

July 22, 2010

## *It's Signed, Now for the Hard Part: What your Board Needs to Know About Corporate Governance and Executive Compensation Provisions in the Dodd-Frank Act*

The wait for financial regulatory reform legislation is over. President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd Frank Act) into law on July 21, 2010. The Dodd Frank Act, while primarily focused on financial regulations, also includes numerous measures affecting corporate governance and executive compensation.

The signing of the Dodd Frank Act follows a lengthy and sometimes contentious process. The Senate passed the Act on July 15 by a vote of 60 to 39 after reconciling the Senate's Restoring American Financial Stability Act of 2010 (the RAFSA)<sup>1</sup> and the U.S. House of Representatives' Wall Street Reform and Consumer Protection Act (the House bill).<sup>2</sup> While many of the corporate governance-related measures in the Dodd Frank Act are similar to those contained in the RAFSA, the final legislation does differ from the RAFSA in a number of areas, including requirements with regard to non-binding shareholder votes on "golden parachutes," the frequency of Say on Pay votes and the elimination of the RAFSA's majority voting standard for the election of directors.

While the year-long effort to pass financial regulatory reform is now over, the task of implementing the Dodd Frank Act's provisions has only just begun. The Dodd Frank Act leaves many difficult decisions in the hands of federal regulators, including 95 separate rules to be made by the U.S. Securities and Exchange Commission (SEC) alone. Speaking before a House subcommittee hearing, SEC Chairman Mary Schapiro indicated that these new responsibilities will be "logistically challenging and extremely labor intensive" and will likely require the SEC to add 800 new positions to its staff in order to implement the requirements placed within the SEC's jurisdiction.

This Legal Alert will summarize the Dodd Frank Act's corporate governance and executive compensation provisions and the timeline for compliance. As indicated in the chart below, while few provisions of the Act are effective immediately, public companies will need to begin responding as soon as practicable in order to be prepared for the implementation of the requirements contemplated by the Dodd Frank Act.

Sutherland intends to hold several webinars on the shifting corporate governance and executive compensation environment in the next several months. Sutherland has an upcoming webinar schedule on July 27, 2010 on Say on Pay issues. To register, please [click here](#).

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<sup>1</sup> S. 3217, 111th Cong. (2010). The bill was returned to the Senate Calendar on May 25, 2010.

<sup>2</sup> H.R. 4173, 111th Cong. (2009). The House bill, which incorporated the corporate governance provisions of the Corporate and Financial Institution Compensation Fairness Act, includes "Say on Pay" for all public companies, an independent compensation committee requirement for public companies, incentive-based compensation standards, and disclosure requirements applicable to financial institutions with \$1 billion or more in assets.

Bill Provision	Senate Bill	House bill	Dodd Frank Bill	Implementation Timeline
Say on Pay	X	X	X	Both Say on Pay vote and vote on frequency of Say on Pay vote to occur at first applicable shareholder meeting occurring within 6 months of enactment
Non-Binding Vote on "Golden Parachutes"	-	X	X	First applicable shareholder meeting occurring within 6 months of enactment
Proxy Access	X	X	X	SEC <u>may</u> establish rules – no deadline specified
Compensation Committee Independence	X	X	X	SEC to direct stock exchanges to develop listing standards within 360 days of enactment Compensation consultant disclosure must be in proxy materials for annual meeting occurring on or after one year of date of enactment
Mandatory "Clawbacks"	X	-	X	SEC must establish rules – no deadline specified
Hedging Disclosure	X	-	X	SEC <u>must</u> establish rules – no deadline specified
Broker Non-Voting	X	-	X	Effective immediately
Chairman/CEO disclosures	X	-	X	SEC must establish rules within 180 days of enactment
Majority Vote in Uncontested Elections	X	-	-	-

## Shareholder Vote on Executive Compensation (Say on Pay)

Section 951 of the Dodd Frank Act requires issuers of securities covered by the SEC's proxy solicitation rules to institute an up or down advisory vote on executive compensation (a Say on Pay vote). The Say on Pay vote is non-binding and is not meant to alter or overrule any specific action or decision by the issuer. The proxy materials for the first annual or other shareholder meeting occurring six months after the enactment of the Dodd Frank Act are required to contain this Say on Pay resolution; based on this timing, the Say on Pay requirement will be in effect for the 2011 proxy season. According to President Obama, these measures will allow shareholders "greater say on CEO pay so they can reward success instead of failure."

