PRYOR CASHMAN LLP

LEGAL UPDATE

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# THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: A SUMMARY OF CORPORATE GOVERNANCE AND EXECUTIVE COMPENSATION PROVISIONS

On July 21, 2010, President Obama signed into law The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The Act, which affects almost every aspect of the U.S. financial services industry, will also have a profound impact on all public companies. This Legal Update highlights certain of the most significant changes that will affect the corporate governance, executive compensation and securities disclosure practices of public companies, including proxy access, shareholder voting on executive compensation, broker discretionary voting, compensation committee independence, compensation clawback policies, modifications to the "accredited investor" standard and the permanent exemption from complying with Section 404(b) of the Sarbanes-Oxley Act of 2002 for non-accelerated filers. Certain of these requirements will become effective immediately or in the near future, while others will require further action and rulemaking by the Securities and Exchange Commission (the "SEC") and the national securities exchanges.

## SHAREHOLDER PROXY ACCESS

The Act amends Section 14(a) of the Securities Exchange Act of 1934 (the "Exchange Act") to permit, but not mandate, the SEC to adopt rules giving shareholders access to an issuer's proxy statement and proxy card to nominate director candidates at the company's expense. The Act does not specify mechanics for the implementation of proxy access; rather, it authorizes the SEC to determine the appropriate standards and procedures for such rules. Specifically, unlike the proxy access rules that the SEC proposed in June 2009, the Act does not specify an ownership threshold or holding period for shareholders to submit nominees for director. The SEC also has been authorized to exempt certain issuers or classes of issuers, such as smaller public companies, from the proxy access rules. It is anticipated that the SEC will adopt proxy access rules in time for them to be in effect for the 2011 proxy season.

## SHAREHOLDER VOTING ON EXECUTIVE COMPENSATION

The Act requires public companies to provide their shareholders with a non-binding advisory vote on: (i) the compensation of "named executive officers" as disclosed in the proxy statement (so-called "say-on-pay" votes); and (ii) golden parachute payments paid to named executive officers (so-called "say-on-golden parachute" votes). These requirements will apply for the 2011 proxy season. Although these shareholder votes are not binding, votes against the proposed payments could put pressure on compensation practices and directors. Furthermore, the loss of broker discretionary voting on "say-on-pay" proposals (discussed below), which will likely result in fewer votes being cast in favor of these proposals, will amplify the issue.

Specifically, at a company's first annual or other shareholder meeting occurring on or after January 21, 2011, companies must provide their shareholders with a non-binding "say-on-pay" vote on executive compensation, as well as a separate vote to determine the frequency of future "say-on-pay" votes (e.g., every one, two or three years). The Act requires companies to hold a shareholder vote on the frequency of "say-on-pay" votes at least once every six years.

The Act also requires that, for any shareholder meeting occurring on or after January 21, 2011 at which shareholders are asked to approve an acquisition, merger, consolidation or sale or other disposition of all or substantially all of the assets of a company, the soliciting person must include "clear and simple" disclosure of any agreements or understandings that such person has with any of the subject company's named executive officers concerning any type of compensation (i.e., present, deferred or contingent) relating to the transaction, the aggregate total of all such compensation, and any conditions to which the compensation is subject. Shareholders will be given the opportunity to cast a separate non-binding advisory vote on such payments. A "say-on-golden parachute" vote will not be required if such agreements or understandings were previously approved by shareholders as part of the annual "say-on-pay" vote.

The SEC may exempt small issuers from "say-on-pay" and "say-on-golden parachute" provisions if it determines that these requirements disproportionately burden such issuers.

Institutional investment managers subject to Section 13(f) of the Exchange Act will be required to disclose no less than annually how they voted on all "say-on-pay" and "say-on-golden parachute" votes with respect to the companies in which they hold shares. Institutional investment managers who already are required to report how they have voted are exempt from this requirement.

