VIII. The Changing Landscape of Executive Compensation after Dodd-Frank

A. Introduction

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or "the Act"), signed into law by President Obama on July 21, 2010, contains several provisions that add significant new executive compensation and corporate governance requirements for U.S. public companies.[1] Government interest in regulating executive compensation has been a fairly recent development, predicated mainly on the assertion that lack of oversight and poor incentives based on current pay packages may have been a significant factor in exacerbating the recent financial crisis.[2] The goals of including provisions within the Act to regulate executive compensation are mainly to decentralize power when it comes to determining executive pay and to provide public shareholders with the information and power to influence the decisions of the corporate directors and executives whom they elect.[3]

B. Executive Compensation Regulation Prior to Dodd-Frank

One of the major objectives behind the inclusion of the new executive compensation regulations in the Dodd-Frank Act was to increase accountability for a system that many believed was partly responsible for the financial crisis of 2008.[4] Prior to the financial crisis, there was little regulation regarding executive compensation beyond mere shareholder approval.[5] Even before the current financial crisis, some analysts began to study the newer generation of executives of publicly-held companies and believed these executives

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[2] Christopher Keller and Michael Stocker, *Executive Compensation's Role in the Financial Crisis*, CORPORATE COUNSEL (Nov. 18, 2008), http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202426091714.
[3] Joe Masterson, *Dodd-Frank Act 'Could be a Home Run'*, BIZTIMES (Sep. 3, 2010), http://www.biztimes.com/news/2010/9/3/dodd-frank-act-could-be-a-home-run.
[4] Keller & Stocker, *supra* note 2.
[5] *Id.*

were gambling long-term stability in favor of achieving short-term financial goals.[6] Some analysts believe this focus on short-term goals was driven primarily by compensation packages that awarded executives with excessive bonuses for meeting short-term and low-aspiring targets.[7] In 2007 and early 2008, it appeared that there was a growing disconnect between performance-based compensation and the actual value added to the corporation by many executives.[8] Bonuses in 2007 increased approximately ten percent while the companies analyzed lost more than $200 billion in shareholder value.[9]

As the market began to trend downward, efforts were put in place to increase regulation but the steps were incremental and, at first, not very effective.[10] One of the first major changes was a Securities and Exchange Commission regulation that required public companies to disclose the compensation packages of their top-level executives.[11] While compliance with this new regulation was limited, it was the first round of company failures and the subsequent government bailouts that set the stage for the Dodd-Frank Act regulations.[12] Following public outrage at the bonuses paid to executives at American International Group and other bailout money recipients, the U.S. Treasury Department implemented the "Interim Final Rule."[13] The rule significantly restricted the compensation that could be paid to recipients of money from the government's Troubled Asset Relief Program ("TARP").[14] The new regulation limited or prohibited most bonuses and other equity incentive rewards for top executives and other key employees in an attempt to deter the same type of short-term focus that caused many of these companies to gamble on risky assets in the first place.[15] This "Interim Final Rule" contained versions of many of the regulations that were

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[6] *Id.*
[7] *Id.*
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] Contributors from the Executive Compensation Emerging Issues Task Force, *The Economic Crisis: Broader Executive Compensation Reforms Coming Soon*, K&L GATES LLP (July, 2009), http://www.klgates.com/newsstand/detail.aspx?publication=5777.
[14] *Id.*
[15] *Id.*

incorporated into the Dodd-Frank Act, yet the rule only applied to companies receiving TARP money.[16] Following the implementation of this rule and the increase in scrutiny of executive compensation from both public shareholders and the government, it became clear that executive compensation regulation was a key issue that would need to be included in any future reform measures.[17]

C. Key Changes to Executive Compensation in Dodd-Frank

The major provisions on executive compensation in the Dodd-Frank Act fall into three general categories: (1) shareholder input on compensation; (2) additional disclosures to the public; and (3) checks and balances on pay.[18]

1. Shareholder Input

Perhaps the most publicized of the compensation provisions are the "Say on Pay" and "Say on Golden Parachutes" provisions.[19] Regarding the "Say on Pay" provision, the Act will require that public companies hold a non-binding shareholder vote on the compensation of their named executives at least once every three years.[20] In addition, these companies must hold a non-binding vote at least once every six years to determine if the vote on compensation will take place every one, two, or three years.[21] Both of these votes must be included in the company's first proxy statement occurring on or after January 22, 2011.[22]

Similar to the "Say on Pay" provision is a regulation granting shareholders a "Say on Golden Parachutes," which requires a non-

