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Implementing the Dodd-Frank Act

Corporate Governance, Disclosure & Capital Raising Provisions of the Dodd-Frank Act

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act") became law on July 21, and is the most significant financial regulatory legislation since the Great Depression of the 1930s. It represents the Congressional response to the excesses in the financial markets that produced the recent Great Recession. Included within the Dodd-Frank Act are various provisions that expand federal involvement in corporate governance matters traditionally within the province of the states to an extent not seen since the Sarbanes-Oxley Act of 2002, which was a Congressional response to a different economic crisis. The Act also includes important revisions to disclosure and capital raising requirements.

While there can be debate over whether corporate governance weaknesses were a cause of the recent financial difficulties, the Act's corporate governance and disclosure provisions have been justified as addressing increased accountability of directors and controlling compensatory practices that are claimed to have contributed to excessive risk-taking. Equally important to the provisions adopted are those that were proposed by shareholder activists and others, but not adopted.

This article covers the operative provisions of the Dodd-Frank Act dealing with corporate governance, disclosure, capital formation and other securities-related matters and their impact on companies. It identifies actions companies can take to deal effectively with the Act's requirements. The Act also calls for numerous studies by the Securities and Exchange Commission and

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other government agencies and grants the SEC expanded authority in a number of areas which might lead to additional future rulemaking.

Corporate Governance Provisions

Director accountability

Proxy Access (§ 971)—The principle provision dealing with director accountability is the authority given to the SEC under § 14 of the Securities Exchange Act of 1934 (the "Exchange Act") to adopt proxy access rules, with authority to exempt smaller issuers. This provision has limited practical significance because the SEC already had proposed proxy access rules. Under these proposals, certain shareholders with sufficient long-term interests would be entitled to have director nominees included in the company's proxy materials. The new legislation, besides encouraging the SEC to proceed with the adoption of the access rules, addresses some of the grounds for challenging the SEC's actions. Without the legislation, challenges were threatened on the grounds that the SEC was exceeding its authority under the Exchange Act proxy provisions and intruding upon state prerogatives without express federal legislative authorization. Although challenges based upon violation of the Administrative Procedure Act are still possible, the challenges based on the SEC's exceeding its authority would appear to be eliminated.

The House bill would have required the SEC to adopt a proxy access rule. The Senate bill and now the Act merely authorize it to do so. In the Conference Committee, Sen. Christopher Dodd (D-Conn.) and several other senators proposed an amendment that would have established a threshold for eligible shareholders of 5% and a two-year ownership period. It was unclear whether aggregation would have been permitted. This proposal was rejected after vocal opposition by shareholder activists, as was a compromise of 3% ownership and a one-year ownership period with an additional provision requiring a shareholder utilizing access to hold the shares for some subsequent period. It is possible, however, that these efforts may have some influence on the SEC's setting thresholds in its rulemaking.

Since the SEC proposed proxy access in June 2009 and in view of recent statements of SEC Chairman Mary Schapiro, it is reasonable to expect a proxy access rule to be adopted in the near future and to be available for the 2011 proxy season unless the SEC defers its application to a later time to give companies an opportunity to take actions on their own to fashion a proxy access regime that works for individual companies. Although final decisions cannot be made until there are final SEC rules, it is not too soon for companies to consider what by-law amendments, such as revision of advance notice provisions, and other changes might be necessary and what variations might be desirable if permitted by the SEC rules. Companies should also evaluate the potential vulnerability of any existing directors, and consider how the company will address dealing with possible shareholder nominees under a proxy access regime.