## BROKER DISCRETIONARY VOTING

The Act requires national securities exchanges to adopt rules that prohibit broker discretionary voting with respect to the election of directors, executive compensation matters, and "any other significant matter" as the SEC may determine. We note that, as a result of amendments to New York Stock Exchange Rule 452 that became effective for the 2010 proxy season, brokers are already prohibited from voting in uncontested director elections without explicit voting instructions from beneficial owners. No deadline has been specified for the SEC or the exchanges to implement rules prohibiting broker discretionary voting on these matters.

## CHANGES TO REQUIREMENTS OF COMPENSATION COMMITTEES

### *Independence Requirement for Compensation Committee Members*

The Act requires that within one year following the date of enactment (i.e., by July 21, 2011), the SEC must issue rules directing national securities exchanges and associations to require all members of a listed company's compensation committee to meet a heightened standard of "independence" that is substantially similar to the standard currently required of audit committee members under Rule 10A-3 of the Exchange Act. Issuers should review the current membership of their compensation committees to determine if any changes will need to be made once the new rules become effective. Issuers should also keep in mind that the members of their compensation committees must satisfy the definitions for "non-employee directors" under Section 16 of the Exchange Act and "outside directors" under Section 162(m) of the Internal Revenue Code, which definitions remain unchanged.

### *Retention and Independence of Committee Advisers*

The Act further provides compensation committees of listed companies with the authority to engage compensation consultants, independent legal counsel and other advisers, and makes the compensation committee directly responsible for the appointment, compensation and oversight of the work of such consultants and advisers. Issuers will be required to provide appropriate funding for such consultants and advisers, as reasonably determined by the compensation committee. The SEC is charged with issuing rules directing national securities exchanges and associations to require the compensation committee of listed companies to evaluate the independence of these consultants and advisers before selecting them. In those rules, the SEC must identify factors that affect independence, such as: (i) whether the proposed adviser provides other services to the issuer; (ii) the amount of fees received in respect of such services by the person that employs the compensation consultant, legal counsel or other adviser, as a percentage of the total revenue of that person; (iii) the policies and procedures of the person that employs the compensation consultant, legal counsel or other advisers that are designed to prevent conflicts of interest; (iv) any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee; and (v) any stock of the company owned by the compensation consultant, legal counsel or other adviser. Such factors must be competitively neutral among categories of advisers, and preserve the ability of compensation committees to retain the services of members of any such category.

Issuers will be required to disclose in any proxy statement for an annual meeting (or special meeting in lieu of an annual meeting) occurring on or after July 22, 2011 whether their 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).

In implementing the requirements regarding the retention and independence of compensation committee consultants and advisers, the exchanges are expressly required to consider the impact on smaller reporting issuers.

## CLAWBACK PROVISIONS

The Act requires the SEC to direct the national securities exchanges to prohibit the listing of issuers that do not adopt "clawback" policies to recoup incentive-based compensation (including stock options) that was paid to current or former executive officers on the basis of erroneous data during the three-year period preceding the date of an accounting restatement. The amount to be recouped is the amount in excess of what would have been paid under the restated results. No deadline for SEC rulemaking is specified.

The Act's clawback provision is broader in several respects than the clawback provision contained in Section 304 of the Sarbanes-Oxley Act of 2002 ("SOX"). Most significantly, the clawback provisions that issuers would be required to adopt under the Act would apply: (i) to all current and former executive officers of a registrant (rather than just the CEO and CFO, as is the case under SOX), (ii) regardless of whether any misconduct occurred (the clawback under SOX is triggered if there is a material noncompliance that is "a result of misconduct"); and (iii) to any incentive-based compensation received during the three years prior to the restatement.

## EXECUTIVE COMPENSATION DISCLOSURES

### *Pay and Performance Disclosure*

The Act requires the SEC to adopt rules requiring the disclosure in an issuer's annual proxy statement of the relationship between executive compensation actually paid and the issuer's financial performance, taking into account any change in the value of its shares and dividends and other distributions. The disclosure may be provided in narrative form or graphically. No deadline is specified for adoption of SEC rules.