Notably, while the RAFSA contemplated annual Say on Pay votes, the Dodd Frank Act requires public companies to provide in their proxy statements a separate resolution to determine the frequency of such Say on Pay votes. At the first annual or other shareholder meeting occurring six months after the enactment of the Dodd Frank Act, issuers are

required to put to a shareholder vote whether to hold Say on Pay votes annually, biennially or triennially. Thereafter, shareholders must again be provided the opportunity to vote on the frequency of Say on Pay votes at least once every six years. This provision has raised several interpretive questions, including whether this frequency vote will be binding upon issuers.

During the conference process, a further provision was added to give the SEC the authority to exempt companies from the Say on Pay requirements after taking into account, among other considerations, whether the requirements would disproportionately burden smaller companies.

Say on Pay votes are already mandatory for recipients of Troubled Asset Relief Program (TARP) funds and have been a focus of U.S. financial regulatory reform efforts since 2007.<sup>3</sup> The growing movement for Say on Pay has culminated this year in the failure of three companies to receive majority support for their compensation plans.<sup>4</sup>

During conference negotiations, the Senate conferees also accepted a proposal from House conferees to require large institutional investment managers to disclose their Say on Pay votes.

### Discretionary Votes on Golden Parachutes

Section 951 of the Dodd Frank Act further requires that proxy statements include a separate, non-binding resolution to approve “golden parachute” payments (payments to named executive officers upon a change of control); while present in the House bill, this provision was not included in the RAFSA. The golden parachute requirement applies to any proxy or consent solicitation materials for a meeting at which shareholders are asked to approve a business combination, acquisition, merger, consolidation or disposition of all or substantially all of the company’s assets and includes disclosure of the aggregate total of all such compensation that may be paid and the conditions for its payment. The provisions for golden parachute votes largely mirror those for Say on Pay votes in that they are (i) non-binding on the issuer and its board, (ii) require large institutional investment managers to disclose their vote and (iii) grant the SEC authority to exempt issuers or classes of issuers from the requirement.

### Proxy Access for Shareholder Nominees

Section 971 of the Dodd Frank Act gives the SEC explicit authority to make rules requiring an issuer to include shareholder nominees in its proxy solicitation materials. Notably, however, it does not require the SEC to issue such rules.

The SEC has already proposed similar proxy access rules that would permit shareholders meeting certain thresholds to place their own nominees alongside a company’s nominees in the company’s proxy materials.<sup>5</sup> At a June 9 meeting of the Business Roundtable in Washington, SEC Chairman Mary Schapiro reiterated that proxy access rulemaking would be done in a time frame which would allow nominees for the 2011 annual meeting season. She also noted that a Concept Release on proxy access would be issued soon.

Although particular ownership thresholds and holding periods with regard to proxy access had been discussed during conference negotiations, the final version of the Dodd Frank Act is largely identical to the RAFSA provisions in that the setting of any standards is left to the SEC. The Senate conferees at one point had appeared to accept a House provision imposing a 5% ownership standard and a two-year

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<sup>3</sup> For more information on the history of Say on Pay initiatives, please see our October 5, 2009, Legal Alert, “Say on Pay: It’s Coming, Are You Ready?”, available at <http://www.sutherland.com/files/News/b41d1bd9-a974-48a5-a9e1-0339bcffc4ed/Presentation/NewsAttachment/85bebe0d-f7b1-4970-9bb9-181b98555321/CORP%20Alert%2010.5.09.pdf>.

<sup>4</sup> In May, a majority of shareholders of Motorola, Occidental Petroleum Corp., and KeyCorp (a TARP recipient) each failed to vote to approve the respective company’s compensation plan.

<sup>5</sup> Proposed Rule Facilitating Shareholder Director Nominations, Securities Act Release No. 9,046, Exchange Act Release No. 60,089, Investment Company Act Release No. 28,765 (proposed June 10, 2009), available at <http://www.sec.gov/rules/proposed/2009/33-9046.pdf>.

holding period on shareholders who wish to nominate directors.<sup>6</sup> While the Dodd Frank Act does not contemplate any such limits, it does alter the RAISA text to give the SEC explicit authority to exempt an issuer or a class of issuers from the proxy access requirements and directs the SEC to take into account whether the requirements disproportionately burden small issuers.