Majority Voting Dropped—The most significant corporate governance requirement dropped was the provision in the Senate bill that would have mandated majority voting in uncontested elections for all public companies. Not only that, it would have required a resignation submitted by an incumbent director who failed to achieve a majority of the votes to be rejected only by unanimous vote of the board. This provision was dropped in Conference Committee, in part as a tradeoff for including proxy access. Although many large companies already have adopted some form of majority voting, the Senate bill would have imposed this director election regime on all stock exchange-listed companies notwithstanding the prevailing state law plurality system and holdover rule designed to ensure the existence of a full board to permit uninterrupted management. Moreover, it would have adopted the overly simple test of a contested election to exclude majority voting. Not all contested elections are alike. For example, although there may be more nominees than directors to be elected, there may not, in fact, be a contest if one of the nominees is ineffective or inactive. Also, a situation in which 14 nominees are contesting for seven seats is very different than 14 nominees contesting for 13 seats, especially if the nonmanagement candidate is not a viable candidate. Finally, the Senate bill's unanimous vote requirement to accept a resignation would have had the potential for great mischief in many situations, for example when a dissident has gotten a board seat through a settlement or board contest, including one under proxy access, and thus would have a veto. Fortunately, the provision was dropped from the final legislation and market forces will be allowed to continue to operate to determine the election regime most suitable for a particular company.

Staggered Board Prohibition Dropped—Another early Senate proposal that did not make it into the Senate bill as passed would have barred staggered boards for stock exchange-listed companies. This proposal would have severely limited a governance option that fosters continuity and long-term focus and that can serve legitimate defensive purposes to avoid unfair, coercive takeover bids and force negotiation with the board. The irony of such a prohibition is that the Senate itself is structured under the Constitution with staggered terms.

Separation of Chairman and CEO (§ 972)—The Act adds § 14B to the Exchange Act to require the SEC to adopt rules not later than 180 days after enactment to require companies to disclose in the annual meeting proxy statement why the company chose to have a separate Chairman of the Board and CEO or to have the same individual serve in both capacities. The SEC already requires disclosure regarding the Chairman and CEO roles and it remains to be seen whether there will be any revisions in response to the legislation.

Broker Non-Votes (§ 957)—The Act amends § 6(b) of the Exchange Act to require national securities exchanges to prohibit member broker-dealers from voting shares of Exchange Act registered companies held in street name in the election of directors, on compensation matters (which would include say-on-pay votes) and on other matters to be determined by the SEC unless instructed by the beneficial owner. The New York Stock Exchange, whose rules govern most broker-dealers, previously amended Rule 452 to prohibit broker voting in all elections of directors, not just, as before, those that are contested. Rule 452 also already prohibits broker voting on approval of equity compensation plans. The new ban on broker voting is being applied immediately, and it will be interesting to see whether additional items will be added to the list of items to which broker nonvoting will apply. In any case, the banning of broker voting makes it more difficult for companies to obtain shareholder votes necessary for a quorum and various actions and increases the influence of institutional investors and proxy advisory firms.

Risk Management for Financial Institutions (§ 165 and § 956)—Certain nonbank financial companies will be required to establish board-level risk committees in accordance with regulations adopted by the Federal Reserve. This is narrower than an earlier version of the Senate bill that would have required most listed companies to have separate risk committees. In addition, covered financial institutions will be required to manage institutional risk arising from compensation arrangements subject to oversight by their federal regulator. Although limited to financial institutions, these requirements may impact practices of nonfinancial companies for whom management of risk is a significant factor. Therefore, companies in this position may wish to consider their methods for management and control of enterprise risk, including the possible use of board-level risk committees or focusing oversight of risk at the board level in some other way.

Compensation Provisions

The compensation provisions are both governance related and disclosure oriented although even the disclosure requirements are designed to affect governance structures and compensation policies.

Governance-related provisions

Say-on-Pay Votes (§ 951)—One of the more significant compensation control provisions in the Act is the addition of § 14A to the Exchange Act to require that shareholders be given the opportunity, beginning with the first annual or other shareholder meeting requiring compensation disclosure occurring six months after enactment, to vote on a non-binding basis on a company's executive compensation as disclosed pursuant to Item 402 of Regulation S-K. Shareholders also must be given the opportunity to vote whether they want the interval for this "say-on-pay" voting to be one, two or three years, and to renew that choice every six years. The SEC is given authority to exempt certain issuers from this vote requirement, including smaller issuers.

