

# ClientAlert

## Financial Markets Developments

July 2010

### [Dodd-Frank Wall Street Reform and Consumer Protection Act](#)

## Corporate Governance and Executive Compensation Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act

In response to the recent financial crisis, on December 12, 2009, the US House of Representatives passed the Wall Street Reform and Consumer Protection Act of 2009 (the "House Bill"), and, on May 20, 2010, the US Senate passed the Restoring American Financial Stability Act of 2010 (the "Senate Bill"). Both Houses of Congress worked to reconcile the House Bill and the Senate Bill, resulting in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act") that was signed into law by President Obama on July 21, 2010 and represents the most comprehensive financial reform since the Great Depression. The Dodd-Frank Act covers a variety of topics, including consumer protection, derivatives, hedge funds and the regulation of the financial industry. This client alert focuses on the corporate governance and executive compensation aspects of the Act, including broker discretionary voting, proxy access, disclosure of leadership structure, say-on-pay shareholder votes, shareholder approval of golden parachutes, compensation committee independence requirements, compensation ratio disclosure, mandatory compensation clawback policies, and certain requirements applicable to covered financial institutions and smaller issuers, and discusses some practical implications they may have on publicly traded companies.

### Corporate Governance

#### [Proxy Access \(Section 971\)](#)

##### Summary

The Act adopts the proxy access provisions of the Senate Bill without significant changes. The Act expressly authorizes, but does not mandate, the SEC to issue rules that would implement a proxy access regime for companies that are subject to the proxy solicitation rules of the US Securities Exchange Act of 1934, as amended (the "Exchange Act"). As a result, any proxy access rules adopted would not impact foreign private issuers.



Client Alerts on topics covered in the Dodd-Frank Act are available by clicking on the links below:

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#### **What is proxy access?**

Proxy access refers to the right of shareholders of a company to include their nominees for the board of directors in the company's proxy solicitation materials, thereby enabling shareholders to avoid the significant costs and procedural challenges that would otherwise be involved in proposing a nominee for the board of directors. Currently, no US state requires proxy access other than North Dakota, which permits a five percent shareholder who has held its shares for at least two years to nominate a director.<sup>1</sup> A number of US states, including Delaware, have amended their corporate laws to permit, but not require, proxy access.<sup>2</sup>

#### **What is the state of proxy access from the SEC's perspective?**

The SEC proposed proxy access rules in June 2009.<sup>3</sup> The proposed rules provided that certain requirements must be met before granting shareholder proxy access. Specifically, a shareholder would be entitled to include the greater of one nominee or 25 percent of the board in the company's proxy statement if such shareholder owned a certain percentage of the shares of a company (which ranged from one to five percent depending on the company's size) for at least one year prior to proxy notice. The June 2009 proposal was highly controversial and raised concerns that proxy access may empower activist investors and special interest groups to manipulate board compositions and interfere with management to promote their own short-term agenda and not the long-term value of a company, including possibly paving the way for a hostile takeover. It also contained a number of potential flaws including the fact that the first shareholders to submit their proposals would gain priority over larger shareholders who submitted proposals after them.

#### **What does the Act actually achieve if it does not mandate proxy access?**

The Act's express authorization of SEC rulemaking on proxy access significantly lowers the risk of a successful challenge to the constitutionality of any future SEC rules in this area. Absent Congressional authorization, it could be argued that board nomination procedures fall among a category of activities relating to corporations and corporate governance that are quintessentially state-law governed. However, there is more certainty that, under the Constitution's Commerce Clause, Congress may authorize the SEC to regulate certain aspects of corporate governance for public companies.

The Act also serves to keep the issue of proxy access alive and on the SEC's agenda. The SEC may ultimately find itself having to justify why it has not used the authority granted to it by Congress if it fails to move forward with some form of proxy access proposal. Nevertheless, it should be noted that a Senate proposal

to impose a three year holding period and a three percent aggregate ownership threshold was rejected by the House at the last stages of the negotiations, leaving these parameters open for the SEC to finalize as part of its rulemaking.

Finally, the Act specifically states that the SEC should consider whether any proxy access rules disproportionately burden smaller issuers when exercising its exemptive authority from any new rules. This provision should give solace to small issuers who will likely benefit from an exemption or lesser application of any proxy access rules.

### **Broker Discretionary Voting (Section 957)**

#### **Summary**

The Act essentially adopts the Senate Bill's provision on broker voting, by requiring each national securities exchange to adopt rules prohibiting broker discretionary voting in connection with a shareholder vote on "the election of directors, executive compensation, or any other significant matter, as determined by the Securities and Exchange Commission, by rule."

