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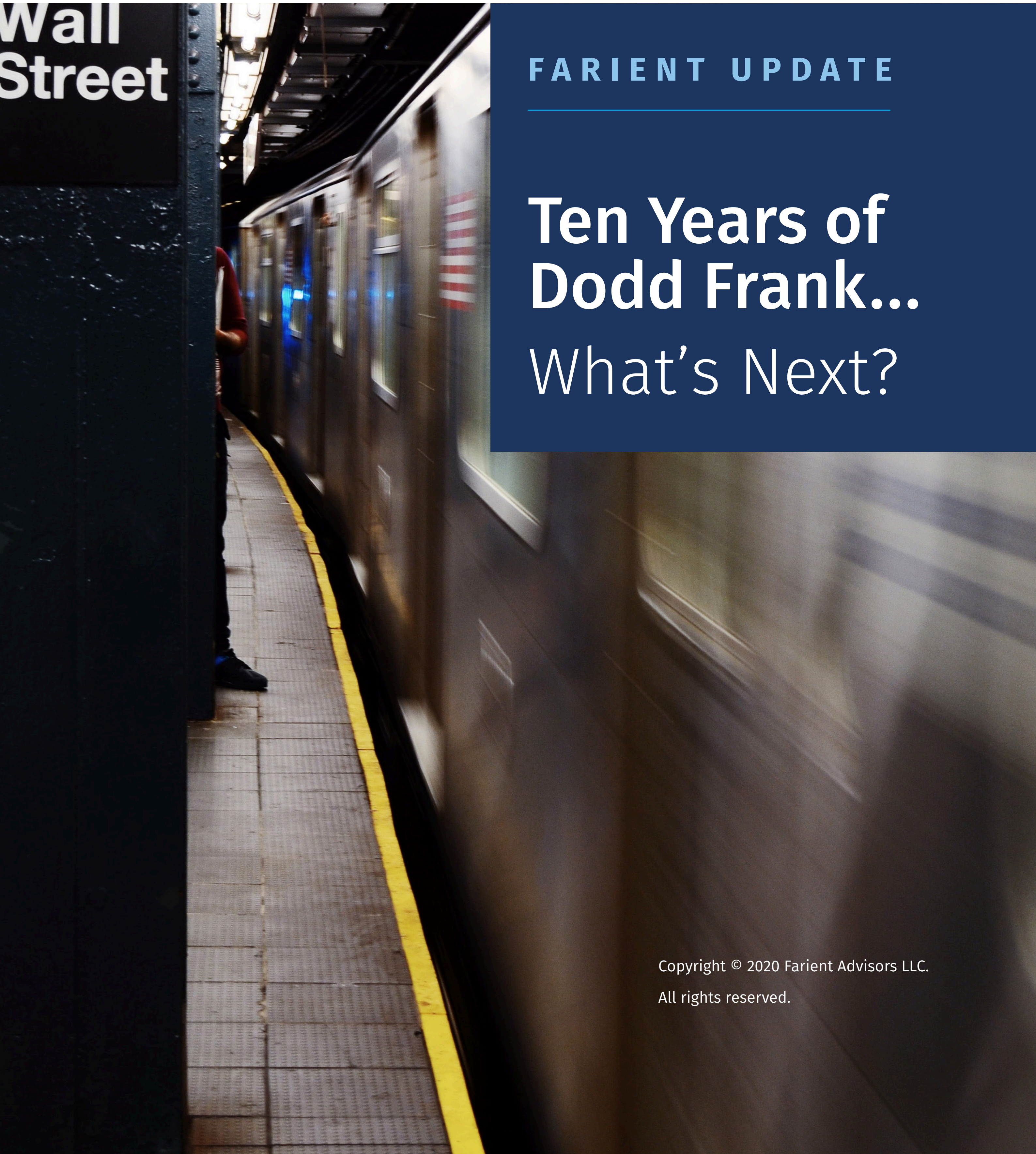


FARIENT UPDATE

Ten Years of Dodd Frank... What’s Next?

Background: **The drumbeat of crisis legislation**

Ten years ago, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) into law. Sparked by the implosion of subprime mortgages and the Great Recession of 2007-2009, Dodd-Frank became the most comprehensive set of financial rules since Sarbanes Oxley in 2002 and the Glass-Steagall Act of 1933. At roughly 2,300 pages of legislation, with 16 major areas of reform, including executive compensation, we asked ourselves, “How did the rules impact executive compensation?” “What worked?” “What didn’t?” And, “What lies ahead?”