Although SEC rulemaking is not required for the say-on-pay vote requirement to apply, some issues that may be clarified by SEC rulemaking are whether preliminary proxy statement filing will be required, how the vote resolutions should be framed and the method of determining the outcome of the interval vote, given that there are three choices (for example, will plurality voting apply as a matter of federal law?). It is expected that the SEC will not require preliminary proxy statement filing, as it does not for TARP say-on-pay votes.

Companies should take the opportunity to consider their compensation policies and disclosure and the likely reaction of shareholders. They should also have in mind the guidelines on compensation practices of proxy advisory firms and institutional investors, such as those of ISS and the Council of Institutional Investors. A company might begin informal communications with its key shareholders to explain the company's compensation policies and solicit the views of those shareholders. Companies also should consider whether to take a position on the frequency of shareholder say on pay votes. For example, some commentators are advocating votes at three-year intervals to emphasize the long-term aspects of compensation. Although the interval vote of shareholders apparently also is nonbinding, companies are unlikely to adopt longer intervals than approved by shareholders.

Although a say-on-pay shareholder vote is nonbinding and does not affect the fiduciary duty of directors, a negative vote can nevertheless have consequences if directors are perceived as being nonresponsive. Thus, withhold vote recommendations or campaigns could be the result, with adverse consequence if a company has majority voting or there is an election contest.

One problem with a say-on-pay vote is that it often will be unclear what the vote in fact means. Such a vote can be a blunt instrument as a referendum. The lack of clarity can have several effects—it may reflect shareholder frustration on a range of issues and possibly a mix of motives with no single factor predominating. Therefore, boards would be well-advised to communicate with key shareholders so that they understand the real meaning of the vote and thus are in a better position to be responsive. On the other hand, a favorable vote may be taken as an endorsement when it represents nothing more than shareholder inertia. Therefore, boards should continue to take seriously their responsibilities with respect to compensation matters in fulfillment of their fiduciary duties.

Golden Parachute Votes *(§ 951)*—In addition to the regular say-on-pay vote on executive compensation, companies will be required under § 14A(b) of the Exchange Act to submit to shareholders beginning six months after enactment, on a nonbinding basis, any executive officer compensation related to an acquisition transaction, unless the compensation arrangement has been previously subject to a shareholder say-on-pay vote. This is to be done in accordance with rules adopted by the SEC, including with respect to the disclosure of the arrangements to shareholders, which is required to be in a clear and simple form, in order to permit an informed vote. The SEC's exemptive authority applies to this vote.

Companies should be aware of these requirements as they enter into golden parachute arrangements and as they plan acquisition transactions. Depending on the circumstances, votes by the shareholders of both the target and the acquiror may be necessary. The required vote and disclosure will apply to arrangements already in effect, as well as to new arrangements. Companies also could consider whether to put standing arrangements in place that are covered by the regular say-on-pay vote in order to avoid the separate vote at the time of the transaction.

Institutional Investment Manager Disclosure *(§ 951)*—Institutional investment managers who exercise investment discretion over at least $100 million of U.S. public company equity and certain other securities (those subject to Section 13(f) reporting) will be required under § 14A(d) of the Exchange Act to report at least annually how they voted on regular say-on-pay proposals and in golden parachute say-on-pay votes. This public disclosure is likely to influence the voting behavior of large institutional shareholders and could make obtaining favorable votes more difficult in the absence of strong efforts by companies to communicate with these shareholders and court their approving vote.

Compensation Committee Independence (§ 952)—Reminiscent of Sarbanes-Oxley's treatment of Audit Committees, the Dodd-Frank Act adds § 10C to the Exchange Act to require each member of the Compensation Committee to be independent and for the Compensation Committee to have the authority for the appointment, compensation and oversight of its consultants and advisers. Unlike in the case of Audit Committees under Sarbanes-Oxley, the new legislation does not require companies to have Compensation Committees, although the New York Stock Exchange rules do require them. The new requirement is to be effected by the SEC's adopting rules not later than 360 days after enactment, directing the national securities exchanges to adopt listing standards. These rules do not apply to "controlled corporations" or foreign private issuers that disclose annually that they do not have an independent compensation committee. The national securities exchanges are to be given authority to provide further exemptions, which may include smaller issuers.