#### **What is discretionary voting?**

Under the New York Stock Exchange (NYSE) rules, brokers holding a company's shares in street name are required to deliver proxy material to beneficial owners and to request voting instructions. If a broker does not receive voting instructions from the beneficial owner by the tenth day preceding the meeting date, the broker may vote those shares on matters considered by the NYSE to be "routine" (e.g., ratification of a company's independent auditors), but not on matters considered to be "non-routine" (e.g., director elections).<sup>4</sup> The authority to vote uninstructed shares is frequently used to establish a quorum at shareholder meetings.

#### **How do the Act's prohibitions on discretionary voting relate to the NYSE's prohibitions that became effective earlier this year?**

This requirement duplicates in part changes to the NYSE rules that became effective on January 1, 2010 and which prohibit brokers from voting in uncontested director elections without explicit voting instructions.<sup>5</sup> The Act now extends this to "executive compensation" and other matters to be designated by the SEC.

#### **What are the implications of the expanded prohibition on discretionary voting?**

The most immediate implication is that the say-on-pay vote mandated under the Act (discussed below in more detail) will not be subject to discretionary voting. As a result, broker nonvotes will not be available to be cast in favor of executive pay packages, which will make it more difficult to obtain majority support for executive pay packages.

#### **How do the rules impact foreign private issuers?**

The change does not impact foreign private issuers because they are not subject to US proxy rules.

#### **When will the prohibition on discretionary voting become effective?**

The provision became effective upon the Act's enactment; however, there is no deadline specified for the SEC or the exchanges to implement rules prohibiting discretionary voting in the circumstances required.

#### **Board Leadership Structures (Section 972)**

##### **Summary**

Adopting the Senate Bill's language, the Dodd-Frank Act calls for the SEC to issue rules that would require a company to explain in its annual proxy materials why it has chosen to either combine or separate its chairman of the board of directors and CEO positions. The SEC is to issue the board leadership structure rules no later than January 17, 2011.

#### **How does the Act's new disclosure requirement relate to the enhanced disclosure requirements already adopted by the SEC in December 2009?**

The new requirement does not appear to alter in any material way the current regulatory regime. Disclosure of the reasons that the chairman of the board and CEO positions are filled by the same person is already required pursuant to the enhanced proxy disclosure rules issued by the SEC in December 2009.<sup>6</sup> The principal difference is that disclosure will also be required under the new rules if the roles are split.

#### **How will disclosure impact board practices?**

It seems unlikely that disclosure will result in any significant changes. Recent data from RiskMetrics for the 2010 proxy season indicates that shareholder proposals requiring an independent board chairperson averaged 28.9 percent support at 36 annual meetings, down from 38.8 percent in 2009.<sup>7</sup> The SEC's enhanced disclosure requirements may have contributed to lower shareholder support. Furthermore, a majority of Fortune 500 companies still have a combined CEO/Chairperson and shareholders only appear to find this of significant concern if the company does not have a lead independent director to counterbalance the CEO/Chairperson or if the company has significant performance issues.

#### **Sarbanes-Oxley Act of 2002 Section 404 Exemption for Non-Accelerated Issuers and Smaller Reporting Companies (Section 989G)**

##### **Summary**

Section 404(b) of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act") will be amended to exempt non-accelerated filers and smaller reporting companies from the requirement to provide an auditor attestation report on the effectiveness of internal control over financial reporting.

#### **Which companies will be impacted by this change?**

Non-accelerated filers are Exchange Act reporting companies with a worldwide unaffiliated market capitalization of less than US\$75 million. The definition includes, but is not limited to, smaller reporting companies. Under the current regime, the SEC allowed non-accelerated filers to postpone their compliance with the requirements of Section 404 of the Sarbanes-Oxley Act. In October 2009, the SEC issued the last deferral and under the existing regime, non-accelerated filers were required to include an auditor's attestation report in their annual reports for fiscal years ending on or after June 15, 2010. However, compliance costs associated with being a public company subject to the requirements of the Sarbanes-Oxley Act have been a focus of debate since the Sarbanes-Oxley Act's enactment.<sup>8</sup> Under the new rules, non-accelerated filers will be permanently exempt from having to comply with the requirement to file an auditor attestation report on management's assessment of internal control over financial reporting.

#### **Do non-accelerated filers still need to include a report from management regarding the effectiveness of their internal control over financial reporting?**

**Yes.** The Act does not provide non-accelerated filers with relief from compliance with Section 404(a) of the Sarbanes-Oxley Act. It will nonetheless reduce compliance costs for non-accelerated filers by removing the attestation requirement.

#### **Majority Voting in Uncontested Director Elections**

##### **Summary**

A provision requiring majority voting in uncontested director elections was included in the Senate Bill, but failed to make it through the negotiations for the Act.