## Recovery of Erroneously Awarded Compensation (Clawback)

Section 954 of the Dodd Frank Act, unchanged from the RAISA, requires issuers to adopt “clawback” policies on excessive incentive-based compensation.

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These policies apply if the issuer is required to prepare an accounting restatement based on material noncompliance with financial reporting requirements under federal securities laws. Issuers must recover from current and former executive officers any incentive-based compensation (including stock options) awarded in excess of what would have been awarded under the restated accounting numbers. The recovery applies to a three-year “look-back” period preceding the date that the restatement was required.

The Dodd Frank Act further requires issuers to disclose their policies on incentive-based compensation that are based on financial information reported under federal securities laws. It also mandates that national exchanges and securities associations prohibit the listing of any class of equity security of issuers that do not comply with these requirements.

## Employee and Director Hedging

Section 955 of the Dodd Frank Act requires the SEC to adopt rules requiring issuers to disclose in their proxy statements whether employees or directors may purchase financial instruments designed to hedge or offset decreases in the value of equity securities. This disclosure includes not only equity securities granted to employees or directors as part of employee compensation, but also equity securities held directly or indirectly by the employee or director. Given the onset of mandatory Say on Pay voting, this disclosure may become increasingly important to investors who seek evidence of the alignment of pay with performance.

## Discretionary Broker Voting and Majority Voting

Section 957 of the Dodd Frank Act, in certain circumstances, prohibits brokers that are not beneficial owners of shares from exercising their discretion to vote those shares by proxy. Brokers are prohibited from voting on director elections, executive compensation or any other “significant matter” (to be defined in future SEC rules) without specific voting instructions from the beneficial owner of the shares. Unlike the

<sup>6</sup> See Ted Allen, *Senate Seeks to Drop Majority Voting From Reform Bill and Weaken Proxy Access*, available at <http://blog.riskmetrics.com/gov/2010/06/senate-seeks-to-drop-majority-voting-from-reform-bill-and-weaken-proxy-access.html>.

RAFSA, the Dodd Frank Act does provide an exception for broker voting in uncontested elections of directors at a registered investment company.

This provision follows the July 1, 2009, approval by the SEC of an amendment to NYSE Rule 452, applicable to all companies listed on the NYSE, which prohibits brokers from voting unrestricted shares in uncontested director elections without receiving specific voting instructions from beneficial owners.<sup>7</sup> Note that this provision may impact Say on Pay voting results by removing discretionary authority for brokers to vote on Say on Pay proposals.

Although the RAFSA would have mandated that directors be elected by a majority (in uncontested elections) or a plurality (in contested elections) of votes cast, the Senate conferees agreed to drop the majority voting provision from the Dodd Frank Act. Senator Christopher Dodd, the lead Senate negotiator, did not express a rationale behind eliminating this provision, which was not present in the House bill, from the Senate conferees' recommendations.

## Separation of Chairman and CEO

Section 972 of the Dodd Frank Act directs the SEC, within 180 days of enactment, to adopt rules requiring issuers to disclose in their annual proxy statements the reasons why they have chosen the same person, or different people, to serve as chairman of the board and as chief executive officer (or the equivalent position).

This provision mirrors a parallel provision in the proxy disclosure rules adopted by the SEC in December 2009 (the 2009 proxy rules).<sup>8</sup> If a company has combined the role of board chair and CEO and has also appointed a lead independent director, the 2009 proxy rules also require disclosure related to that decision and the specific role of the lead independent director.<sup>9</sup> In adopting the 2009 proxy rules, the SEC made clear that it would not express a preference for a particular leadership structure.<sup>10</sup>

## Compensation Committee Independence

Section 952 of the Dodd Frank Act requires each member of a board's compensation committee to meet independence requirements to be established by the national exchanges. Any compensation consultants or other advisers retained by the compensation committee also must meet independence standards to be identified by the SEC. The Dodd Frank Act adds a new provision to the RAFSA mandating that the SEC

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<sup>7</sup> The amendment to NYSE Rule 452 took effect for shareholder meetings held on or after January 1, 2010. See Order Approving Proposed Rule Change, as modified by Amendment No. 4, to Amend NYSE Rule 452, Exchange Act Release No. 60,215 (approved July 1, 2009), available at <http://www.sec.gov/rules/sro/nyse/2009/34-60215.pdf>.