In addition to the members of the Committee being independent, as prescribed by the SEC and the exchanges, the Compensation Committee is required to consider, in selecting compensation consultants, legal counsel and other advisers, their independence based on factors that the SEC is to identify. However, there is no requirement that the Compensation Committee use consultants and advisers or, if they do, that they be independent, so long as the Committee considers their independence. Also, there is no prohibition on the Committee's continuing to involve the company's consultants and counsel in its activities. They just should not be considered as consultants or counsel of the Committee and certainly should not be considered as independent consultants or counsel.

Related to the focus on consultant and adviser independence, companies will be required, pursuant to SEC rules, to disclose in annual meeting proxy statements whether consultants were used by the Compensation Committee and, if so, whether the engagement raised any conflicts questions.

Companies should begin now to review the independence of current Compensation Committee members. Although most Compensation Committee members already meet traditional independence standards, it is reasonable to anticipate heightened independence requirements akin to those for Audit Committees under SEC Rule 10A-3. These might include disqualifying from being independent affiliated persons, such as large shareholders, and directors with separate compensatory arrangements. Compensation Committee charters also should be reviewed to identify any changes that may be necessary.

Clawbacks (§ 954)—In what may prove to be one of the more difficult provisions to deal with, the Dodd-Frank Act adds § 10D to the Exchange Act to require companies to adopt a policy to recover from current and former executives any incentive compensation, including stock options, received during the three-year period preceding an accounting restatement resulting from erroneous financial data. The recovery must be any portion of incentive compensation that would not have been awarded based on corrected data and is without regard to an executive's involvement in activities requiring the restatement. The clawback requirement is to be implemented by the SEC's adoption of rules requiring national securities exchanges to adopt these requirements as listing standards. No timeline is provided in the statute but the SEC can be expected to deal with this within the 360-day period provided for related provisions.

This new clawback provision goes beyond the clawback provision in § 304 of Sarbanes-Oxley by applying to a broader category of officers, covering a longer look-back period, making explicit that fault is not needed and adding other specificity.

The Act requires the SEC's rules to provide for companies to disclose their policy on incentive-based compensation subject to clawback. It is possible that the SEC's disclosure requirements will go beyond that to cover, for example, how the policies have been implemented and what clawbacks have taken place.

Companies should begin to review their existing executive compensation arrangements and how a potential clawback provision would apply. For example, the clawback arrangement might have retroactive application to existing incentive compensation arrangements and to incentive compensation already earned or paid. On the other hand, payments pursuant to preexisting contractual commitments without clawback provisions might not be vulnerable because retroactive application to these would create constitutional impairment of contract issues. In addition, what arrangements will be subject to a clawback because they are dependent on accounting data is not entirely clear. For example, if an executive is entitled to a bonus if the company's stock price reaches a specified level, would an accounting restatement that reduces net income affect that bonus and, if so, in what amount? There are numerous issues like this that can begin to be considered, and there may be further guidance in the rulemaking process.

Companies can also begin to review more broadly—with the clawback requirements in mind—their compensation methods, including the mix of fixed and incentive compensation, and the type of incentive-based compensation utilized. While it is unlikely that the potential for clawbacks will be a driver of compensation policies, it nevertheless may be a factor to take into account. Companies might also consider the approach they take in designating who are executives and thus subject to a clawback requirement.

Disclosure Provisions

In addition to the disclosure requirements noted above that are tied to the governance-related provisions, the Dodd-Frank Act adds several stand-alone compensation disclosure requirements to § 14 of the Exchange Act.

Pay Relative to Performance (§ 953(a))—Companies will be required to disclose in the annual meeting proxy statement the relationship between executive compensation required to be disclosed pursuant to Item 402 of Regulation S-K actually paid and the companies' financial performance (taking into account changes in share value and dividends) in accordance with rules to be adopted by the SEC. There is no deadline for the SEC's adoption of rules. The SEC's rules may permit the disclosure to be depicted graphically. They also may clarify what compensation "actually paid" means and how financial performance is to be determined.