#### **How will the failure to include mandatory majority voting in uncontested elections impact market practice?**

According to RiskMetrics, 69.9 percent of S&P 500 firms now have majority voting provisions, while just 34.7 percent of S&P 1,500 issuers have such policies.<sup>9</sup> While most companies may decide to retain their majority voting requirements, the Act will continue to allow companies and shareholders flexibility in devising their majority voting policies.

## Whistleblower Protection and Incentives (Section 922)

### Summary

The Dodd-Frank Act creates a complex new regime to incentivize whistleblowers and protect them from retaliation. Under the Act, the SEC is authorized to make a payment to any individual or individuals who provide original information to the SEC that leads to a successful judicial or administrative action brought by the SEC resulting in the imposition of monetary sanctions in excess of US\$1 million. The amount of the payment is between 10 percent and 30 percent of the monetary sanctions, the percentage to be determined by the SEC based on the level and type of assistance provided by the whistleblower. The Act establishes a fund containing monies collected pursuant to sanctions up to a maximum of US\$300 million to provide a source for payment to whistleblowers.

The Act prohibits employees from retaliating against whistleblowers and permits an employee who has been the subject of retaliation to bring a claim for reinstatement, two times back pay and legal expenses.

### How do the new provisions differ from those contained in the Sarbanes-Oxley Act?

While Section 806 of the Sarbanes-Oxley Act provides protections from retaliation against whistleblowers, it did not provide them with monetary incentives to come forward. In addition, while the Sarbanes-Oxley Act provided for reinstatement and back-pay plus interest and reimbursement of legal expenses, the Act provides for two times back pay.

### What are the implications of the new whistleblower provisions?

The new provisions of the Act make it even more important for companies to avoid retaliation against whistleblowers. More than that, the new provisions may unfortunately create an incentive for employees to bypass a company's corporate compliance mechanism (which is unlikely to provide any significant monetary reward for reporting noncompliance) and report any issues immediately to the SEC (in the hope of garnering a reward). In fact, since an employee only receives a payment for "original information," the employee is further incentivized to avoid reporting any information to the issuer, lest it self-report to the SEC, thereby precluding the whistleblower from providing original information to the SEC.

### When will the new whistleblower provisions become effective?

The provisions are effective immediately; however, the SEC is directed to issue rules implementing them by April 22, 2011.

## Executive Compensation

### Say-on-Pay—Approval of Named Executive Officer Compensation (Section 951)

#### Summary

The Dodd-Frank Act narrows the say-on-pay provisions of both the House and Senate Bills. It requires that, at least every three years (rather than annually), each company that is required to provide executive compensation disclosure pursuant to the SEC's proxy rules must include a say-on-pay vote in its proxy statement with respect to the compensation of the company's named executive officers. Further, in a separate non-binding vote held at least once every six years, shareholders will be able to determine the frequency of the say-on-pay vote (e.g., every one, two or three years). Finally, institutional shareholders subject to Section 13(f) of the Exchange Act will be required to report annually how they voted in any say-on-pay vote.

#### What is say-on-pay?

A say-on-pay vote is a non-binding advisory vote on executive compensation which affords a company's shareholders the opportunity to make their views known on a company's executive compensation pay and practices.

#### Does say-on-pay already exist for any US companies?

The only companies that are subject to a say-on-pay vote as a matter of federal law are financial institutions that received Troubled Assets Relief Program (TARP) funds pursuant to The American Recovery and Reinvestment Act of 2009, enacted on February 17, 2009. Beyond that group of companies, a growing number of US public companies have voluntarily adopted say-on-pay votes, in some cases after losing a shareholder vote seeking the adoption of a say-on-pay policy by the subject company. As a result, during the 2010 proxy season, 55 publicly traded US companies voluntarily gave shareholders a say-on-pay vote.<sup>10</sup> While this represents a significant increase from only six in 2008, when Aflac Inc. became the first to adopt the practice, and 19 in 2009, it is still only a small fraction of the many thousands that will have say-on-pay votes on their ballots next year as a result of the new rules.

#### How have shareholders tended to vote when given the opportunity?

As of the end of May 2010, KeyCorp became the third public company in the United States to fail to obtain shareholder support for its executive compensation package at its annual meeting, joining Motorola and Occidental Petroleum.<sup>11</sup> This was a particularly interesting development given that the three companies are not Wall Street banks where the public is angry over excessive bonuses. Furthermore, there were no prior

indications of dissatisfaction with executive pay practices at these companies, such as organized campaigns against executive pay packages, making the results of the vote especially surprising. Conversely, shareholders of each of the financial institutions that received TARP funds approved the compensation of their executive officers.