[16] *Id.*
[17] *Id.*
[18] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 §§ 951-57, 124 Stat. 1376 (2010).
[19] *Id.* at § 951.
[20] *Dodd-Frank Act: Executive Compensation and Corporate Governance Provisions*, CHADBOURNE & PARKE LLP (Aug. 12, 2010), http://www.chadbourne.com/files/Publication/378ecd84-5e42-48ca-8192-83741f05f35c/Presentation/PublicationAttachment/4cbcf580-82ad-4554-8a8e-99ea0560c05a/Corporate%20--%20DoddFrank%20CA%20-%20Aug%202010.pdf [hereinafter *Chadbourne*].
[21] *Id.*
[22] *Id.*

binding shareholder vote on "golden parachute" compensation whenever the shareholders are asked to approve a merger, sale, or acquisition.[23] A "golden parachute" is a large payment that an executive is due to receive when their employment is terminated.[24] Additionally, this provision requires that persons soliciting proxies must provide clear disclosure of all arrangements and understandings with any named executive officers that provide for compensation based on the merger, sale, or acquisition and the total amount to be paid to those executives.[25] Upon receiving this information, shareholders will be able to enter a non-binding vote on any of these "golden parachute" payments that have not already been subject to the normal "Say on Pay" shareholder votes at previous meetings.[26]

One notable point on the shareholder input votes is that they are non-binding with regard to the board's decisions.[27] This means that a "negative vote cannot overrule any company or board decision, change or create any fiduciary duties for the company or board members or limit shareholders' ability to submit executive compensation proposals for inclusion in the company's proxy materials."[28] It is expected that despite their non-binding nature, these shareholder votes will be given considerable weight by public company boards and compensation committees when choosing how best to implement and respond to them.[29] This is due to other changes in corporate governance regulation in the Act that will make it easier for shareholders to nominate new directors to replace those who do not comply with shareholders' suggestions.[30]

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[23] Amy C. Seidel, *The Dodd-Frank Act: Executive Compensation*, FAEGRE & BENSON LLP (July 15, 2010), http://www.faegre.com/showarticle.aspx?Show=11703.
[24] Joseph Alley, Jr., Terrell E. Gilbert, Jr. and Robert F. Dow, *Executive Comp and Governance Provisions of Dodd-Frank Act*, BUSINESS ETHICS (July 22, 2010), http://business-ethics.com/2010/07/22/1640-executive-compen sation-and-corporate-governance-provisions-of-the-dodd-frank-act/.
[25] Seidel, *supra* note 23.
[26] *Id.*
[27] *Chadbourne*, *supra* note 20.
[28] *Id.*
[29] *Id.*
[30] *See generally id.*

2. Increased Disclosures

Another major issue sought to be resolved via provisions in the Act is the imbalance of information that exists between the executives and board members of a corporation on the one hand and its shareholders on the other. As such, the Act includes a few provisions designed to require additional disclosures to be released to shareholders, mainly focused on executive compensation and competing incentives.[31] In order for shareholders to have an understanding of the executive's value, the Act now requires that companies disclose the relationship between executive compensation actually paid and the company's financial performance, including any change in value to the company's shares and any distributions or dividends.[32]

Additionally, companies will have to disclose information that provides a frame of reference for the executives' compensation, including the median annual total compensation for all employees not including the CEO, the CEO's annual total compensation and the ratio of the one to the other.[33] The disclosure provisions also allow shareholders to examine the incentives for executives that are tied to share price.[34] Specifically, a company must disclose in its proxy statements whether any employee or director is permitted to purchase financial instruments that are designed to hedge against any decrease in the equity value of securities granted as compensation to the director or employee.[35] These provisions are designed to increase transparency and provide shareholders with more information with which to make informed decisions when utilizing their newly minted rights via the non-binding votes.

3. Checks and Balances

The final changes implemented by the Act are designed to ensure the integrity and accuracy of executive compensation by establishing new standards for compensation committee independence, as well as a "Clawback" provision to ensure no excess

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[31] Alley, Jr. et al., s*upra* note 24.
[32] *Id.*
[33] *Id.*
[34] *Id.*
[35] *Id.*

payment is made based on falsely reported data.[36] In an attempt to eliminate biased recommendations by a corporation's compensation committee, the Act requires the securities exchanges to establish standards requiring the committee's directors to satisfy heightened independence standards in order to maintain the company's listing on the exchange.[37] These standards will include examining the sources of a director's compensation, any fees for consulting or advising they may obtain from the company and whether they are affiliated with any subsidiary or other affiliates of the company.[38] Only after meeting these standards will a director be considered independent and allowed to serve on the compensation committee, to which the Act grants sole discretion over the hiring of consultants or other advisors on the issue of compensation.[39]

While the new rules on independence for committee members helps legitimize the compensation process at the early stages, the new "Clawback" provision is designed to ensure no over-compensation occurs when it is time to pay out to these executives.[40] This "Clawback" rule requires companies to maintain policies providing for the recovery of incentive compensation paid to current or former executives.[41] The "Clawback" is triggered in the event of "an accounting restatement due to material noncompliance with financial reporting requirements for the three-year period preceding the date of the restatement" allowing the recovery of any excess bonuses paid.[42]

D. Potential Implications of Dodd-Frank Compensation Reform

While there are a wide variety of beliefs as to how these new regulations will affect the corporate world moving forward, one thing is clear: the changes will have a serious impact on how shareholders, executives and corporations interact. Much has been made of how