<sup>8</sup> Proxy Disclosure Enhancements, Securities Act Release No. 9,089, Exchange Act Release No. 61,175, Investment Company Act Release No. 29,092 (adopted December 16, 2009), available at <http://www.sec.gov/rules/final/2009/33-9089.pdf>.

<sup>9</sup> *Id.* at 43.

<sup>10</sup> *Id.* at 42.

conduct a study to be submitted to Congress within two years of the enactment of the Dodd Frank Act on the use of compensation consultants and the effects of such use.

Echoing the 2009 proxy rules, an issuer is required to disclose in its annual proxy statement whether the compensation committee hired a compensation consultant, whether the consultant's work raised any conflicts of interest, and, if so, the nature of the conflict and how it is being addressed.<sup>11</sup>

The Dodd Frank Act provides the compensation committee with the authority to appoint, oversee and determine the compensation for independent legal counsel and other advisers. The compensation committee is under no obligation to implement the adviser's recommendations nor is the committee to be relieved of any of its existing obligations. This provision mirrors Title III of the Sarbanes-Oxley Act of 2002, which specifically empowered a company's audit committee to engage outside experts at company expense. Courts have also recognized the need for directors to look to competent outside consultants and legal advisers.<sup>12</sup>

The Dodd Frank Act also directs the SEC, within one year of enactment, to issue rules requiring national exchanges and securities associations to prohibit the listing of any securities of issuers that are not in compliance with these requirements. A non-compliant issuer does have an opportunity under the bill to cure any related defects.

## Executive Compensation Disclosures

Section 953 of the Dodd Frank Act directs the SEC to adopt enhanced rules relating to disclosure of executive compensation. Each issuer is required to include in its annual proxy statement a clear description of compensation paid to its executives and how the compensation relates to the issuer's financial performance.

Section 956 of the Dodd Frank Act further requires that issuers disclose the median total annual compensation of all employees other than the CEO, the annual total compensation of the CEO, and the ratio of these two amounts. Shareholder advocacy groups point to extreme disparities between CEO compensation and other executive compensation as a red flag that could induce shareholders to withhold approval in any Say on Pay vote.<sup>13</sup> It is worth noting that the Act does not mandate whether any particular analysis putting this ratio in context will be required, although it is possible that the SEC might adopt such rules going forward.

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<sup>11</sup> In contrast to the RAFSA, however, the 2009 proxy rules set forth specific monetary thresholds that determine the disclosure of aggregate fees paid to compensation consultants, as well as disclosure related to the circumstances under which the decision to hire a consultant was made.

<sup>12</sup> For example, the Delaware Supreme Court in the *Disney* case focused on the alleged failure of the compensation committee to seek expert advice in advance of important compensation decisions. *In re The Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 59–61 (Del. 2006).

<sup>13</sup> For example, The Corporate Library lists CEO compensation that is "more than three to five times the average [compensation] of the other named executive officers" as one of its 10 most important factors for shareholders to consider in deciding how to cast a "Say on Pay" vote. Paul Hodgson, *A 10-Point Test: When We Have Say on Pay, How Will I Decide Whether to Vote Yes or No?*, The Corporate Library, available at [http://info.thecorporatelibrary.com/say-on-pay-how-to-vote-yes-or-no/?utm\\_campaign=Say-on-Pay&utm\\_source=TCL-homepage](http://info.thecorporatelibrary.com/say-on-pay-how-to-vote-yes-or-no/?utm_campaign=Say-on-Pay&utm_source=TCL-homepage).

## Whistleblower Program

Section 922 of the Dodd Frank Act creates a new whistleblower program that authorizes cash rewards to whistleblowers who voluntarily provide the SEC with information leading to successful prosecution of securities laws violations. The SEC is required to pay whistleblowers who provide the Commission with “original information” cash rewards of between 10% and 30% of any monetary sanctions in excess of \$1,000,000 that the government recovers through either civil or criminal proceedings as a result of the whistleblowers’ assistance. “Original information” must be (i) derived from the independent knowledge or analysis of the whistleblower; (ii) cannot be known to the SEC by an alternative source; and (iii) cannot be exclusively derived from an allegation made in a hearing, government report or from the media.

This provision expands the SEC’s previous whistleblower program, which applied to insider trading cases only and limited rewards to a maximum of 10% of any monetary sanctions recovered, with no minimum reward guaranteed.



*If you have questions regarding this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

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