#### **Will inclusion of the say-on-pay vote trigger a preliminary proxy statement filing requirement?**

Under Rule 14a-6 of the Exchange Act, a preliminary proxy statement is not required to be filed in connection with a say-on-pay vote by a TARP participant. It remains to be seen whether the SEC will amend the rules to clarify whether the advisory vote will trigger a requirement to file a preliminary proxy statement, thus shortening the proxy preparation process by about 10 days, as well as to specify the content of the resolution to be submitted to shareholders for a say-on-pay vote. We expect that they will provide that a preliminary proxy statement is not required to be filed for a say-on-pay resolution.

#### **When will the new rules become effective?**

The required vote will need to be held at the first annual meeting that occurs on or after January 22, 2011, thus making the new requirements effective for the 2011 proxy season which traditionally begins around the end of February for companies with a calendar fiscal year.

### **Golden Parachutes (Section 951)**

#### **Summary**

Although this provision was part of the original House Bill, it was omitted from the Senate Bill, but then restored in the Dodd-Frank Act. The provision gives shareholders a non-binding vote on golden parachute payments to named executive officers. It requires a separate vote on golden parachute payments to named executive officers related to an acquisition, merger, consolidation or proposed sale of the company. In addition to the advisory vote itself, new Section 14A(b) of the Exchange Act imposes a new mandatory "clear and simple" disclosure requirement for all proxy or consent solicitation materials pursuant to which shareholders are asked to approve a merger or other corporate transaction. Specifically, the person making the solicitation must disclose (1) any agreements or understandings that such person has with any named executive officer of the company that is the subject of the transaction concerning any type of compensation (present, deferred, or contingent) that relates to the transaction; and (2) the aggregate total of all such compensation that may (and the conditions upon which it may) be paid or become payable to or on behalf of such named executive officer.

#### **What are golden parachutes?**

A golden parachute is a benefit provided to an executive officer in the event of his or her termination. The Act's provisions are directed specifically to terminations following a change of control.

#### **How will this requirement impact practices with respect to golden parachutes?**

Similar to the say-on-pay requirements discussed above, the vote is non-binding, but will give shareholders an opportunity to make their views known. Board sensitivity to shareholder wishes may impact the size of change of control payments more than is currently the case.

#### **Are there any exceptions to the shareholder approval requirement?**

A shareholder vote is not required in connection with a golden parachute payment if shareholders have already approved the agreement pursuant to which the payment is made as part of the annual say-on-pay vote. We expect that the majority of companies will seek shareholder approval of these arrangements as part of their "say-on-pay" votes rather than waiting until a payment needs to be made in connection with a change of control. Thus, a shareholder vote on golden parachutes will generally only be necessary for new executive officers or new compensation arrangements that were not subject to a regular say-on-pay vote.

#### **How does the Act's new requirement relate to the executive compensation rules adopted in 2006?**

The focus on golden parachutes is not new. Since the adoption of the executive compensation disclosure rules in 2006, the SEC has been focusing on disclosure relating to post-employment benefits paid to named executive officers. Qualitative disclosure with respect to golden parachute provisions is required in the Compensation Discussion and Analysis pursuant to Item 402(b)(2) (xi) of Regulation S-K and quantitative estimates of such potential payments are required by Item 402(j) of Regulation S-K (Potential Payments Upon Termination of Change-in-Control). Many companies have been reassessing the appropriateness of their existing post-employment benefit programs to avoid the perception that they might reward failure through excessive payouts.<sup>12</sup> The SEC is likely to issue rules to clarify how the "clear and simple" disclosure standard is to be satisfied. For example, it may require disclosure similar to that required by Item 402(j) of Regulation S-K (Potential Payments Upon Termination of Change-in-Control) with an executive-by-executive narrative description of terms and total amount to be received if each agreement is triggered. The rules may tie the disclosure to the amounts disclosed under Item 402(j) as of the most recent fiscal year end or require disclosure as of a date that is closer to the date of the proposed transaction.

#### **When will the new rules become effective?**

The required votes will need to be held at any meeting that occurs on or after January 22, 2011 to approve a change of control transaction.

#### **Independent Compensation Committees (Section 952)**

##### **Summary**

The Dodd-Frank Act requires the SEC to issue rules directing the national securities exchanges to amend their listing standards to require that each listed company (subject to certain enumerated exceptions) require that each member of its compensation committee be (1) a director and (2) independent (as defined by the SEC). While the House Bill and the Senate Bill were largely consistent on the issue, the Act generally adopted the Senate Bill's language, including the requirement that compensation committees look at the sources of compensation of any director as well as whether the director is affiliated with the company, any of its subsidiaries or any affiliate of a subsidiary.

