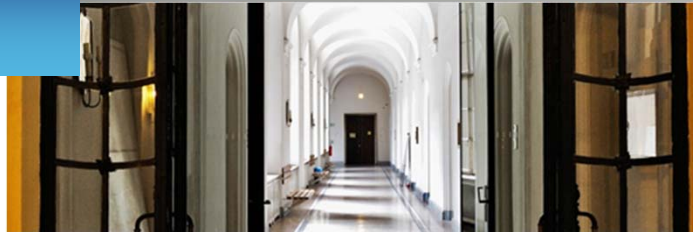


Financial Regulatory Reform: Reform Arrives in the Boardroom



The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”) touches nearly every part of the financial industry; this paper focuses narrowly on those corporate governance provisions that alter dynamics between shareholders and directors. The majority of these changes relate to executive compensation, but also touch on such issues as director elections and incentives for whistleblowers. In this paper we present a brief overview of the Act’s key corporate governance provisions and provide BlackRock’s perspective on each.

Executive Compensation Provisions

Independent Compensation Committees. The Act requires that the listing standards of national securities exchanges and national securities associations (the “listing standards”) be amended to mandate that the compensation committees of listed companies be comprised solely of independent directors. This rule does not apply to certain listed companies, such as investment companies and controlled companies. This provision will be effective once the listing standards are amended in accordance with the Act.

This new standard is consistent with BlackRock’s proxy voting guidelines for independence of key board committees (i.e. audit, nominating, and compensation committees). BlackRock believes that all of the key board committees should consist solely of independent directors to ensure that these vital functions are fully aligned with shareholders. BlackRock’s standards on committee independence are consistent with most large institutional investors and listing standards already require this of most companies. As a result, most issuers already have fully independent compensation committees, so we do not anticipate that this provision will cause a change for most boards.

Additionally, we note the Act amends the Securities Exchange Act of 1934 to provide that compensation committees have the power to hire compensation consultants and other advisers.

What’s Inside

Information on the Dodd-Frank Act’s impact on:

- ▶ Executive Compensation
- ▶ Compensation Disclosure Requirements
- ▶ Shareholder Nominated Directors
- ▶ Whistleblower Policy

This is a power that is already commonly granted by compensation committee charters, but the regulatory change makes this a more prominent best practice.

Voting on Executive Compensation

Say on Pay. The Act requires that public issuers present their shareholders with a non-binding vote to approve executive compensation at least once every three years, and receive shareholder approval of the frequency of such votes at least once every six years. Such votes on executive compensation are commonly referred to as “say on pay”. The Act does not indicate what shall happen if a majority of shareholders vote against the say on pay proposal, but does indicate that the say on pay vote does not represent an overruling of board decisions or create or imply any change to the fiduciary duties of the board. In essence, Congress has given boards the leeway to ignore the results of a shareholder say on pay vote.

Although market-wide mandated say on pay is a new development, BlackRock has a well established policy regarding

Companies Voluntarily Giving Shareholders Non-binding Votes On Compensation

Aflac	MBIA
Ameriprise Financial	Microsoft
Apple	Motorola
Bank of America	Occidental Petroleum
Bank of New York Mellon	Pfizer
Blockbuster	PG&E
Colgate-Palmolive	Prudential
ConocoPhillips	State Street
Frontier Communications	Tech Data
Goldman Sachs	Tupperware Brands
Honeywell International	Valero Energy
Intel	Verizon
Jones Apparel Group	Wells Fargo
Lexmark International	Yum! Brands

Source: RiskMetrics, BlackRock
As of 18 August 2010

say on pay. While some companies may have egregious pay packages, BlackRock believes that board members, rather than shareholders, should be accountable for determining the appropriate model to connect pay and performance. Board members have significantly more information regarding the incentives that will best motivate an executive and the business plan that the executive is responsible for implementing. As a result, BlackRock believes that compensation committees should have flexibility in structuring executive compensation, and should be held accountable for their conclusions. BlackRock votes against members of an issuer's compensation committee when BlackRock determines that the executive compensation at a company is excessive in light of the company's performance relative to peers. BlackRock's analysis of, and vote on, say on pay proposals mirrors its vote on compensation committee members. BlackRock is concerned that say on pay may insulate boards by directing shareholder votes on pay toward non-binding resolutions rather than toward election of compensation committees who are responsible for setting pay. BlackRock is further concerned that shareholders are likely to be perceived as "signing off" on pay packages through their vote on say on pay proposals which would further insulate the board from "withhold"/"against" votes if shareholders "approve" pay packages that later turn out to have been faulty. In an effort to mitigate these impacts, Congress has allowed for these proposals to come before shareholders as infrequently as every 3 years. In our opinion, even this is an unhealthy outcome for shareholders.

Golden parachutes. The Act also requires that companies seeking shareholder approval of a merger, acquisition, asset sale or similar corporate transformation ask shareholders to approve any "golden parachute" arrangements that will be triggered by such change. This vote is not required if shareholders have previously reviewed the golden parachute arrangement in the course of a say on pay vote. This provision may contain a significant loophole, as the Act does not require that the shareholders have previously approved the golden parachute as a component of an executive compensation package, merely that they have reviewed it. As such, it seems unlikely that shareholders will often have the chance to vote on such standalone golden parachute proposals. As with say on pay, the Act makes clear that the golden parachute proposal is non-binding and is not intended to force a change in the decisions of the board.