Dodd-Frank Timeline

- 2007 – Great Recession Begins
- March 2008 – Bear Stearns avoids bankruptcy by selling for $2 a share to JP Morgan Chase & Co.
- September 2008 – Lehman Brothers files for bankruptcy
- October 2008 – President George W. Bush signs TARP
- Summer 2009 – Framework of Dodd Frank is proposed to House of Representatives
- July 2010 – President Obama signs Dodd Frank into law
- April 2011 – Say on Pay (SOP) required in proxy disclosures
- June 2012 – Dodd Frank rules requiring Compensation Committee independence and Chairman/CEO pay disclosure in proxy
- August 2015 – CEO Pay Ratio rules are implemented
- May 2018 – President Trump signs legislation to roll back parts of Dodd Frank
- June 2020 – Supreme Court rules that president can fire at will the head of the Consumer Financial Protection Bureau

A Brief History of Dodd-Frank

The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law by President Barack Obama on July 21, 2010. The Act, consisting of approximately 2,300 pages, is designed to promote financial stability, provide consumer financial protection (by preventing predatory mortgage lending), eliminate speculative trading, and improve the integrity of credit ratings. Key components of the bill focus on ensuring that independent Compensation Committees set compensation that is subject to the scrutiny and approval of investors and does not encourage undue risk-taking.

Reflecting on 10 years of Dodd-Frank

Dodd-Frank increased public and investor transparency through increased disclosures by corporations and other financial institutions such as credit rating agencies. Covering the gamut, the legislation included a variety of shareholder protections and disclosures. Where corporate power had historically rested with management, Dodd- Frank attempted to move power from the C-suite to investors, and the board on investors' behalf. The legislation included a number of executive compensation rules, of which most, but not all, have been fully implemented.

Dodd Frank Implementation Timeline

CODE	PROVISION	SUMMARY REQUIREMENTS	STATUS
951	Say on Pay	■ Non-binding shareholder vote to approve executive compensation packages ■ Determination of frequency of approval	■ Final rules 1/25/2011 - Implemented
	Say on Golden Parachutes	■ Non-binding vote to approve pay related to a change in control when a prospectus is filed	■ Final rules 1/25/2011 - Implemented
952	Listing Standards on Compensation Committee and Advisor Independence; Disclosure of use of Compensation Consultants and Conflict of Interest	■ Requires stock exchanges to adopt new independence rules for committee members ■ Provides for authority, funding and oversight of Compensation Committee advisors ■ Identifies independence factors that must be considered by Compensation Committee ■ Requires additional disclosures regarding whether the work of the compensation consultant raises any conflict of interest and how it was addressed	■ Final rules 1/20/2012 – Implemented
953	New Compensation Disclosures	■ Ratio of CEO total compensation to median total compensation of all company employees	■ Final rules 8/5/2015 - Implemented
		■ Enhanced "pay for performance" disclosure	■ Proposed rules issued in April 2015; comment period ended; still pending
954	Clawbacks	■ Requires the SEC to direct stock exchanges to adopt rules for clawbacks of executive compensation	■ Draft rules issued in April 2015; comment period ended; still pending
955	Hedging	■ Requires disclosure of whether employees or Directors are permitted to hedge equities	■ Final rules 12/18/2018 - Implemented
956	Prohibition on certain compensation arrangements	■ Disclosure of, and prohibition of, certain executive compensation structures and arrangements at certain financial institutions	■ Proposed rules issued in May 2016; comment period ended; still pending

