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Dodd-Frank Wall Street Reform and Consumer Protection Act: Corporate Governance and Executive Compensation Provisions

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (H.R. 4173) (the "Act"). The Act significantly expands federal regulation and oversight of the financial industry. The Act also contains amendments to the Securities Exchange Act of 1934, as amended (the "Exchange Act"), that impose new corporate governance and executive compensation requirements on public companies. The following summarizes certain corporate governance and executive compensation provisions from the Act (which are contained in Subtitle E - Accountability and Executive Compensation, Sections 951-955, and Section 957 (voting by brokers), and Subtitle G - Strengthening Corporate Governance, Sections 971-972) that will impact public companies outside the financial services industry. As discussed further below, the Act also exempts certain smaller companies from Sarbanes-Oxley internal control over financial reporting attestation requirements, and the applicability of these new provisions to publicly-traded partnerships will depend on SEC rulemaking as well as the scope of the new requirements.

1.* Non-Binding Shareholder Approval of Executive Compensation (New Section 14A under the Exchange Act)

A. *Non-Binding Advisory Votes for "Say on Pay."* Paragraph (a) of new Section 14A of the Exchange Act will require a public company to include in its proxy materials, for the first annual or other shareholder meeting that occurs six months after the enactment of the Act, a separate resolution subject to a non-binding, advisory vote to approve the compensation of the named executive officers as disclosed in the Compensation Discussion and Analysis and related compensation tables under Item 402 of Regulation S-K. Going forward, new Section 14A(a) will require this "say on pay" advisory vote to be included in a company's proxy materials at least once every three years. In addition, public companies will be required to include (at least once every six years) a separate proposal for a non-binding, advisory shareholder vote to determine whether the say on pay advisory vote should occur at least every one, two or three years.

B. *Non-Binding Advisory Votes on Golden Parachute Compensation.* Paragraph (b) of new Section 14A of the Exchange Act will require, in the context of a proxy solicitation related to an acquisition, merger, consolidation or proposed sale of all or substantially all the assets of an issuer, disclosure of any agreements or understandings that the soliciting person has with any named executive officers of such issuer (or of the acquiring issuer, if such issuer is not the acquiring issuer) concerning any type of compensation that is based on or otherwise relates to such proposed transaction. Any such proxy solicitation occurring six months after the enactment of the Act will have to include a separate resolution seeking non-binding shareholder approval of the transaction-related compensation arrangements, unless such disclosure and vote had already been included in the resolution required under paragraph (a) of new Section 14A as described above.

C. *General Observations.* The foregoing non-binding advisory votes may be given further effect depending on the SEC's rulemaking regarding voting by brokers, and companies will need to consider the effect of disregarding an advisory vote on the election of its compensation committee members based on the prohibition of discretionary voting in the election of directors and changes in proxy access (see discussions below). New Section 14A(d) will also require institutional investment managers subject to Section 13(f) of the Exchange Act to report at least annually on their advisory shareholder votes on executive compensation and golden parachutes.

2. Independence of Compensation Committees (New Section 10C under the Exchange Act)

A. *Compensation Committee Independence.* New Section 10C under the Exchange Act will require the SEC, within 360 days, to adopt rules directing national securities exchanges to prohibit the listing of any equity security of an issuer that does not have an independent compensation committee. This rule will not apply to an issuer that is a "controlled company," a limited partnership, a company in bankruptcy proceedings, an open-ended management

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investment company that is registered under the Investment Company Act of 1940 and certain foreign private issuers. A “controlled company” is an issuer where more than 50 percent of the voting power is held by an individual, a group or another issuer. The rule will require that each member of the compensation committee be an independent member of the issuer’s board of directors, and is subject to a cure period.

In making the independence determination, the new rules will require the national securities exchange to consider relevant factors, including—

- (i) the source of compensation of a member of the board of directors of an issuer, including any consulting, advisory or other compensatory fee paid by the issuer to such member of the board of directors; and
- (ii) whether a member of the board of directors of an issuer is affiliated with the issuer, a subsidiary of the issuer or an affiliate of the issuer.