As with executive compensation generally, BlackRock believes that golden parachutes, as a component of executive compensation plans, are best reviewed and assessed by a board's compensation committee, rather than by shareholders. However, we do believe that shareholders should have a binding vote to approve golden parachute plans that would exceed 2.99 times an executive's current compensation because of the potential economic loss related to tax treatment associated with such a package.

We note that many issuers choose to disregard non-binding proposals approved by shareholders, so these say on pay and golden parachute votes are unlikely to be effective in changing the structure of executive pay packages. It would appear that Congress's goal was to provide an opportunity for shareholders to have their voice be heard, without risking a disruption of contractual arrangements and distracting management.

Expanded disclosure requirements. All institutional filers of 13(f) quarterly reports on equity holdings will be required to disclose at least annually how they voted on say on pay and golden parachute proxy proposals. Mutual funds and exchange traded funds are already required to disclose their full proxy voting record on an annual basis. As such, BlackRock's voting position on almost all issuers held in our various portfolios is already public. This provision will not drive a change in BlackRock's policies or voting decisions, which will continue to be driven by the economic best interests of shareholders.

These provisions will be effective January 2011.

Median Compensation Ratio. The Act instructs the Securities Exchange Commission (the "SEC") to establish a rule requiring companies to disclose the median total annual compensation of all employees excluding the chief executive officer alongside the annual total compensation of the chief executive officer, and the ratio of these two amounts. While this reflects populist sentiment and public distrust regarding executive compensation, BlackRock does not believe that this additional information will be additive to our analysis of executive compensation. This provision of the Act raises many challenging questions that will need to be clarified in implementing regulations. For example, how should the pay packages of non-US employees be integrated into the calculation, and should contractors be included in the calculation. Depending on these answers and the composition of a given firm, we expect the median pay, and the ratio of median pay to CEO pay, to vary widely without providing meaningful information for investors.

Executive Compensation and Total Shareholder Return. The Act requires the SEC to establish a rule requiring companies to calculate and publicly disclose in their proxy statement information showing the relationship between executive compensation actually paid and any change in total shareholder return (value of shares including dividends and distributions). This information is already generally available to institutional investors through proxy advisory services, and is a useful guide when assessing the connection between pay and performance. BlackRock believes that this information is also already addressed in the compensation discussion and analysis section of most issuers' proxies. This additional disclosure requirement should not represent a significant burden to issuers and will be helpful to shareholders.

Independent Board Advisers. The Act highlights the influence of advisers to boards by requiring the SEC to establish factors that boards must consider prior to selecting a compensation consultant, legal counsel or other adviser. The new requirements will focus boards on the independence of their advisers and possible sources of conflicts of interest. BlackRock believes that all well-governed boards should be sensitive to the independence of their advisers and that this additional requirement will essentially remind boards of their existing fiduciary responsibilities.

Compensation Claw Back Policy. The Act requires the establishment of new listing rules that will require companies to adopt policies to recoup any excess incentive based compensation that is paid out based on financial information that is in material noncompliance with securities laws. This provision applies to all executives regardless of whether they were responsible for the inaccuracies. BlackRock believes that claw back policies like those required by this new rule are generally in the best interest of shareholders and we have long supported them through our voting at companies.

Hedging of Executive Stock Holdings. The Act requires disclosure in proxy materials of whether any employee or board member is permitted to hedge their exposure to equity securities that are granted to that individual as compensation or are otherwise held by that individual. This rule is intended to address the potential for employees and board members to decouple their ownership interest in a security from its economic volatility. Such decoupling could have the effect of reducing any incentive component of equity compensation. Such hedging could also allow an employee or board member to disclose in a public filings a large holding of an issuer's equity that creates an illusion of economic alignment with the interests of other shareholders when, in fact, that individual's holdings did not represent an ongoing economic stake in the future of the issuer. BlackRock believes that such hedging arrangements are destructive to the incentive structures underlying many executive compensation packages. This additional disclosure will be helpful to shareholders when assessing board oversight of management, the appropriateness of an executive compensation package, and management's alignment with shareholder interests.

Incentivizing Risk at Financial Institutions. The Act requires that the various federal regulators of certain large financial institutions (such as FDIC insured depository institutions, broker-dealers, and credit unions with more than \$1 billion in assets) jointly develop regulations (by April 2011) that require disclosure to regulators of sufficient information regarding compensation structures to assess whether the compensation structure results in excessive compensation or could lead to material financial loss at the institution and prohibits such structures. This provision strikes at the concern that financial institutions may structure pay in a way that incentivizes inappropriate risk taking. It also addresses popular concern regarding perceived excessive pay at financial institutions.

BlackRock believes that it will be difficult to develop appropriate regulations consistent with this new requirement. It is unlikely that any public company would intentionally structure its compensation model in a way that incentivizes undue risk. Such inappropriate incentives are often more apparent in retrospect. Investors know that investing is an inherently risky activity that bears the risk of some or all invested capital. We are concerned that such regulations not unduly restrict management's incentives to take a healthy amount of risk, which is necessary for a company to innovate and grow.

