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The Dodd Frank Act: A Guide to the Corporate Governance, Executive Compensation, and Disclosure Provisions

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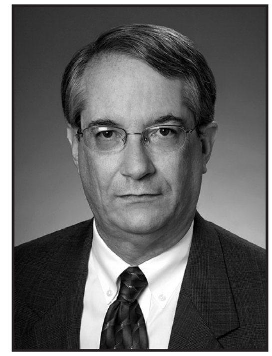

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act")[1] became law on July 21, 2010. The primary purpose of the Act is to identify and manage threats to the stability of the nation's financial system, such as those that contributed to the economic downturn commencing in 2008. Many provisions of the Act require various regulatory bodies to draft, adopt, and implement regulations, and these will have a significant effect on the Act's impact. This article summarizes the principal provisions of the Act that apply to U.S. public companies generally, not just to the financial services industry. These provisions are contained in Title IX of the Act and relate primarily to the following:

- shareholder advisory votes on executive compensation;
- limitations on discretionary voting by brokers;
- clawbacks of incentive compensation;
- independence of compensation committees;
- enhanced proxy disclosures;
- whistleblower incentives and protection; and
- proxy access.

For the status of SEC rulemaking, see www.sec.gov/spotlight/dodd-frank.shtml.

Shareholder Advisory Votes on Executive Compensation

Section 951 of the Act adds section 14A to the Securities Exchange Act of 1934 (the "Exchange Act"). Section 14A requires companies to periodically conduct separate shareholder advisory votes to:

- approve the compensation of certain executive officers; and
- determine the frequency of the shareholder advisory vote on executive compensation.

Section 14A also requires companies soliciting votes to approve a merger or acquisition to disclose any "golden parachute" arrangements and, in certain circumstances, to conduct a separate shareholder advisory vote to approve these arrangements. The shareholder votes required by section 14A are not binding on the company or its board. Institutional investment managers subject to section 13(f) of the Exchange Act are required to report annually how they voted on any shareholder advisory vote required by section 14A.

On January 25, 2011, the SEC adopted a new Rule 14a-21 and related amendments to its rules and forms to implement section 14A. As of the date of this article, the SEC has not issued final rules with respect to reporting by institutional investment managers.[2]

Say-on-Pay and Say-on-Frequency. Section 14A(a)(1) requires that, not less frequently than once every three calendar years, a proxy or consent solicitation include a separate resolution subject to shareholder vote (a "say-on-pay" vote) to approve the compensation of the company's "named executive officers" (as defined in Item 402(a)(3) of Regulation S-K). Section 14A(a)(2) requires that, not less frequently than once every six calendar years, a proxy or consent solicitation include a separate resolution subject to shareholder vote (a "say-on-frequency" vote) to determine whether the say-on-pay vote will occur every one, two, or three years. The say-on-pay vote and the say-on-frequency vote are required to be included only in (1) the proxy or consent solicitation materials for an annual meeting of shareholders at

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which directors will be elected and for which the SEC's proxy solicitation rules require the disclosure of executive compensation pursuant to Item 402 of Regulation S-K, or (2) a special meeting in lieu of such annual meeting. The initial say-on-pay vote and say-on frequency vote must be included in the proxy or consent solicitation materials for the first such meeting occurring on or after January 21, 2011 (or January 21, 2013 in the case of smaller reporting companies), whether or not the SEC's final rules implementing section 14A were then in effect and even if the preliminary or definitive proxy or consent solicitation materials were filed with the SEC before that date. Because a company with outstanding indebtedness under the Troubled Asset Relief Program ("TARP") is already required to conduct an annual shareholder advisory vote on executive compensation under Rule 14a-20, such a company would not be required to conduct a separate say-on-pay vote or a say-on-frequency vote under section 14A until the first annual meeting after it has repaid all outstanding amounts under TARP.

Neither section 14A nor Rule 14a-21 requires any specific language or form of resolution for the say-on-pay vote. However, the vote must relate to all executive compensation as disclosed pursuant to Item 402, including the compensation disclosed in the Compensation Discussion and Analysis ("CD&A"), the compensation tables, and the other narrative compensation disclosures required by Item 402. A proposal to approve only compensation policies and procedures would not satisfy the requirements of section 14A or the rule.[3] A company is not limited to the shareholder advisory votes required by Rule 14a-21, and may solicit shareholder votes on other compensation matters to obtain more specific feedback on its compensation policies and practices. The vote does not encompass director compensation disclosed pursuant to Items 402(k) or (r) of Regulation S-K or the disclosure required by Item 402(s) of Regulation S-K concerning the company's compensation policies and practices as they relate to risk management and risk-taking incentives because such policies and practices relate to compensation of employees generally. However, if risk considerations are a material aspect of compensation decisions or policies for the named executive officers, then they must be included in the CD&A and are subject to the say-on-pay vote. Disclosure of golden parachute arrangements included pursuant to Item 402(t) discussed below also would be subject to the say-on-pay vote.