### *Internal Pay Equity Disclosure*

The Act directs the SEC to amend Item 402 of Regulation S-K to require issuers to disclose: (1) the median annual total compensation of all of the issuer's employees, excluding the CEO; (2) the annual total compensation of the issuer's CEO; and (3) the ratio of the median annual total employee compensation to the annual total compensation of the CEO. For purposes of this requirement, "total compensation" of employees is determined in the same manner as it is determined for executive officers under Item 402 of Regulation S-K. We expect that many issuers may find it difficult to compile this information on a timely basis for all employees given the complexity of the analysis required by Item 402. This new requirement also raises concerns about the impression that the disclosure of pay equity may have on both employees and shareholders. No deadline is specified for adoption of SEC rules.

### *Disclosure of Chairman and CEO Structure*

The Act requires the SEC, within 180 days after enactment, to adopt rules providing for disclosure by each issuer in its annual proxy statement of the reasons why it has chosen the same person to serve as both the chairman of its board of directors and its CEO or why it has chosen two different individuals to fill those positions. This is essentially the same disclosure regarding board leadership structure that is already required as a result of the enhanced proxy disclosure rules adopted by the SEC on December 16, 2009, and thus any implementation issues should be minimal.

## ADJUSTMENT TO THE "ACCREDITED INVESTOR" STANDARD

Effective immediately, the Act revises the "accredited investor" standard so that a natural person will no longer be able to apply the value of his or her primary residence toward the $1 million minimum net worth standard to qualify as an "accredited investor." This change will make it more difficult for individual investors to qualify as "accredited investors" for purposes of participating in private placements of securities that may be limited to "accredited investors." The SEC staff has indicated that an individual investor need not deduct from his or her net worth the amount of mortgage debt secured by an excluded primary residence, except to the extent that the amount of the mortgage liability exceeds the fair value of the residence.

The Act also provides that the SEC may immediately review and modify the other provisions of the "accredited investor" definition as it applies to natural persons (such as the net income test). However, during the first four years after enactment of the Act, the SEC cannot modify the net worth standard. Once this four-year period has expired, and no less frequently than once every four years thereafter, the SEC is tasked with reviewing the "accredited investor" standard as it applies to individuals, including both the net worth and income tests, and making such adjustments as it deems appropriate.

The changes to the "accredited investor" standard apply to all private placements under Regulation D. Issuers relying on the "accredited investor" definition in connection with ongoing private offerings that may involve investors who are natural persons are advised to revise disclosure and subscription documents to reflect the modification of the net worth test, and to confirm that existing investors meet this test. Issuers should also modify their "accredited investor" questionnaires for future offerings to reflect this change.

## SARBANES OXLEY RULE 404(B) EXEMPTION FOR NON-ACCELERATED FILERS

Section 404(b) of SOX requires the auditors of public companies to attest to, and report on, management's assessment of the effectiveness of the company's internal control over financial reporting. The SEC has repeatedly deferred the date by which non-accelerated filers (i.e., issuers with less than $75 million of market capitalization) must comply with this requirement. Effective immediately, the Act amends SOX to exempt non-accelerated filers from complying with this requirement. In addition, the Act directs the SEC to conduct a study to determine how to reduce the burden of complying with SOX §404(b) for companies with market capitalizations between $75,000,000 and $250,000,000, and to deliver a report to Congress not later than nine months after enactment of the Act.

## CHANGES TO SECTIONS 13 AND 16 REPORTING

The Act authorizes, but does not require, the SEC to issue rules shortening the filing period: (i) for Schedule 13D in connection with acquiring beneficial ownership of more than 5% of a registered class of equity securities; and (ii) for Form 3 in connection with becoming a director, officer or greater than 10% shareholder of a public company. Currently, the deadline is ten days following each such event. There is no deadline for the SEC to adopt rules to make these changes.

## CONCLUSION

Although the exact parameters of many of the provisions contained in the Act have not yet been determined, and will only come into clearer focus following action by the SEC and other regulators, it is clear that the Act will have a substantial impact on all public companies for the foreseeable future. Issuers should begin to analyze the relevant provisions in the Act and think critically about how they affect their corporate governance, executive compensation and securities disclosure practices.