Non-Compensation Governance Provisions

Shareholder Nominated Directors. One of the most significant provisions in the Act is a revision to the proxy rules to make explicit reference to the concept popularly referred to as "proxy access". Proxy access refers to the ability of shareholders to include their board nominees on an issuer's proxy statement, even if the nominating committee of the board does not support the nomination, in effect creating a competitive election for corporate board seats. The Act does not specify the rules to enable or restrict such access to the proxy. Instead, the Act permits, but does not require, that the SEC issue rules permitting proxy access. The SEC was already in the process of reviewing proposed rules regarding proxy access, a shareholder right that the SEC has contemplated several times over the last decade. This provision of the bill is likely to enable the SEC to overcome a legal challenge that may have successfully called into question the SEC's right to promulgate such rules.

BlackRock believes that proxy access is a valuable right for shareholders confronted with an unresponsive board, provided that the rules permitting proxy access are sufficiently restrictive. In most circumstances, proxy access represents an unacceptable distraction to management and could result in disruption of a high quality board. However, if a company or a board has taken actions that indicate a lack of attention to shareholder rights, we believe that a large, long-term investor in the company should be able to propose an alternative director or directors without undertaking the burdensome expense of launching a proxy contest. We also believe it is important that any regulations permitting proxy access include barriers to the abuse of proxy access as a takeover mechanism or other lever for agendas that are not broadly supported by shareholders.

On August 25, 2010, the SEC adopted new rules enabling proxy access, which were originally scheduled to take effect for most listed issuers by November 2010. The SEC has delayed the effectiveness of the proxy access rules due to a legal challenge by the U.S. Chamber of Commerce and the Business Roundtable. It is unclear when, or if, the rules will take effect.

The rules authorize a shareholder who has held at least 3% of the voting power in a company for at least 3 years to submit their board nominees to shareholders. The rule's holding requirements and another provision that bans the use of the proxy access mechanism by investors seeking a change of

control of the board make it less likely that the proxy access right will be abused. Although we believe a more restrictive structure for proxy access could have provided additional protections against abuse, we generally support this rule as balanced and reasonable.

Broker Uninstructed Share Votes. The Act prohibits brokers from voting shares that they do not beneficially own in director elections. This ban on broker voting of uninstructed shares is already a reality for most brokers as a result of changes instituted by the SEC in 2009. Although the implementation of restrictions on broker votes raised many concerns in the issuer community, our experience of the 2010 proxy season did not reveal any major issues as a result of the absence of broker votes. The rule does not apply to votes at investment companies (such as mutual funds and exchange traded funds), which face federally mandated quorum requirements and might have greater difficulty meeting such quorum requirements if they were subject to this rule.

The Role of Chair and CEO. The Act requires that companies include in their proxy materials disclosure regarding why the board has chosen to have a separate or combined chair and CEO. The Act does not indicate a preference or bias regarding either structure. BlackRock believes that it is important for independent directors to have a strong leader in the boardroom. However, we do not believe that this leader must also be the board chair. We believe that each board should have the opportunity to review its own circumstances to determine how best to structure the role of board chair and leadership of the independent directors. This new disclosure is unlikely to add much as the SEC already required boards to explain where relevant why a company has chosen to combine the roles of chair and CEO.

This provision will be effective by February 2011.

Incentivizing Whistleblowers. The Act establishes additional protections and new incentives for whistleblowers who provide the Commodities Futures Trading Commission (the "CFTC") or the SEC with information that results in successful SEC

enforcement action. In such circumstances, whistleblowers will now be eligible for 10-30% of the monetary sanctions collected by the CFTC or SEC in excess of \$1 million. The amount will vary based on the circumstances; employees of registered entities, futures associations and self-regulatory organizations are not eligible. This is a significant incentive for whistleblowers to provide information regarding wrongful conduct to regulators. BlackRock believes that whistleblowers represent an important source of information to regulators and that encouraging individuals with knowledge of wrongful conduct to reach out to regulators is generally protective of shareholder interests. However, the accompanying regulations must discourage unfounded reports in order to avoid unproductive investigations that distract management.

This provision will be effective by April 2011.

Looking Ahead

The Act contains several provisions pertaining to corporate governance. Some merely codify existing practices or will have marginal impact on companies, while others raise the risk of unnecessary distraction for management and boards. We support the importance of director independence, transparency regarding compensation practices, and the appropriate management of risk. We are concerned that certain provisions, such as proxy access and some of the more granular executive compensation disclosures, may not function quite as intended. However, it is our hope that all of these new provisions will serve to motivate companies to adopt best practices with regards to governance.

Many of the corporate governance related components of the Act are not due to take effect for many months, and they may be further delayed by the regulatory rulemaking process. We will monitor these provisions as they take effect and will evaluate the final rules for their impact on BlackRock as an investor. We will continue to exercise our shareholder rights consistent with our role as a fiduciary acting on behalf of our clients – with the goal of acting in their best long term economic interests.

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