B. Authority of Compensation Committee to Hire Independent Compensation Consultants, Legal Counsel and Other Advisors. Clause (c) of new Section 10C will give the compensation committee sole discretion to retain, and obtain advice from, an independent compensation consultant, legal counsel or other adviser (each, a “Consultant”). Clause (d) of new Section 10C imposes on the compensation committee direct responsibility for the appointment, compensation and oversight of Consultants. The issuer will be required to provide appropriate funding for the compensation of a Consultant.

The SEC is required to identify in the new rules that it will adopt factors that affect the independence of Consultants, which shall be competitively neutral and must include: (i) the provision of other services to the issuer by the person that employs the Consultant; (ii) the amount of fees received from the issuer by the person that employs the Consultant; (iii) the policies and procedures of the person that employs the Consultant that are designed to prevent conflicts of interest; (iv) any business or personal relationship of the Consultant with a member of the committee; and (v) any stock of the issuer owned by the Consultant.

Section 10C(g) exempts controlled companies from the requirements of this section.

3.* Disclosure of Pay versus Performance and Ratio of CEO Compensation to Median Employee Compensation

A. Pay versus Performance. New Section 14(i) of the Exchange Act will require the SEC to adopt rules requiring each issuer to disclose, in any proxy or consent solicitation material for an annual meeting of shareholders, a clear description of any compensation required to be disclosed under Item 402 of Regulation S-K, including information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions. Such disclosure may include a graphic representation.

B. Ratio of CEO Compensation to Median Employee Compensation. Additionally, the SEC is directed to amend Item 402 of Regulation S-K to require disclosure in the applicable Exchange Act filings (including annual reports to security holders and proxy statements) and registration statements filed under the Securities Act of 1933 of (i) the median of the annual compensation of employees of the issuer other than the CEO, (ii) the annual total compensation of the CEO, and (iii) the ratio of these two amounts.

4.* Policies to Recover Erroneously Awarded Compensation (New Section 10D under the Exchange Act)

New Section 10D will require the SEC to adopt rules that direct the national securities exchanges to prevent the listing of the securities of issuers that do not develop and implement “clawback” policies and disclose such policies. These future SEC rules are to apply to policies of an issuer with respect to incentive-based compensation that is based on financial information required to be reported under the securities laws. In the event of an accounting restatement (due to material noncompliance with financial reporting requirements) that would restate pertinent financial information causing a decrease in incentive

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compensation, the policy shall require any current or former executive officer to repay to the issuer any amounts of incentive compensation actually received in excess of the amounts the executive should have received during the preceding 3 years (including stock options awarded as compensation).

5. Disclosure Regarding Employee and Director Hedging (New Section 14(j) under the Exchange Act)

New Section 14(j) will require issuers to disclose, in any proxy or consent solicitation material for an annual meeting of shareholders, whether any employee or director is permitted to purchase financial instruments that are designed to hedge or offset any decrease in the value of equity securities (i) granted by the issuer as equity compensation or (ii) held, directly or indirectly, by such employee or director.

6. Voting by Brokers (Amended Section 6(b) under the Exchange Act)

Section 6(b) under the Exchange Act will be amended to require that the rules of each national securities exchange prohibit discretionary voting by brokers on the following matters: (i) the election of a director; (ii) executive compensation; and (iii) any other significant matter as determined by the SEC by rule. To vote on such matters, a broker must have received specific instructions from each beneficial holder. The foregoing does not apply to uncontested elections of directors of any registered investment company.

We will have to wait to see what “other significant matters” are determined by the SEC, but we believe it is likely that the “say on pay” voting may be considered as part of the SEC’s rule making and investor comments.

This new requirement extends beyond existing NYSE Rule 452, which was amended effective in January 2010 to eliminate discretionary authority of brokers to vote on uncontested director elections, but otherwise allows brokers to have discretionary authority to vote on certain routine matters without instruction from beneficial owners. Since many non-institutional investors do not vote their shares, we believe this change in voting requirement will give RiskMetrics and other proxy advisory firms (whose recommendations are followed by many institutional investors) much greater influence in the election of directors and other matters for which discretionary voting by brokers is not permitted.

7. Proxy Access (Amended Section 14(a) under the Exchange Act)

The provisions of this amended Section 14(a) expressly permit the SEC to issue rules requiring that a solicitation of proxy, consent or authorization by a shareholder by or on behalf of an issuer include a nominee submitted by a shareholder to serve on the board of directors; and the procedures to be followed.