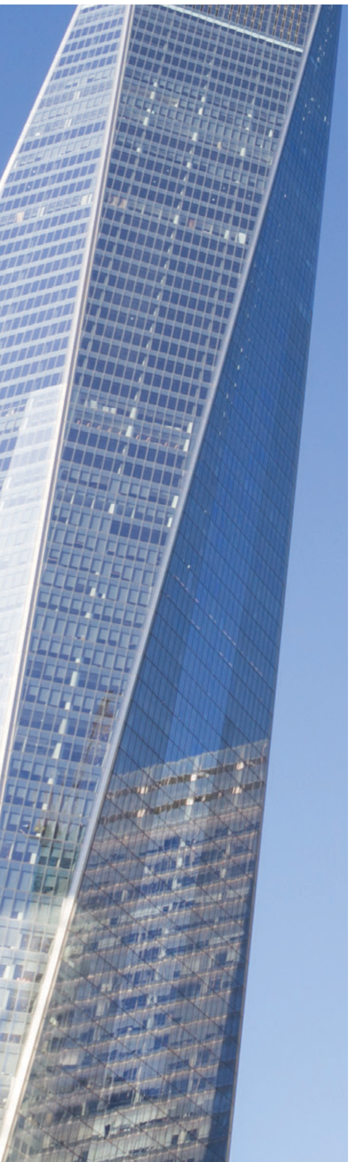
Not yet implemented

Dodd-Frank got out of the starting gates relatively quickly. By early 2011, the Say on Pay (SOP) and Say on Golden Parachutes (SAGP) rules had been implemented. Given SOP and the other compensation-related provisions in the bill, Dodd-Frank became to Compensation Committees what Sarbanes-Oxley (signed into law in 2002) was to Audit Committees. In 2012, the rules for Compensation Committee independence were finalized, pushing the Compensation Committee further into investor and corporate consciousness.

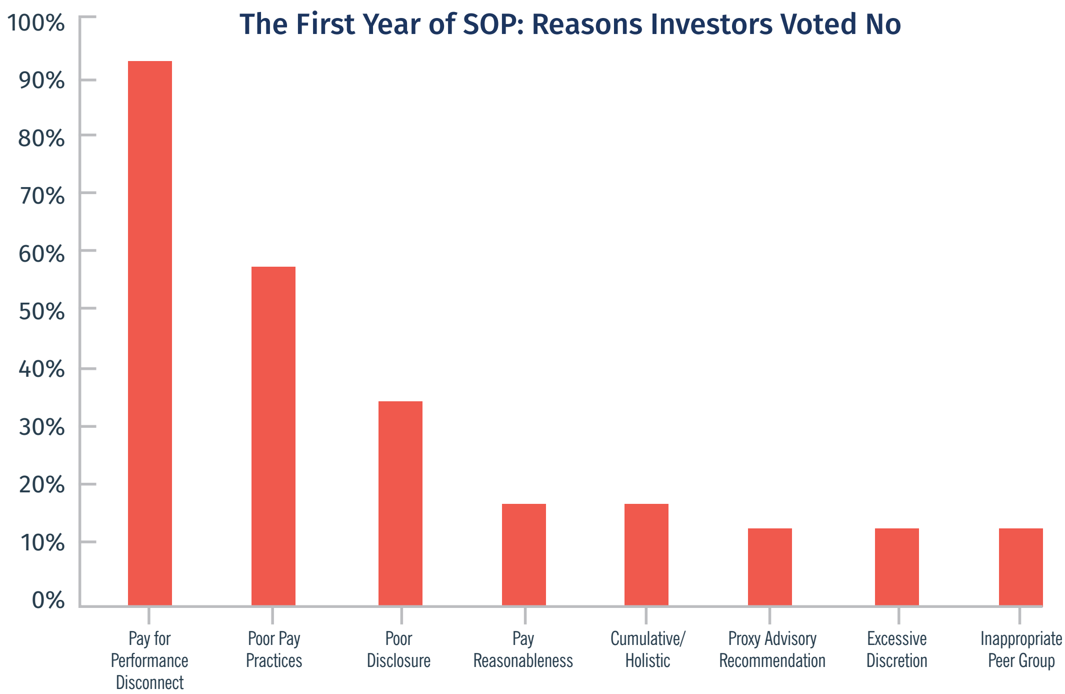
Although there were a few marquee brand companies (think back to Citigroup and HP) that failed their first SOP vote, the number of companies failing to obtain majority support on SOP was then, and remains today, relatively low. Only 1.3% of SOP votes for S&P 500 companies have failed to receive majority support in any specific year over the past 10 years, with very little change by year. Among today's S&P 500 companies, 10% have received a failing vote in at least one year in the last 10 years, and 70% have received less than 90% at least one year in the last 10 years. Moreover, many companies received "warning shots" before receiving failed SOP votes, as shown in the chart below.