#### **How does the new requirement compare to the requirements relating to audit committee independence under the Sarbanes-Oxley Act?**

The Sarbanes-Oxley Act presents the definition of independence as an absolute requirement to be adopted by the national securities exchanges. The Dodd-Frank Act outlines substantially the same definition, but reference to it merely as containing factors to be considered. This seems to provide more room for flexible implementation by the exchanges.

#### **How will the new rules impact the existing composition of audit committees?**

One potentially troubling aspect of the Act is the requirement to consider affiliate status when determining independence. Rule 10A-3 under the Exchange Act creates a safe harbor pursuant to which a person who is not the beneficial owner, directly or indirectly, of more than 10 percent of any class of voting equity securities of a company is not considered to be an affiliate for the purpose of audit committee membership. This has resulted in greater-than-10 percent shareholders generally being unable to include persons affiliated with them on an audit committee. It is hard to understand why a greater than 10 percent shareholder should be precluded from having a person affiliated with them on the compensation committee. A private equity fund or other large institutional shareholder would often be the ideal entity to appoint a person affiliated with it to the compensation committee.

#### **How does the new requirement tie to the existing "independence" requirements under NYSE and Nasdaq?**

The NYSE and the Nasdaq Stock Market ("Nasdaq") already require a listed company to have a compensation committee that meets the applicable definition of "independent." One significant

difference is that, currently, ownership of a significant amount of stock does not per se impair independence under the NYSE and Nasdaq rules. It remains to be seen whether large shareholders will be precluded from compensation committee membership because of their affiliate status. Other differences will only become known when the SEC adopts rules requiring the national securities exchanges to implement this provision.

#### **Will the new rules standardize the "independence" definition under the standards for governance, securities law and tax law?**

While the new rules seem to be an attempt to standardize the "independence" definition, the definitions for "non-employee directors" under Section 16 of the Exchange Act or "outside directors" under Section 162(m) of the Internal Revenue Code remain unchanged, thus resulting in a regime under which companies will have to evaluate the qualifications of their compensation committee members under the standards for governance, securities law and tax law. In particular, the reference to consideration of "business or personal" relationships is a significant change from other independence definitions where the notion that personal relationships might adversely affect independence is usually not the case or is subject to a high threshold.

#### **What are the consequences of noncompliance?**

The rules issued by the SEC will direct the national securities exchanges to delist any company that is not in compliance with the new compensation committee requirements. The Act contains provisions for an opportunity to clear any defects before delisting.

#### **When will the rules be issued?**

The SEC is required to issue rules no later than July 16, 2011; however, the effective date of those rules is not known.

#### **Independent Compensation Advisors (Section 952)**

##### **Summary**

The Act gives compensation committees the authority to engage a compensation consultant and makes the compensation committee directly responsible for the appointment, compensation and oversight of the work of a compensation consultant.

Compensation committees are also permitted to engage independent legal counsel and other advisors. Each company is required to provide appropriate funding determined by the compensation committee for payment of reasonable compensation to a compensation consultant, legal counsel or other advisor. In connection with an annual meeting (or special meeting in lieu of an annual meeting), each issuer is required to disclose whether its compensation committee retained or obtained the advice of a compensation consultant and whether the work of the compensation consultant raised any conflict of interest and, if so, how such conflict was addressed.

The Act adopts the language of the Senate Bill requiring compensation committees to consider certain factors when evaluating the independence of compensation consultants, legal counsel and other advisors. The SEC is directed to outline certain factors that affect the independence of consultants, legal counsel or advisors to the compensation committee, including (1) the provision of other services to the company by the person that employs the compensation consultant, legal counsel or other adviser; (2) the amount of fees received from the company by the person that employs the compensation consultant, legal counsel or other adviser as a percentage of the total revenue of that person; (3) the policies and procedures of the person that employs the compensation consultant, legal counsel or other adviser that are designed to prevent conflicts of interest; (4) any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee; and (5) any stock of the company owned by the compensation consultant, legal counsel or other adviser. Such factors must be competitively neutral among categories of consultants, legal counsel and other advisers, and preserve the ability of compensation committees to retain the services of members of any such category.

#### **How do the new requirements fit within the existing regulatory regime?**

Overall, the changes heighten the focus on compensation committees and will force such committees to consider and document carefully the independence of their advisors. The provisions relating to independent advisors are consistent with the December 2009 proxy disclosure enhancements, requiring additional disclosure with respect to compensation consultants, including fees and scope of engagement, in light of perceived conflict of interest issues. The new requirements will also likely result in compensation committees of larger companies considering whether to engage separate legal counsel.

