July 16, 2010 | Posted By

Senate Passes Dodd-Frank Wall Street Reform and Consumer Protection Act

On Thursday, July 15, 2010, the Senate passed the Dodd-Frank Wall Street Reform and Consumer Protection Act by a vote of 60-39. The bill passed in the House of Representatives on June 30, 2010. The legislation is expected to be signed into law by President Obama next week. The Dodd-Frank Act introduces wide-ranging reforms of the US financial regulatory system. The legislation calls for hundreds of rulemakings and studies, so the full impact will not be known for many years.

The Dodd-Frank Act includes reforms and other provisions in the following areas: regulatory structure (including creation of a new Financial Services Oversight Council), regulation of systemically significant financial institutions, bank capital requirements, proprietary trading by certain banking entities, sponsorships of and investments in hedge funds and private equity funds by certain banking entities, resolution of failing financial institutions, fees paid to the Deposit Insurance Fund, securitization, swaps and derivatives, SEC authority, executive compensation, corporate governance, private equity and hedge funds (including registration of fund advisors), credit rating agencies, consumer regulations, and a new Federal Insurance Office to identify issues or gaps in the regulation of insurers.

In this blog article, we discuss only the provisions applicable to non-financial public companies, which are primarily the executive compensation and governance provisions. Below is a summary of key provisions that will affect public companies:

- Beginning with annual meetings of shareholders occurring after the 6-month period following the enactment of the act, companies listed with national securities exchanges or national securities associations will be required to hold a non-binding shareholder “say on pay” vote on all disclosed compensation at least once every three years. At least once every six years, companies must allow shareholders to vote on whether to hold “say on pay” votes every one, two or three years.

- In connection with the vote on certain change in control transactions occurring after the 6-month period following the date of enactment of the act, companies listed with national securities exchanges or national securities associations must hold a non-binding advisory vote on any change in control benefits and merger-related compensation agreements that have not been previously approved by shareholders. This is effective for any shareholder meeting occurring six months after the act is enacted.

- Banks and brokers holding shares in street name will not have discretionary authority to vote on compensation advisory votes. The act also mandates no discretionary authority for director elections, but such provision has little practical effect as the New York Stock Exchange previously amended its Rule 452 to remove discretionary authority for director elections. The SEC may enact rules which would eliminate discretionary authority to vote on other significant matters as it determines.

- Each member of the compensation committee of the board of directors of an issuer must be independent. The act requires the SEC to require that the national securities exchanges and national securities associations determine rules relating to independence and allows them to create exemptions for controlled companies. In determining the definition of independent, the national securities exchanges and national securities associations must be directed to consider the source of compensation of a director and whether the director is affiliated with the issuer. Because the definition of independent is not specified in the act, the practical effect of this provision is still uncertain. Companies must comply with these provisions not later than 360 days from the enactment of the act.

- Compensation consultants, legal counsel and other advisors retained by the compensation committee must be independent. In retaining a compensation consultant, legal counsel or other advisor, the compensation committee must take into account factors identified by the SEC affecting their independence, including: (a) provision of other services to the issuer by such provider, (b) the amount of fees received from the issuer by such provider (as a percentage of revenue), (c) the policies and procedures of the provider designed to prevent conflicts of interest, (d) any business or personal relationship of such provider with a member of the compensation committee and (e) any stock of the issuer owned by such provider. Within one year of the enactment of the act, companies must be in compliance with this provision and must also disclose in any proxy or solicitation material whether the compensation committee has retained a compensation consultant, obtained advice of a compensation consultant, or whether the work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how it is being addressed.

- Annual proxy statements must add disclosures concerning the relationship of historical executive compensation and financial performance.

- Annual proxy statements must add disclosures comparing the CEO’s total compensation to the median annual total compensation of all employees of the issuer excluding the CEO. As drafted, this provision will create significant burdens on issuers relating to the calculation of total compensation for rank and file employees.

- Issuers must develop a policy which provides for “clawbacks” of executive compensation in the event of a restatement. The clawback requirements are not dependent on any wrongdoing and will operate for restatements that result from mistakes.

- Annual proxy statements must disclose whether employees or directors are permitted to purchase derivates that hedge the risks of holding equity securities granted by the issuer.

- The act authorizes the SEC to adopt proxy access rules to allow shareholders to include director nominations in proxy solicitation materials. The act also allows the SEC to exempt an issuer or class of issuers from this requirement and specifically instructs the SEC to consider whether the requirement disproportionately burdens small issuers.

- Requires the SEC to adopt disclosure rules within 180 days after the date of enactment of the act regarding the combination or separation of CEO and chairman rules. The SEC adopted rules requiring such disclosure in February 2010.

- The act clarifies that the SEC may impose joint and several liability against control persons under Section 20(a) of the Securities and Exchange Act of 1934.

- The act provides the SEC increased enforcement powers such as the ability to bring actions for aiding and abetting violations of the Securities Act of 1933, the Investment Company Act of 1940 and the Investment Advisers Act of 1940.

- The act requires the SEC to issue rules disqualifying “bad actors” (including felons and persons subject to a final orders by regulators based on fraudulent or deceptive conduct) from participating in an offering exempt from registration requirements under Rule 506 of Regulation D under the Securities Act. Currently, bad actors are restricted from participating in offerings under Rule 505, but not rule 506.

- The act gives the SEC authority to enact new rules and regulations regarding the duties owed by broker-dealers and investment advisers to clients. Currently, broker-dealers do not owe fiduciary duties to customers, while investment advisers do owe fiduciary duties to their customers. The act requires the SEC to study the existing standards of care applicable to broker-dealers and investment advisers that provide personalized investment advice to customers and gives the SEC authority to promulgate rules imposing uniform duties applicable to the provision of personalized investment advice to retail and other customers by broker-dealers and investment advisers. There is speculation that any rulemaking by the SEC establishing fiduciary duties for broker-dealers might impact how broker-dealers vote shares held in street name for those matters where they retain voting discretion.

- The act amends the accredited investor definition to exclude from the net worth calculation the value of a person's primary residence and calls for the SEC to increase the $1 million net worth requirement four years after enactment of the act.

- The act enhances whistleblower protections in several ways. The whistle blower protections form the Sarbanes-Oxley Act are expanded to cover additional employees, increase the statute of limitations and exempt whistle blower claims from mandatory arbitration. The act also strengthens whistle blower protections in the False Claims Act. The act permits whistleblowers to share in recoveries by the SEC or the Commodities Futures Trading Commission (CFTC). The recovery sharing may incentivize whistleblowers to go directly to the SEC or the CFTC rather than use a company's internal whistleblower mechanisms. The SEC must issue final regulations implementing these recovery sharing provisions not later than 270 days after the enactment of the act.

- The definition of beneficial ownership is expanded to include any person who "becomes or is deemed to become a beneficial owner of any [covered equity security] upon the purchase or sale of a security-based swap that the Commission may define by rule."

- Non-accelerated filers are permanently exempted from the internal control rules of Sarbanes-Oxley Section 404(b).

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