Under a related amendment to Schedule 14A, a company would be required to disclose in its proxy statement that it is providing separate say-on-pay and say-on-frequency votes and to briefly explain the general effect of each vote, such as whether the vote is nonbinding, and to disclose the current frequency of say-on-pay votes and when the next say-on-pay vote will occur. In addition, under an amendment to Item 402(b), the company would be required to address in its CD&A whether it has considered the most recent say-on-pay vote and, if so, how that consideration has affected its executive compensation decisions and policies. A company also should address its consideration of earlier say-on-pay votes to the extent material to the compensation policies and decisions discussed. Rule 14a-21 does not change the scaled disclosure requirements for smaller reporting companies, and smaller reporting companies will not be required to provide a CD&A to comply with this rule. However, they are required by Item 402(o) of Regulation S-K to provide a narrative description of any material factors necessary to an understanding of the Summary Compensation Table required by Item 402(c). If consideration of prior shareholder advisory votes is such a factor, disclosure would be required.

Under an amendment to Rule 14a-4, the proxy card must provide shareholders the opportunity to select from among four choices regarding the frequency of the say-on-pay vote: whether the say-on-pay vote will occur every one, two, or three years or whether to abstain from voting in the matter. An alternative formulation of the say-on-frequency vote would not be permitted, such as a proposal to hold the say-on-pay vote every two years or a proposal to approve or disapprove the company's recommendation as to the frequency of the say-on-pay vote. Although the board may include a recommendation as to how shareholders should vote on the say-on-frequency vote, the proxy materials must make clear that the shareholders have the above four choices and are not voting to approve or disapprove the board's recommendation.[4] The SEC has added a note to Rule 14a-8(i)(10) to permit a company to exclude a shareholder proposal that seeks an advisory vote with substantially the same scope as the say-on-pay vote or that relates to the frequency of the say-on-pay vote (including those drafted as a request to amend the governing documents) if, in the most recent say-on-frequency vote, a single frequency received a majority of votes cast (excluding abstentions) and the company has adopted a policy on the frequency of say-on-pay votes consistent with that majority vote.

Item 5.07 of Form 8-K currently requires disclosure of the preliminary results of shareholder votes within four business days following the day the shareholder meeting ends and requires disclosure of final voting results within four business days after they are known. The SEC has amended Item 5.07 to require a company to disclose its decision regarding how frequently it will conduct the say-on-pay vote (in light of the results of the shareholder vote on frequency), by filing an amendment to its prior Form 8-K filings under Item 5.07 that disclose the preliminary and final results of the say-on-frequency vote. The amended Form 8-K will be due no later than 150 calendar days after the end of the shareholder meeting, but in no event later than 60 calendar days prior to the deadline for the submission of shareholder proposals under Rule 14a-8 for the subsequent annual meeting, as disclosed in the company's proxy materials for the meeting at which the say-on-frequency vote occurred. Under an amendment to Rule 14a-6, any shareholder advisory vote on executive compensation, including the say-on-pay and the say-on-frequency votes required by section 14A, would not trigger a requirement that the company file preliminary proxy materials with the SEC.

Section 957 of the Act requires national securities exchanges to amend their rules to prohibit broker discretionary voting of uninstructed shares on certain matters, including shareholder votes on executive compensation. The New York Stock Exchange has amended NYSE Rule 452 to eliminate broker discretionary voting of the uninstructed shares of a company with a class of securities listed on a national securities exchange on a shareholder vote on executive compensation, the frequency of such a vote, or a golden parachute arrangement. See "Discretionary Voting by Brokers" *infra*.

