Dodd-Frank Financial Reform Act - Key Corporate Governance and Executive Compensation Provisions

July 27, 2010

CORPORATE FINANCE & SECURITIES ALERT - JULY 27, 2010

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), arguably the most far-reaching package of financial regulatory reforms since the New Deal. The legislation restructures the regulatory framework for much of the U.S. financial system, and its effects will be most pronounced on the financial services industry.

However, the Dodd-Frank Act will affect all U.S. public companies by extending the federal regulation of matters relating to corporate governance and executive compensation. For example, provisions of the Dodd-Frank Act will:

- Authorize the Securities and Exchange Commission (“SEC”) to adopt “proxy access” rules that would facilitate shareholders’ use of a company’s proxy materials to solicit votes for election of shareholders’ nominees for director, in competition with the company’s own recommended slate of directors
- Further limit discretionary voting by brokers of shares held in street name
- Require companies to obtain periodic advisory “say on pay” shareholder votes on their executive compensation, as well as advisory votes on “golden parachute” payments that are made in connection with mergers and other extraordinary transactions
- Expand proxy statement disclosure of corporate governance and executive compensation matters
- Require the adoption of a “claw back” policy providing for the recovery of executive incentive compensation in the event of a company restatement
- Require companies to adopt new practices regarding their compensation committees’ independence and use of compensation consultants and other advisers.

It is likely that all of these provisions will be effective for the 2011 proxy season. Even before that, they will have implications for current corporate governance and executive compensation decision making. We recommend that public companies begin preparing now for compliance with the new statutory requirements, the SEC’s implementing regulations, and new stock exchange listing standards. In separate Client Alerts we will provide more detailed guidance and practical suggestions for compliance with these new requirements as they are implemented.

Proxy Access

In June 2009, the SEC issued proposed “proxy access” rules that would require companies to include shareholder nominees for directors in their proxy materials under prescribed circumstances, including a requirement that the nominating shareholder have beneficially owned a minimum percentage of the company’s shares for a specified period of time. Under current rules, usually only a company’s own nominees for election to the board of directors are included in its proxy materials. If shareholders desire to nominate their own candidates, they must prepare, pay for and distribute separate proxy materials. The SEC’s proxy access reforms are intended to simplify and reduce the expense of soliciting proxies for the election of shareholder nominees who are not on the company’s slate, with the goal of enhancing shareholder democracy and increasing the responsiveness of corporate boards.

Previous SEC efforts at reform in this area stalled in 2003 and 2007, and the 2009 proposals were also highly controversial. The SEC received more than 500 comment letters in response to the 2009 proposals, including some objecting that the SEC lacked authority to regulate in this area, which has historically been the subject of state corporation law. As a result, the SEC still has not adopted a final rule.

The Dodd-Frank Act authorizes — but does not require — the SEC to adopt proxy access rules. The Act does not address the substantive content of any such rules, leaving the SEC to resolve controversial issues such as minimum ownership and holding period requirements. Significantly, the Act omitted a previously proposed provision that would have made majority voting mandatory in the election of directors. The Act also authorizes the SEC to exempt an issuer or class of issuers, such as smaller reporting companies, from proxy access. A final version of the SEC proxy access rules is expected to be adopted within the next several months.

Limits on Discretionary Voting by Brokers

Shares that are held in “street name” — shares that brokers hold on behalf of beneficial owners — are normally voted by the brokers in accordance with the instructions of the beneficial owners. When beneficial owners do not provide instructions, New York Stock Exchange Rule 452 allows member firms to vote in their discretion on certain routine matters. However, the NYSE amended Rule 452 effective January 2010 to eliminate broker discretionary authority to vote on director elections, even if uncontested.

The Dodd-Frank Act further limits discretionary voting by brokers, by requiring all national securities exchanges to adopt standards prohibiting discretionary broker voting in elections, as well as in connection with executive compensation (presumably including say on pay) or any other “significant matter,” as determined by SEC rulemaking.

Say on Pay

Beginning with the 2011 proxy season, the Act requires that public companies include a resolution in their proxy statements asking shareholders to approve, in a non-binding advisory vote, the compensation of their executive officers for the most recent fiscal year as that compensation was as disclosed in company proxy materials. A separate shareholder vote will also be required (in the 2011 proxy, and at least every six years thereafter) to determine whether subsequent say on pay votes will take place every one, two or three years.

"Say on Golden Parachute"

In connection with any shareholder meeting held after January 21, 2011 to approve a merger or similar extraordinary transaction that would trigger "golden parachute" severance payments for executive officers, the company must solicit a separate non-binding advisory vote to approve the golden parachute compensation, unless those arrangements have previously been approved in a say on pay shareholder vote. The proxy statement used for soliciting the advisory vote must include clear and simple disclosure of the golden parachute arrangements and the amounts payable.

Interestingly, the Dodd-Frank Act also includes a requirement that institutional investment managers that are subject to reporting requirements under Section 13(f) of the Securities Exchange Act must publicly disclose how they have voted with respect to say on pay and "say on golden parachute" proposals.