Many companies already have been dealing with the concept of pay relative to performance under standards developed by proxy advisory firms and institutional investors. Although these standards may differ from those finally adopted by the SEC, they nevertheless should be relevant. Therefore, companies should consider their use of existing pay relative to performance standards and how they might best present their story both under the disclosures that the SEC mandates and as supplemental information. This could include changes in a company's Compensation Discussion and Analysis (CD&A) and graphic presentations (in addition to the currently required stock price performance graph).

Pay Equity (§ 953(b))—Companies will be required to disclose, in accordance with SEC amendments to Item 402 of Regulation S-K, the median total compensation of all employees other than the CEO, annual total compensation of the CEO and the ratio of the two. Compensation is to be determined consistently with the requirements of Item 402 for purposes of the Summary Compensation Table as in effect on the day before the Act's enactment. Although this disclosure will not add a burden for the CEO's compensation, which is done anyway for the Summary Compensation Table, it will present considerable difficulty for other employees since it is not a calculation that is otherwise made. Moreover, if the SEC's Summary Compensation Table disclosures are changed in the future, two sets of computations would need to be made. It remains to be seen whether the SEC rules will mitigate some of these difficulties.

The Act's specified pay ratio is a blunt instrument for assessing pay equity and results will vary widely among different companies due to the nature of their employee demographics and can vary widely from year to year. Companies, thus, may want to consider voluntarily providing additional information, such as peer company comparisons, explanations for the variance and multiyear information, to put the required pay equity information in context. In addition, the new disclosure may impact business decisions, such as the use of outsourcing.

The Act does not specify a timeframe for SEC rulemaking, and therefore it is not clear when the SEC may act. However, companies should begin the process of compiling the necessary information. The SEC rules may clarify as of what date the calculation is to be made and which employees are to be included. A company may want to do a trial run using fiscal 2009 information to see what the disclosure is likely to produce.

Hedging Policy (§ 955)—Companies will be required to disclose in the annual proxy statement, in accordance with SEC rules to be adopted, whether employees or directors may purchase financial instruments designed to hedge or offset market value decreases of equity securities granted to them as compensation or otherwise held by them. This disclosure is designed to provide shareholders with additional information regarding the extent to which the equity interests of employees and directors are aligned with those of shareholders. No deadline is provided for SEC rulemaking.

Companies should revisit their policies regarding permissible hedging and consider expanding them in view of the increased disclosure that will be required. This is likely to require revising company insider trading policies to reflect any new restrictions on hedging. Companies also will want to consider whether to have different policies for directors and senior officers and for other employees. In addition, companies should review their existing disclosures regarding hedging policies.

Capital Raising Changes

Revision of "Accredited Investor" Definition (§ 413)—The SEC is authorized to revise the criteria for individuals to satisfy the net worth test for "accredited investor" status, provided that the test for four years after enactment shall be $1 million excluding the value of the individual's primary residence. The SEC has clarified that this revised test was effective immediately. While this appears to be a provision broadening the SEC's authority, in reality it is restrictive by locking in the net worth test for individuals at $1 million, excluding primary residence, for four years

The Act is silent on whether related debt on an excluded primary residence is also excluded in calculating net worth, but the SEC has provided guidance (see C&DI 179.01 and 255.47) that permits netting any related debt secured by the primary residence up to its fair market value, with any excess being treated as a deduction to net worth. This appears to be the case even in states that do not permit deficiency judgments.

Companies should revise now their questionnaires and agreement representations used in connection with exempt offerings to reflect the change in the "accredited investor" definition.

Addition of "Bad Boy" Disqualifiers (§ 926)—The SEC is required to adopt rules not later than one year after enactment to add "bad boy" disqualification provisions to Rule 506, the private offering safe harbor under Regulation D. The required disqualifications are drawn from Rule 262 under Regulation A, supplemented by the addition of final orders of state blue sky regulators and certain state and federal banking and insurance regulators that involve bars or are based on fraudulent conduct within 10 years prior to the offering. Bad boy disqualifiers based on Rule 262 currently apply to the Rule 505 limited offering exemption. It is possible that the SEC could seek to conform the Rule 505 disqualifiers to the new Rule 506 disqualifiers.