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[36] *Alert—What You Need to Know About the Dodd-Frank Act*, BRIGGS & MORGAN (Aug. 6, 2010), http://www.briggs.com/what-you-need-to-know-about-the-dodd-frank-act-08-06-2010/.
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *See generally id.*
[41] *Id.*
[42] *Id.*

these regulations developed to fix issues with incentives, which were causing executives to focus primarily on short-term goals at the expense of long-term stability. However, it is unclear whether these regulations will help correct this problem or exaggerate it. Those who fear the Dodd-Frank provisions will have the opposite effect than originally intended argue that because the "Say on Pay" provisions require management's performance to be tested periodically with shareholder votes, CEOs "will be focused relentlessly on producing short-term results to avoid the substantial potential consequences from a no-confidence vote by shareholders."[43] This could create the unintended consequence of narrowing the focus of executives further instead of encouraging a more forward-looking approach to management.[44]

Beyond creating the desire to keep shareholders satisfied on a short-term basis, the new system will also vastly increase the power of large institutional investors such as hedge funds.[45] These funds can use their large voting blocks to put pressure on executives and directors to amend their corporate strategies through the threat of disapproval of compensation packages or the exercise of new corporate governance rights.[46] Other groups likely to gain influence from the new regulations are proxy advisory firms, whose approval of a given pay package will likely have a strong influence on the uninformed shareholders and institutional investors who may lack the expertise to personally evaluate an executive compensation package.[47]

This shift in power will likely be accompanied by a shift in standards. For one thing, a more homogenized executive pay structure across companies could emerge, as corporate boards may try to tailor their executive pay packages to meet advisory firm standards in an effort to avoid negative votes.[48] As more companies

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[43] Lyle G. Ganske, Robert A. Profusek &Lizanne Thomas, *Reform Brings a Renewed Focus on Short-Term Results*, FORTUNE (July 29, 2010), http://money.cnn.com/2010/07/29/news/financial_reform_short_term.fortune/index.htm

[44] *Id.*

[45] *Id.*

[46] *Id.*

[47] Ronald D. Orol, *Dodd-Frank's 'Say on Pay' Could Impact Executive Pay*, MARKETWATCH (Aug. 26, 2010), http://www.marketwatch.com/story/new-say-on-pay-law-could-temper-ceo-pay-2010-08-26.

[48] *Id.*

go through the approval process, a general framework of acceptable pay packages will likely develop, potentially driving directors to utilize these generally approved standards instead of tailoring a pay package more to the needs of their executives.[49] Others disagree; Professor Lucian Bebchuck believes shareholders will understand that compensation packages should differ based on the needs and expectations of an individual firm.[50] Yet even he believes that some pay practices will be eliminated entirely due to the new regulations, as they are so distasteful to shareholders as to warrant universal disapproval.[51] An example is a massive "golden parachute" payment to a director who will be retained as a top executive by an acquiring firm during a merger.[52] This potential benefit for public shareholders could create issues within the organization and opportunity costs that did not exist prior to the new regulations; some candidates may be cast aside as they are only attracted by more tailored packages or larger "golden parachutes" for job security.[53]

There are also those who believe that increased shareholder powers and required disclosures by corporations will send a message to directors that they will be accountable to shareholders like never before.[54] This increase in scrutiny could lead public companies and their directors to be more careful and diligent in establishing their corporate governance and compensation packages and in explaining these packages to the public, hopefully leading to greater confidence in the shareholders and a long-term improvement in financial performance.[55] Despite the many predictions touting potential benefits to shareholders and possible detriments to corporate operations that the Act's provisions could bring about, it will not be until their implementation over the coming months and years that the lasting effects on our financial system can measured.

E. Conclusion

The executive compensation provisions of the Dodd-Frank Act were included to address what many regulators and analysts

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[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] Masterson, *supra* note 3.
[55] *Id.*

believed to be a significant factor in causing the 2008 financial crisis.[56] The goals of the new regulations are to increase executive accountability to shareholders and close the gap between executive compensation and actual company performance.[57] The changes enacted include required non-binding shareholder votes on executive compensation and golden parachutes, additional disclosures on compensation to the public and increased oversight on compensation to ensure it is unbiased and accurate.[58] Supporters of the Act believe that the increased accountability to shareholders will cause companies to be more careful in their establishment of compensation and that directors will give a greater focus to long-term improvements in financial performance.[59] In contrast, critics of the executive compensation provisions view the new shareholder votes as an incentive to focus exclusively on short-term performance in order to satisfy the scrutiny of the newly empowered shareholders.[60] Both sides agree that the Act will cause significant changes in the compensation packages for most executives, though debate remains whether pay will become homogenized across companies or adapt to the specific needs of each individual company.[61] While most of the predictions about the effects of the Act are mere speculation at this point, the results will become clearer when the Act takes effect in early 2011.

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[56] Keller & Stocker, *supra* note 2.
[57] Masterson, *supra* note 3.
[58] Dodd-Frank Wall Street Reform and Consumer Protection Act, *supra* note 18.
[59] Masterson, *supra* note 3.
[60] G. Ganske et al., *supra* note 43.
[61] Orol, *supra* note 47.
[62] Student, Boston University School of Law (J.D. 2012).