#### **What will be the effect of a conflict of interest determination with respect to a compensation consultant engagement?**

Under the new rules, disclosure will be required with respect to whether the committee retained or obtained the advice of a compensation consultant, and whether the consultant's work has raised any conflict of interest and, if so, the nature of and the resolution to such conflict. However, because the rules simply require consideration of certain factors and do not automatically disqualify compensation consultants based on any particular criterion, it seems likely that smaller companies, in particular, will note that their regular legal counsel acts as counsel to the board and to the compensation committee.

#### **How will the new rules impact existing advisor relationships?**

Because the new requirements appear to apply to existing advisor relationships, once the SEC has promulgated rules implementing this provision, compensation committees will have to evaluate their existing advisor relationships to determine whether they satisfy the new "independence" requirements.

#### **What companies are required to comply with the new requirement?**

Companies will be required to comply with this requirement only if they are listed on a national securities exchange.

#### **When will the disclosure requirement become effective?**

Issuers are required to include disclosures regarding retention of compensation committee advisors and related conflicts of interest in any proxy statement for an annual meeting (or special meeting in lieu of an annual meeting) occurring on or after July 22, 2011.

#### **Are any companies exempt from the rules?**

In addition to granting the national securities exchanges exemptive authority, the Act specifically requires the exchanges to consider the impact of the requirement on smaller reporting issuers. The Act also exempts "controlled companies" consistent with the provisions of national securities exchanges that exempt controlled companies from their compensation committee requirements. A controlled company is defined as a company in which more than 50 percent of the voting power is held by an individual, a group or another issuer.

#### **How do the requirements apply to foreign private issuers?**

Foreign private issuers are only exempt from the new requirements if they have opted out of the national securities exchanges corporate governance requirements requiring an independent compensation committee (as they are permitted to do) and disclosed that opt out in their annual report. This raises a number of questions, including whether the new requirements apply to a foreign private issuer that has opted out of the independent compensation committee requirement, but cannot provide disclosure of that fact until that year's annual report is required. It is also unclear whether a foreign private issuer could officially opt out of the independent compensation committee requirement, but state that it will comply with the requirement on a voluntary basis.

#### Pay for Performance and Compensation Ratios (Section 953)

##### Summary

The Dodd-Frank Act adopts the language of the Senate Bill directing the SEC to issue rules requiring a company to include in its annual proxy statement a clear description of any executive compensation required to be disclosed by the issuer under the SEC's proxy rules, including information that shows the relationship between executive compensation paid and the financial performance of the company, taking into account any change in the value of the shares of stock and dividends of the company and any distributions. The disclosure may be provided in a narrative form or graphically.

The SEC is also directed to amend Item 402 of Regulation S-K to require disclosure of (1) the median of the annual total compensation of all employees of the issuer, except the CEO; (2) the annual total compensation of the CEO; and (3) the ratio of its CEO's compensation to the median compensation of all other employees. A company is also required to disclose in its annual proxy statement the total compensation of an employee will be determined in accordance with the rules applicable to determining the total compensation for each named executive officer as reported in the summary compensation table as in effect on July 21, 2010.<sup>13</sup>

##### **What are the implications of the new disclosure requirement?**

Implementing this requirement will likely result in a significant amount of work and expense for a company with a large employee base. This is because it essentially requires the same analysis that is applied to named executive officers be applied to all employees of the company. In addition, some commentators have expressed concerns about a potential incentive to manipulate the numbers by, for example, outsourcing low-paying jobs. At the very least, the disclosure would highlight any pay disparity between the CEO and other employees, which may result in greater focus on CEO pay packages.

##### **What is the effective date of the new disclosure requirement?**

It is not clear. There is no deadline for the SEC to issue the required rules or to amend Item 402 of Regulation S-K.

#### Expanded Clawback Requirements (Section 954)

##### Summary

The Dodd-Frank Act adopts the language of the Senate Bill and directs the SEC to issue rules directing national securities exchanges to prohibit the listing of any company that does not have a compensation recovery policy that complies with the Act. In the event of a financial restatement, a company will be required

to recoup incentive compensation that was paid on the basis of erroneous data from any current or former executive officer during the three-year period preceding the restatement. Disclosure of a company's policy on incentive-based compensation that is based on financial information is also required.

##### **What are clawbacks?**

Clawbacks require executives to pay back previously-paid compensation, usually incentive compensation, upon the occurrence of certain events, such as a restatement or misconduct.

##### **What companies are required to comply with the new requirement?**

The requirement applies to any company that has securities listed on a national securities exchange. The requirement does not apply to reporting companies that do not have such listed securities (i.e., companies that have conducted an A/B exchange offer). This requirement is broader than the clawback provision of the Emergency Economic Stabilization Act of 2008 (which applies only to TARP participants) and narrower than Section 304 of the Sarbanes-Oxley Act (which applies to all public companies).