SOP Results In Year Prior to Failed Vote

Less than 50%	Between 50% and 90%	Greater than 90%
18%	36%	45%



Following the first year of Say on Pay, Farient was engaged by the Council of Institutional Investors (CII) to work closely with investors to better understand "Why Investors Voted No." The published report coalesced shareholder thinking around corporate pay practices - what was acceptable and what was not. The findings from this research helped board members and C-suite executives address targeted initiatives for improving their executive pay practices, structures, and policies. This research essentially became the baseline for investor engagement and reforms.



Source: Farient/CII Report: Say on Pay, Identifying Investor Concerns

What worked

Despite the fact that Dodd-Frank has not yet been fully implemented, and the SOP vote for US companies is non-binding, one could argue that Dodd-Frank has improved the reliability and safety of the capital markets. This is because it is often the intent of the law, and not the letter of the law, that is most meaningful. As investor voices continue to be amplified through their trillions of dollars of global holdings, as well as their voting power and strength in numbers through investor coalitions such as CII and the International Corporate Governance Network (ICGN), shareholders now have a powerful influence on how corporations dispatch their responsibilities around pay levels, design, practices, policies, processes, and disclosures. More specifically, the primary changes that are largely attributable to Dodd-Frank and the SOP vote include:

- **Compensation Committee independence, not just in form, but in substance:** Compensation Committees are not only more independent today on paper, but they are more independent in the way they behave. For example, they meet regularly around disciplined agendas. They routinely consider CEO pay with separate materials focused on the CEO. And they almost always call for an executive session as part of every meeting. Compensation Committees also are more inclined toward hiring their own independent consultant who is accountable to the board. This is a far cry from prevalent practices of 10 years ago

- **Elimination of most problematic pay practices:** Investor influence and the SOP vote has all but eliminated what many shareholders view to be poor pay practices, such as excise tax gross ups, evergreen contracts, excessive severance arrangements, and single trigger change in control provisions. These provisions help to eliminate the excesses created by asymmetric plan provisions (heads I win, tails you lose) that disproportionately favor executives at the expense of shareholders

- **More complete, transparent disclosures:** While some may argue that disclosures have gone overboard with voluminous proxy reports that border on obfuscation, most disclosures contain clearer messages and a better roadmap for following these messages. After all, shareholders want to understand the details of their portfolio companies' pay plans and they want proof points that management's interests are aligned with their own

- **Engagement between corporations and investors:** The SOP vote encouraged boards and investors to communicate directly with one another. In the old days, investors only spoke with portfolio managers. There were no governance professionals with whom to talk. When governance professionals first appeared on the scene in investor organizations, boards were somewhat hesitant about talking with them. Today, engagement with the governance side of the investor house is on most corporate agendas. This direct communication has led to some convergence on how to bridge corporate and investor perspectives, with influence rather than votes being the primary instrument for change. Investors tend to escalate to “No” votes, first on SOP and then on Director elections, if shareholder engagement does not result in desired outcomes

- **Use of mechanisms, besides pay, to obtain alignment between executives and shareholders:** Clawbacks and ownership guidelines, both mechanisms to align management with shareholder interests, have become widespread. Clawbacks have become nearly universal despite the fact that the Dodd-Frank clawback rules have not yet been implemented. Moreover, many companies have instituted clawbacks that go beyond the Dodd-Frank preliminary rules by allowing companies to discretionarily claw back incentive pay in instances of management misconduct. These trends are a case in point as to how the spirit of the law can be more powerful than the letter of the law and how informal investor engagement can be a powerful influencer

Future frontiers: **There's more work ahead**

Dodd-Frank helped to get the ball rolling on a number of reforms, and in fact, corporations are now leading the charge in some of these arenas, like clawbacks. However, Dodd-Frank has not been fully implemented, and since the adoption of Dodd-Frank, new issues have arisen that Dodd-Frank never even contemplated. As a result, there is still considerable work that lies ahead. Key areas of concern are achieving reasonable pay for performance alignment and paying for the delivery of stakeholder, not just shareholder, value.