Say-on-Golden Parachutes. Section 14A(b)(1) requires any person soliciting shareholder approval of an acquisition, merger, consolidation, or sale or disposition of all or substantially all of the assets of a company to disclose in the proxy or consent solicitation materials any agreements or understandings that it has with any named executive officers of that company (or the named executive officers of the acquiring company, if the company is not the acquiror) concerning compensation (whether present, deferred, or contingent) that is based on or otherwise relates to the transaction (a "golden parachute" arrangement).[5] An acquiring company soliciting shareholder approval of such a transaction must disclose any golden parachute arrangements it has with its own named executive officers or those of the target company. A target company soliciting such shareholder approval must disclose any golden parachute arrangements it has with its own named executive officers or those of the acquiring company, but not any such arrangement between its named executive officers and the acquiring company.

New Item 402(t) expands the disclosure required by the Act to include disclosure of golden parachute arrangements between the acquiring company and the named executive officers of the target company if the target company is making the solicitation.[6] In addition, Item 402(t) provides that the disclosure must be in both tabular and narrative form. The required table must separately disclose, for each named executive officer, the dollar value of any cash severance payments (including any base salary, bonus, or non-equity incentive plan compensation), equity awards accelerated or cashed out, pension and nonqualified deferred compensation enhancements, perquisites and tax reimbursements, as well as any other compensation, that is based on or otherwise relates to the change-in-control transaction, and the total of all such compensation. A footnote must identify and quantify each separate form of compensation included in each amount reported in the table, as well as the amount attributable to a single-trigger arrangement and the amount attributable to a double-trigger arrangement. Item 402(t) would not require disclosure of compensation disclosed in the Pension Benefits Table or Nonqualified Deferred Compensation Table, previously vested equity awards, or bona fide post-transaction employment agreements to be entered into in connection with the transaction, and requires disclosure only of compensation that is based on or otherwise relates to the subject transaction.[7]

Item 402(t) requires a narrative description of any material factors necessary for an understanding of each arrangement, including: the specific circumstances that would trigger payment; whether payments would or could be lump sum or annual, as well as the duration of the payments and by whom the payments would be provided; any material conditions or obligations applicable to the receipt of payment (including non-compete, non-solicitation, non-disparagement, or confidentiality agreements) and their duration and provisions regarding waiver or breach; and provisions regarding modifications of outstanding options to extend vesting or the exercise period or to lower the exercise price. Information would not be required with respect to an individual who would have been among the most highly compensated executive officers but for the fact that he was not serving as an executive officer at the end of the last completed fiscal year.

The SEC has adopted additional rule amendments to require that the disclosure set forth in Item 402(t) (but not the say-on-golden parachute vote) be included in connection with certain transactions not specifically referenced in the Act, including certain registration statements on Forms S-4 and F-4, going private transactions, and third-party tender offers, unless such arrangements have previously been subject to a say-on-pay vote.

Section 14A(b)(2) generally requires a separate shareholder advisory vote on golden parachute arrangements that are required to be disclosed under section 14A(b)(1), unless such arrangements have previously been subject to a say-on-pay vote (whether or not the arrangements were approved). Although Item 402(t) expands the disclosure required by section 14A(b)(1) to include disclosure of golden parachute arrangements between the acquiring company and the named executive officers of the target company if the target company is making the solicitation, Rule 14a-21(c) provides that such additional arrangements would not be subject to the shareholder advisory vote. A company may voluntarily subject these additional golden parachute arrangements to the shareholder vote.

Neither section 14A nor Rule 14a-21(c) requires any specific language or form of resolution for shareholder advisory votes on golden parachute arrangements. A company may take advantage of the exemption from the shareholder advisory vote requirement for a golden parachute arrangement that had been subject to a prior say-on-pay vote only if the disclosure associated with the prior vote voluntarily included the disclosures required by Item 402(t) and the terms of the golden parachute arrangement subject to the prior vote remain in effect and have not been modified since that vote. New golden parachute arrangements and any revisions to arrangements subject to a prior say-on-pay vote would require a separate shareholder advisory vote. A proxy statement including a shareholder vote on new arrangements or revised terms must include two separate tables under Item 402(t): one table would disclose both the arrangements previously disclosed and the new arrangements or the revised terms; and the second table would disclose only the new arrangements or the revised terms. NYSE Rule 452 prohibits broker discretionary voting of uninstructed shares on a shareholder vote on executive compensation, including a shareholder advisory vote under section 14A(b)(2).

Section 14A(b) and Rule 14a-21(c) require the disclosure of and vote on golden parachute arrangements for initial proxy and information statements filed on or after April 25, 2011.