Companies should confirm whether any officers, directors or affiliates are subject to any of the disqualifying events in order to determine whether the company is eligible to use the Rule 506 safe harbor in connection with future private offerings. Questionnaires used in connection with these offerings should be revised to elicit disqualification information.

Rescission of Rule 436(g)(§ 939G)—The Act rescinds, effective immediately, SEC Rule 436(g) under the Securities Act of 1933 (the "Securities Act"). That rule provided that credit ratings on debt and certain other securities were not considered "expertized" portions of a registration statement for which the expert making it, whose consent is required to be filed, would be subject to potential liability under § 11 of the Securities Act.

In response to this repeal, the three major credit rating agencies have declined to furnish consents to being named as experts in registration statements. As a result, companies need to exercise care in using credit ratings in the absence of consents as part of registration statements subject to the expert consent requirement, including in prospectuses and documents incorporated by reference. This restriction would not apply to disclosure of credit ratings in free-writing prospectuses and press releases under Rule 134 because these do not require consents (see C&DI 233.06). It also would not apply to shelf registration statements that include or incorporate ratings information that were effective before July 22, 2010 until the next posteffective amendment (such as the next Form 10-K) is filed and so long as no subsequent incorporated report includes offering-related ratings information (see C&DI 233.07 and .08). In addition, the SEC has made clear that reference to credit ratings in Exchange Act reports that may be incorporated by reference into a registration statement as part of disclosure—for example, to disclose a change in ratings or with respect to covenant compliance and not for offering purposes—would not create a problem (see C&DI 233.04 and .05). Companies should review their disclosures of ratings to determine whether the nature of their use will cause registration problems and consider elimination of the rating information if it would.

A special problem was created by the repeal of Rule 436(g) for asset-backed securities that were registered because Regulation AB requires inclusion of the credit rating in the registration statement if a rating is required for issuance of the security. Following a brief freezing of the market for these securities, the SEC provided temporary relief in a no action letter to Ford Motor Credit Co. (July 22, 2010) by allowing issuers of registered asset-backed securities to omit credit ratings for six months (see C&DI 233.04).

Other Securities-Related Provisions

Smaller Issuer Section 404(b) Exemption (§ 989G)—Effective immediately, nonaccelerated filers are exempt from the requirement of § 404(b) of the Sarbanes-Oxley Act to obtain an auditor's attestation of the company's internal controls over financial reporting. This change is designed to relieve smaller issuers of the cost of the auditor attestation. However, the requirement of § 404(a) that management assess the company's internal controls over financial reporting remains unchanged and no relief is provided for smaller issuers who are accelerated filers because their market float exceeds $75 million.

Because the SEC's deferral of the auditor attestation requirement has already expired, many companies may have started down the path of having such an attestation. These companies may want to consider the desirability of continuing down that path notwithstanding the availability of an exemption. Moreover, a company that currently is a nonaccelerated filer may lose that status when it applies the market float test at the end of its second quarter and thus finds itself subject to the auditor attestation requirement in the future. Therefore, a company near the $75 million market float level might consider proceeding with auditor attestation or being ready to obtain an attestation should it become required.

Beneficial Ownership Reporting—Section 929R of the Act amends § 13(d) and § 16(a) of the Exchange Act to give the SEC the authority to shorten the ten-day time periods for filing Schedule 13D upon acquiring beneficial ownership of more than 5% of a registered class of equity securities and for filing a Form 3 to report beneficial ownership upon becoming a director, officer or greater than 10% shareholder of a public company. In view of the pressures for more timely disclosure, the SEC may use this new authority to shorten the filing time periods as was done for Form 4 filings pursuant to the Sarbanes-Oxley Act.

Regulation FD Revision (§ 939B)—As part of the regulation of credit rating agencies, the Act requires the SEC, no later than 90 days after enactment, to amend Regulation FD relating to selective disclosure to remove the exemption for disclosures to credit rating agencies. Companies should review their disclosure and Regulation FD compliance policies to determine whether any changes are necessary. However, this change is unlikely to have a significant effect since rating agencies typically receive information in confidence and thus would come under a Regulation FD exemption.