.

This is a distinct departure from past regulatory practice. Institutions that are, or expect to be, greater than $1 billion in assets should match their practices to the final guidance when issued. In addition, smaller institutions should expect pressure from examiners to substantially comply with the new guidelines.

To avoid being a target, you must align your bank's compensation policies and practices with the new demands of Dodd-Frank.

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