- **Pay for performance alignment:** In our 2019 Global Trends in Corporate Governance Research, *Seven Lessons from Engaged Investors*, global investors reported continued frustration around pay quantums (at least for the "outliers") and pay for performance disconnects, which are still the most frequently cited reasons for "No" SOP votes. Diagnostic tools, like Farient's Pay for Performance Alignment Reports™ (PARs™), exist to gauge the long-term pattern of alignment between a company's management and its investors. Clearly, Dodd-Frank and SOP votes have not completely solved pay and performance alignment issues, and there is more work to be done in this regard

- **Paying for stakeholder, not just shareholder, value:** Greater shareholder value is created by sustaining performance above the cost of capital over a very long-time (e.g., 20 years), not just the foreseeable future (e.g., 3 years). However, our planet is being severely compromised environmentally, which threatens the ability of corporations to generate healthy cash flows over the long-term, and adversely impacts the quality of life for all of earth's inhabitants. As a result, investors are looking for evidence that companies are paying sufficient attention to Environmental, Social, and Governance (ESG) concerns. In other words, ESG is a kind of shorthand for predicting the ability of businesses to create value for stakeholders over the long-term. As a result, companies will need to identify ways in which performance can be measured against broader interests.

Final thoughts

Dodd-Frank accomplished some, but not all, of what it set out to do. While Dodd-Frank attempted to shift power from the C-suite to investors, and on their behalf, the board, the robust economy has created a white hot labor market for executive talent, which in turn, has helped executives retain considerable power. Against this reality, we have the backdrop of social injustice and the ever widening divide between pay at the top and the bottom. If we are not careful, this set of circumstances could put us on a collision course toward even more legislation, particularly with a presidential election just around the corner. We've seen it happen in other venues. Countries like Australia and Switzerland, for example, have SOP regulations with sharp teeth compared to the non-binding SOP rules in the U.S. (see sidebar).

To avoid this outcome, boards and their Compensation Committees, management, and investors all have a role to play.

- **Boards and their Compensation Committees:** Boards, for their part, should seek to fill the top chairs in the company with evolved leaders who are working at the company because of its purpose. These leaders will not leave the company for the next marginal dollar of pay. Compensation Committees, on behalf of boards, should seek to establish disciplined and fair pay, while avoiding excesses. They should view executives who demand unreasonable pay as being potentially damaging to the ethos of the company
- **Management:** Management should respect the independence of the Compensation Committee and their right to choose their advisors. In turn, management has a right to expect fair target pay, while letting the performance take care of what is actually earned
- **Investors:** Investors should use their judgment, being careful not to apply overly prescriptive, rule-based algorithms for determining their SOP votes. For example, while ESG measures may be appropriate for some companies' incentive plans, they will not be suitable for all. Investors should allow companies to choose what measures are right for them, as long as the companies articulate a compelling rationale

Australia and Switzerland: Tough on Say on Pay

Australia's 'Two-Strikes' Law is designed to hold directors accountable for executive salaries and bonuses. It means an entire company board can face re-election if shareholders disagree with how much executives are being paid. The law is an amendment to Australia's Corporations Act and came into effect on July 1, 2011.

- **First strike:** The 'first strike' occurs when a company's remuneration report, which outlines each director's individual salary and bonus, receives a 'no' vote of >25% at the company's annual meeting
- **Second strike:** The 'second strike' occurs when a company's remuneration report the following

year also receives a ‘no’ vote of ≥25%. When a ‘second strike’ occurs, the shareholders will vote at the same annual meeting to determine whether all the directors will need to stand for re-election. If this ‘spill’ resolution passes with ≥50% of eligible votes, then a ‘spill meeting’ will take place within 90 days

- **Spill meeting:** At the spill meeting, those individuals who were directors when the directors’ report was considered at the most recent annual meeting will be required to stand for re-election (other than the managing director, who is permitted to continue to run the company).

Switzerland’s Minder Initiative, signed into law in 2013, is the most aggressive say on pay jurisdiction in the world. Approximately 68% of Swiss voters approved a people’s referendum against “corporate rip-offs.” The Initiative provides for *binding* say-on-pay votes in Swiss public companies, which must provide for an annual vote on the total sum of all consideration (money or value given in kind) to be paid to the management board, the company management, and the advisory board. Board members are barred from receiving severance or other compensation, advance payments, bonuses for acquisitions or sales of firms, or advisory or employment contracts. Violations are punishable by 3 years’ imprisonment and forfeiture of 6 years’ salary.

At the end of the day, boards, management, and investors all can be powerful contributors to carrying out the intent of Dodd-Frank. Adhering to the spirit of the law, even without the complete implementation of the law, will help obviate the need for even more legislation. Setting pay through this lens will result in companies that will be more reliant on purpose, and less on pay, for attracting and retaining the right talent for building long-term, sustainable stakeholder value.