As noted above, the Act is a comprehensive piece of legislative reform that affects the entire financial services industry. There are many other aspects of the Act that we have not addressed in this Legal Update, as we have focused the discussion on matters most relevant to U.S. public companies. If you have any questions or would like any further information about this topic, please contact any of the authors of this Legal Update or the Pryor Cashman attorney with whom you work.

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*The foregoing is intended to summarize the corporate governance and executive compensation provisions of The Dodd-Frank Wall Street Reform and Consumer Protection Act, and does not constitute legal advice. Please contact the Pryor Cashman attorney with whom you work with any questions you may have. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Michael T. Campoli at (212) 326-0468 or Durre S. Hanif at (212) 326-0128.*

## ABOUT THE AUTHORS


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Michael Campoli devotes his practice to counseling public and private companies on a broad range of corporate matters, including securities law compliance, corporate formation and governance, mergers and acquisitions, public and private debt and equity financing transactions, and limited liability company and partnership counseling.

Mr. Campoli's work at Pryor Cashman has included the representation of:

- Marina Biotech, Inc. (NASDAQ: MRNA) as outside general counsel in connection with its equity and debt financings, M&A initiatives and compliance with Securities and Exchange Commission (SEC) reporting requirements
- Javelin Pharmaceuticals, Inc. (AMEX: JAV) as outside general counsel in connection with its equity financings and compliance with the reporting requirements of the SEC and other regulatory agencies
- Henry Schein, Inc. (NASDAQ: HSIC) in connection with the acquisition of various private companies in the medical equipment and software industries
- Briad Restaurant Group in its prevailing tender offer for Main Street Restaurant Group, Inc., the largest T.G.I. Friday's franchisee
- The Kushner Companies in connection with its acquisition of the office building located at 666 Fifth Avenue, New York, New York
- A private telecommunications company in connection with the issuance of a $260 million secured note to the Rural Utilities Service of the U.S. Department of Agriculture and the concurrent placement of $110 million of preferred stock to venture capital investors

**Previous Positions**

- Jenkins & Gilchrist Parker Chapin LLP, Associate (2000–03)

**Publications**

- Co-Author (with Yavonia Wise), *SEC Adopts Changes to Compensation and Corporate Governance Disclosure Rules*, Pryor Cashman Legal Update, December 2009
- Author, *SEC Delays Vote on Proxy Access Rules and Grants Extension for Compliance with Section 404(b) of the Sarbanes-Oxley Act*, Pryor Cashman Legal Update, October 2009
- Author, *House Approves Legislation Requiring Say-on-Pay Compensation Committee Independence*, Pryor Cashman Legal Update, August 2009
- Author, *Delaware Legislature Adopts Amendments to Delaware General Corporation Law Regarding Proxy Access and Other Issues*, Pryor Cashman Legal Update, July 2009
- Author, *SEC Approves Amendments to NYSE Rule 452 and Proposes Other Disclosure Enhancements*, Pryor Cashman Legal Update, July 2009
- Author, *Proxy Access Proposal*, Pryor Cashman Legal Update, May 2009

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Durre S. Hanif is an associate in Pryor Cashman's Corporate Group, where her practice covers general corporate matters.

Durre is a 2009 graduate of Benjamin N. Cardozo School of Law, where she was a Cardozo Scholar, Public Service Scholar, and a member of the *Arts and Entertainment Law Journal*. While in law school, Durre served as an oralist and teaching assistant for the Willem C. Vis International Arbitration Moots in Vienna and Hong Kong. As a participant in the school's Mediation Clinic, Durre also has experience mediating in the New York State Unified Court System and for the EEOC.

Durre received her Honors B.A. from Trinity College, University of Toronto in 2004, where she was a recipient of the National Book Award and the Plaque for Exemplary Service to the University Community.

In her free time, Durre volunteers to help promote literacy and women's rights in South Asia.

**Previous Positions**

- Honorable Denise L. Cote, United States District Court, S.D.N.Y., Judicial Intern (Summer 2007)
- Ernst & Young Kuwait, Analyst specializing in oil and gas strategy consulting (2005-06)

**Publications**

- Co-author (with John J. Crowe), *Hart-Scott-Rodino Transactions Thresholds Decrease*, Pryor Cashman Legal Update, March 2010