The SEC may issue rules permitting the use by a shareholder of proxy solicitation materials supplied by an issuer, under such terms and conditions as the SEC determines are in the interests of shareholders and for the protection of investors. Such requirements may exempt an issuer or class of issuers (including smaller issuers).

These provisions were a compromise to proposed requirements to permit shareholder access to a company’s proxy materials (compared to current rules not permitting access, and thus requiring shareholders to prepare and distribute their own materials at their own expense), and debates regarding minimum share ownership thresholds and holdings periods for shareholders desiring to nominate directors using an issuer’s proxy materials. Accordingly, the SEC has been tasked with resolving these issues.

On July 14, 2010, the SEC issued a Concept Release (PDF) seeking public comment on the U.S. proxy system during the next 90 days. This review will address issues such as (i) the role of proxy advisory firms that make recommendations to shareholders, (ii) “empty voting” practices, when a shareholder’s voting rights significantly exceed its economic interest in a company, and whether such practices improperly influence results, and (iii) improvements to the flow of investor information, including enhancing the use of the internet.

8. Disclosures Regarding Chairman and CEO Structures (New Section 14B under the Exchange Act)

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New Section 14B directs the SEC, within 180 days after the enactment of the Act, to issue rules that require an issuer to disclose, in the annual proxy sent to investors, the reasons why the issuer has chosen: (i) the same person to serve as chairman of the board of directors and CEO; or (ii) different individuals to serve as chairman of the board of directors and CEO.

Provisions Applicable to Smaller Companies

The Act amends Section 404 of the Sarbanes-Oxley Act of 2002 to exempt public companies that are not "large accelerated filers" or "accelerated filers" from compliance with the internal control over financial reporting auditor attestation requirements.

* Special Note Regarding Publicly Traded Partnerships

Since publicly traded, master limited partnerships ("MLPs") are generally controlled companies that have general partners whose boards of directors are not elected by unitholders or at annual meetings, many of the foregoing provisions will not apply to such MLPs. The foregoing new requirements will potentially affect such MLPs as follows:

Shareholder Vote on Executive Compensation Disclosures. With respect to new Section 14A(a) under the Exchange Act, it is unclear whether the periodic advisory vote requirements are intended to apply to MLPs. Since the requirements apply to any "other meeting," if an MLP issuer submits an equity-based plan for the vote of unitholders, the requirements for these advisory votes would clearly appear to apply to that proxy statement for any such special meeting occurring after the end of the 6-month period after the enactment of the Act.

The requirements under new Section 14A(a)'s two provisions for other periodic votes are that "Not less frequently than once every [3][6] years, a proxy or consent or authorization for an annual or other meeting of the shareholders for which the proxy solicitation rules of the Commission require compensation disclosure, shall include a separate resolution subject to shareholder vote" While MLPs are required to include such information in proxies required to approve executive compensation plans (which approval is required under NYSE and other exchange rules), it is unclear whether these new requirements are intended to require advisory votes and the filing of separate proxy statements for meetings not otherwise required. If so, it would appear an MLP would have up to three years to call a meeting and include this advisory vote unless an earlier proxy statement was filed for another purpose.

The requirements under new Section 14A(b) regarding non-binding advisory votes on golden parachute compensation would also appear to apply to MLPs when filing the applicable reports in the context of a business combination within the scope of new Section 14A(b).

Section 14A(e) gives the SEC authority to exempt an issuer or class of issuer from these requirements, and we would expect the SEC to consider an MLP exemption for at least the periodic "say on pay" requirements, particularly for MLPs that are controlled companies and do not have annual meetings.

Executive Compensation Disclosures. The new Regulation S-K Item 402 rules to be adopted by the SEC under new Section 14(i) regarding disclosure of (i) the median annual compensation of employees of the issuer other than the CEO, (ii) the annual total compensation of the CEO, and (iii) the ratio of these two amounts will apply to MLPs. The other SEC rules to be adopted relating executive compensation disclosures that are required to be included only in a proxy statement for an annual meeting will not affect MLPs that do not hold annual meetings or file such related documents.

Recovery of Erroneously Awarded Compensation. The required "clawback" policies under new Section 10D will apply to MLPs.