##### **How does the new clawback policy requirement compare to the current regime under the Sarbanes-Oxley Act?**

Section 304 of the Sarbanes-Oxley Act requires a CEO or CFO to return incentive-based compensation to an issuer when a financial restatement occurs "as a result of misconduct." Clawbacks returned to the spotlight with the enactment of the Emergency Economic Stabilization Act of 2008 requiring participants in TARP to adopt such policies as a condition to receiving financial assistance. Recently, the SEC achieved a significant victory in the first litigated no-fault clawback case under the Sarbanes-Oxley Act. The court in *SEC v. Jenkins* concluded that the clawback provision under the Sarbanes-Oxley Act could be used to force the return of incentive-based compensation by CEOs and CFOs to issuers, even when they are not personally responsible for any alleged "misconduct."<sup>14</sup> The Act reaches beyond the requirement of the Sarbanes-Oxley Act, which only contains compensation recovery provisions applicable to the CEO and the CFO and applies only if noncompliance results from misconduct, and expands the clawback requirements to all current and former executive officers who received compensation during the three-year period before the date on which the company is required to prepare an accounting restatement.

##### **What challenges does the new requirement create?**

The clawback requirement only applies in the case of "material noncompliance with any financial reporting requirement" and looks back three years from "the date on which the issuer is required to prepare an accounting restatement." These requirements are likely to present significant interpretative challenges at the time any clawback is being considered.

As a general matter, the scope of the clawback may result in a degree of uncertainty for executive officers of a company. In many cases, this will be more people than the five named executive officers. Executive officers may be wary of spending incentive compensation until the three-year period has passed. Furthermore, the potential for a non-fault clawback creates a significant incentive for company management not to restate. This, in turn, places an additional burden on boards and audit committees in overseeing the financial reporting process and auditors in auditing the company's financial statements.

#### **When will the requirement become effective?**

There is no deadline for the SEC to issue the clawback policy rules, but given the significance of the provision, it is expected that the SEC will act swiftly in time for the 2011 proxy season.

### **Employee and Director Hedging (Section 955)**

#### **Summary**

This provision directs the SEC to promulgate rules requiring issuers to disclose in their proxy statements whether any employees or directors are allowed to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) designed to hedge or offset any decrease in the market value of equity securities granted to them as part of their compensation or otherwise held by them directly or indirectly. The Act only requires disclosure of an issuer's hedging policy, not that the issuer adopts such a policy or that the issuer disclose the specific hedging transactions by its employees or directors.

#### **What companies are subject to the employee and director hedging disclosure requirement?**

Any public company that is subject to the SEC's proxy rules will be required to comply with the hedging disclosure requirement. This provision therefore applies to companies that file reports under the Exchange Act pursuant to Section 12(g), even if they are not listed on a national securities exchange.

#### **How does the new requirement tie to the disclosure obligations under Section 16 of the Exchange Act?**

Section 16(c) of the Exchange Act contains a prohibition on "short sales" and "short sales against the box" by directors, officers and 10 percent stockholders. However, the new requirement requires disclosure of a company's policy with respect to a wider range of hedging transactions and the application of that policy to all employees in the company.

#### **What disclosure would be required from companies?**

Most companies prohibit short selling and other hedging transactions by directors and officers as part of their insider trading policies. Companies whose existing policies do not apply this

prohibition to their entire workforce will have to disclose that fact in their proxy statements. It seems likely that companies will amend their insider trading policies to extend these prohibitions to all employees. Exceptions for situations where a director or officer holds a large amount of stock and may want to enter into some sort of hedging transaction should be subject to approval on a case-by-case basis.

#### **How does the new requirement tie to the disclosure obligations in Compensation Discussion and Analysis and what are potential implications of the new disclosure requirement?**

Disclosure of hedging policies is one of the elements listed as a potential disclosure item in a company's Compensation Discussion and Analysis.<sup>15</sup> While the new provision does not require companies to adopt employee hedging provisions as part of their insider trading policies (merely to disclose whether such policies exist), coupled with the Compensation Discussion and Analysis rules, the new requirement will result in many companies adopting a hedging policy to avoid the potential negative implications of disclosing that (and possibly explaining why) the company did not believe it appropriate to implement a hedging policy.

#### **When will the new requirement become effective?**

Section 955 requires the SEC to promulgate rules, but does not establish a time frame for their adoption. Therefore, it is not clear whether the requirement will be effective for the 2011 proxy season.