Although it will be months before the SEC adopts the new say on pay and "say on golden parachute" rules, clients should begin to consider the practical implications of the new rules now. Steps that should be considered include a review of executive compensation disclosures in the proxy statement, more active engagement with institutional investors and proxy advisory services in anticipation of the say on pay vote, and revision of incentive compensation plans and policies, severance and change-in-control arrangements, executive perquisites and stock ownership and retention policies.

Enhanced Proxy Statement Disclosure

The Act requires the SEC to adopt rules that will further expand proxy disclosure requirements to address several areas of officer, director and employee compensation, and other matters:

- Pay versus Performance. The Act requires that the SEC adopt rules mandating that companies disclose the relationship of the compensation paid to their executive officers in comparison to the company's financial performance, as measured by share price appreciation and dividends or distributions. This disclosure may be presented either graphically or in narrative form.

- Internal Pay Equity. The Act requires that the SEC adopt rules mandating disclosure of the annual total compensation of the CEO, the median annual total compensation of all other employees (excluding the CEO), and the ratio of the CEO's total compensation to the median for all other employees. The calculation of this ratio could require significant effort, depending on the complexity of employees' compensation.
- Incentive Compensation Tied to Financial Results. In connection with the new "clawback" requirements discussed below, additional disclosure will also be required of a company's policy with respect to incentive-based compensation, to the extent that it is based on the company's reported financial results.
- Employee or Director Hedging. The Act directs the SEC to adopt rules mandating disclosure of whether company policy permits employees or directors to hedge the value of company equity securities granted to them as compensation or otherwise held by them, including through the purchase of financial instruments such as equity swaps, collars or exchange funds.
- Board Leadership Structure. The Act directs the SEC to promulgate rules mandating proxy statement disclosure of the reasons why the company has chosen to have one person serve as Chairman and CEO, or to have different individuals serve in those roles. The SEC had already amended the proxy rules in December 2009 to require a discussion of this topic, and it is unclear what (if any) additional regulation will be forthcoming from the SEC in this area.

Incentive Compensation Clawbacks

The Act requires that stock exchange listing standards be amended to require that listed companies adopt "claw back" policies requiring the recovery from any current or former executive officer of the company of incentive compensation (including stock options) in the event of an accounting restatement that results from the company's material noncompliance with financial reporting requirements.

Incentive compensation paid for the three-year period preceding the date the company is required to prepare the restatement must be recovered to the extent that it exceeds what would have been paid had it been based upon the restated financial results. The claw back requirement applies whether or not the executive had any responsibility for the noncompliance that led to the restatement.

This claw-back policy extends beyond the current requirements of Section 304 of the Sarbanes-Oxley Act of 2002, which covers only CEO's and CFO's, has a 12-month instead of a three-year claw-back period and requires that the restatement result from misconduct.

Independence of Compensation Committee Members and Advisers

Compensation Committee Independence. The Act mandates that national stock exchanges adopt listing standards requiring that members of a listed company's compensation committee meet enhanced independence standards, similar to those required for audit committee members under the Sarbanes-Oxley Act. The new independence standards will direct boards to consider all forms of compensation received by a compensation committee member from the company, including consulting, advisory, or other compensatory fees, as well as any affiliations between the member and the company, a subsidiary of the company, or an affiliate of a subsidiary of the company.

Compensation Adviser Independence and Disclosure. In December 2009, the SEC adopted rules requiring disclosure of fees paid to compensation consultants when they provide the company with executive compensation consulting or other additional services under certain circumstances. The Dodd-Frank Act expands this requirement, so that, beginning in July 2011, proxy statements must affirmatively disclose whether the compensation committee retained or obtained the advice of a compensation consultant and whether the consultant's work raised any conflicts of interest, the nature of any such conflict, and how it was addressed.

The Dodd-Frank Act also directs national stock exchanges to adopt standards prohibiting employment by the compensation committee of a listed company of a compensation consultant, legal counsel or other adviser without first considering independence standards to be established by the SEC. The new SEC independence standards are to include consideration of:

- Other services provided to the company by the adviser
- Fees received as a percentage of the adviser's revenue
- The adviser's policies and procedures designed to prevent conflicts of interest
- Business or personal relationships between the adviser and any member of the compensation committee
- Stock ownership in the company by the adviser

The Act requires, in addition, that the compensation committee (rather than management) must have direct authority for the appointment, compensation, and oversight of the work of the compensation adviser. The Act does not require committees to adopt the recommendations of any consultant or other adviser, but it makes clear that the engagement of a consultant or other adviser does not absolve committee members of their obligations to exercise their own judgment in fulfilling their duties.

Conclusion

With a total of 11 regulators required to make 243 rulemakings, 67 studies and 22 new reports under the Act, the rulemaking process under the Dodd-Frank Act is likely to take some time. However, we believe it is advisable to begin to address many of these issues now, particularly in anticipation of the 2011 proxy season. We will provide further updates and practical guidance as the SEC and stock exchanges propose and adopt rules and standards under the Act's new requirements.