### **"Excessive Compensation" at Regulated Financial Institutions (Section 956)**

#### **Summary**

Section 956 requires the appropriate federal regulators to issue rules applying enhanced reporting and regulation of incentive-based compensation structures to certain covered financial institutions (unless they have less than US\$1 billion in assets), including disclosure to the regulators of the structure of all of their incentive compensation arrangements. The Act also requires that the rules or guidelines prohibit any type of incentive compensation arrangement that encourages inappropriate risks by an executive officer, employee, director, or principal shareholder of the covered financial institution by providing "excessive compensation, fees, or benefits" or that could lead to material financial loss to the institution.

#### **What is a "covered financial institution"?**

A "covered financial institution" includes depository institutions, registered broker-dealers, registered investment advisors, credit unions, Fannie Mae, Freddie Mac and any other financial institution as determined by the federal regulators.

#### **What is “excessive compensation”?**

The terms “excessive compensation” or “incentive-based compensation arrangements” are not defined in the Act. Therefore, the scope of the provision will ultimately be determined by the regulators issuing the guidelines under the Act.

#### **How does the specific requirement applicable to financial institutions compare to the current regulatory regime?**

The provision is consistent with the overall shift towards additional disclosure in connection with any compensatory arrangements that could create risks that are reasonably likely to have a material adverse effect on the company.<sup>16</sup> This is also similar to the type of disclosure the TARP participants are required to make to their primary federal regulators and to the US Department of the Treasury. However, the Act’s requirements only extend to financial institutions with a minimum of US\$1 billion in assets.<sup>17</sup>

#### **When will the provision become effective?**

Regulators are required to jointly establish rules implementing the provision of the Act by no later than April 22, 2011; however, the effective date of those rules is not known.

#### **Conclusion**

While the Dodd-Frank Act is intended to address the aftermath of the financial crisis through enhanced scrutiny by regulators and investors, the corporate governance and executive compensation provisions are of general application to thousands of companies that played no role in causing the crisis and, in many cases, were as much a victim of it as anyone else. There is a lot in the Act that will require careful attention and implementation over the coming months and companies will need to work with their advisors to develop new policies and practices in a number of areas. Many of the provisions ultimately depend on SEC rules which could impact significantly the ultimate implementation of the Act. As Chris Dodd correctly stated, according to the Washington Post, “No one will know until this is actually in place how it works.”<sup>18</sup>

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1. N.D. Cent. Code §10-35 (2010).

2. 8 Del. Code Ann. §112 (2010).

3. Facilitating Shareholder Director Nominations, Release No. 33,9046, 74 Fed. Reg. 29,024 (June 10, 2009); *see also*, Facilitating Shareholder Director Nominations, Release No. 33,9086, 74 Fed. Reg. 67,144 (December 14, 2009).

4. NYSE Listed Company Manual § 452.

5. *Id.*

6. Proxy Disclosure Enhancements, Release No. 33, 9089, 74 Fed. Reg. 68,334 (Dec. 16, 2009).

7. Ted Allen, The ISS Preliminary US Report (June 28, 2010), available at <http://www.thecorporatecounsel.net/member/blogs/proxy>.

8. *See*, Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, US Securities and Exchange Commission, Office of Economic Analysis, September 2009, available at [http://www.sec.gov/news/studies/2009/sox-404\\_study.pdf](http://www.sec.gov/news/studies/2009/sox-404_study.pdf).

9. Ted Allen, Reform Bill Won’t Include Majority Voting Mandate (June 24, 2010), available at <http://blog.riskmetrics.com/gov/2010/06/house-agrees-to-drop-majority-voting-mandate.html>.

10. Michael Connor, Say-on-Pay Shareholder Votes Gain Momentum, The Magazine of Corporate Responsibility (March 2, 2010), available at <http://business-ethics.com/2010/03/02/1823-say-on-pay-shareholder-votes-gain-momentum/>.

11. Ted Allen, KeyCorp Receives Majority Opposition on Pay (May 25, 2010), available at <http://blog.riskmetrics.com/gov/2010/05/keycorp-receives-majority-opposition-on-pay.html>.

12. Internal Control Over Financial Reporting, Release No. 33,8732A, 71 Fed. Reg. 47056 (August 29, 2006).

13. 17 C.F.R. §229.402(c)(2)(x) (2010).

14. *SEC v. Jenkins*, No. CV 09-1510-PHX-GMS (D. Ariz. 2010).

15. 17 C.F.R. §229.402(b)(2)(xiii) (2010).

16. 17 C.F.R. §229.402(s) (2010).

17. Pub. L. No. 110-343, §111 (2010).

18. Washington Post, Lawmakers guide Dodd-Frank bill for Wall Street reform into homestretch, June 26, 2010.

## Client **Alert**

### Dodd-Frank Wall Street Reform and Consumer Protection Act

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