Smaller Reporting Companies. Smaller reporting companies (generally those with a public float of less than $75 million) are not required to conduct a say-on-pay or say-on-frequency vote until the first annual or other meeting of shareholders (at which directors will be elected and for which the SEC's proxy solicitation rules require the disclosure of executive compensation pursuant to Item 402) occurring on or after January 21, 2013. This temporary exemption does not apply to the disclosure of golden parachute arrangements required by section 14A(b)(1) and Item 402(t) or the say-on-golden parachute vote required by section 14A(b)(2) and Rule 14a-21(c).

What to Do Now

Engage Key Shareholders. Expand your outreach to key shareholders to understand their views on your executive compensation practices, including their preference on the frequency of the say-on-pay vote and extent to which they will be influenced by the recommendations of proxy advisors.

Review Voting Guidelines of Proxy Advisors. Review the voting guidelines of proxy advisors and key shareholders to identify problematic compensation policies or practices and either conform such compensation policies and practices to those guidelines and best practices or develop a clear and convincing rationale as to why the current policies and practices are appropriate for your company.

Enhance CD&A. Review the CD&A to ensure that it provides a clear and comprehensive discussion of the company's compensation philosophy, the reasons for specific executive compensation decisions, the relationship between executive pay and objective measures of the company's short and long-term performance, the way in which your compensation policies mitigate risk-taking, any aspect of executive compensation unique to your company, and the rationale for any problematic compensation practices. Consider including an executive summary at the beginning of the CD&A to highlight the extent to which your compensation policies and practices conform to best practices and to provide a clear link between the company's performance and executive compensation.

Consider the Impact of the Prohibition on Broker Discretionary Voting. The prohibition on broker discretionary voting of uninstructed shares on executive compensation, including say-on-pay and say-on-frequency votes, may require additional outreach to key shareholders to obtain their support on these votes.

Develop a Response to a Negative Say-on-Pay Vote. The say-on-pay vote and the say-on-frequency vote are not binding on the board. However, the failure to convince shareholders that the board has carefully weighed these shareholder votes in setting compensation policy and the frequency of the say-on-pay vote may give rise to a number of negative consequences, including recommendations against the election of the company's nominees in future elections, shareholder nominations under the proxy access rules, or shareholder proposals on the say-on-pay vote and the frequency of such vote. Because shareholders will be provided with only two choices – to approve or to disapprove executive compensation as a whole – the say-on-pay vote does not provide any guidance on the compensation practices to which the shareholders object. This difficulty is enhanced if the vote covers compensation decisions made over two or three years. Furthermore, a negative say-on-pay vote may represent a shareholder's dissatisfaction with the company's performance or matters other than executive compensation.

Develop a Recommendation on the Frequency of Say-on-Pay Votes. The first annual meeting occurring on or after January 21, 2011 must provide for a say-on-frequency vote. Proponents of annual say-on-pay votes argue that (1) shareholders who are dissatisfied with executive compensation may be more likely to withhold or vote against the company's nominees in those years in which a biennial or triennial say-on-pay vote does not provide a means to express their dissatisfaction; (2) annual votes are likely to become routine, like approval of the auditors; (3) a biennial or triennial vote covering all compensation decisions during the two or three years between votes would make it more difficult to discern the compensation practices to which shareholders object; and (4) a company that receives a negative say-on-pay vote may not want to wait two or three years for a shareholder vote validating any change made in its compensation practices. However, a biennial or triennial vote may (1) facilitate evaluating compensation decisions in light of longer-term performance; (2) allow adequate time for dialogue with shareholders and the development of a thoughtful response by the company; (3) relieve the administrative burden on the company of soliciting shareholder support annually and on institutional shareholders of annually analyzing the executive compensation practices of every portfolio company; and (4) avoid the effect on the shareholder vote of a short-term drop in stock price. Consider the frequency recommendations of peer companies. ISS has released its 2011 policy position supporting annual say-on-pay votes and suggesting that it will recommend a withhold or negative vote on compensation committee members of companies with problematic compensation practices in years in which there is no say-on-pay vote. Support for a triennial vote may be increased by agreeing to (1) resubmit at the next annual meeting any say-on-pay vote that receives less than a majority vote; (2) hold a say-on-frequency vote every three years rather than every six years as permitted by the Act; or (3) consult with shareholders through surveys or individually during the years between the say-on-pay votes. Develop a recommendation on the frequency of the say-on-pay vote and a clear and persuasive rationale for that recommendation and build support for that recommendation among key shareholders.

Develop a Response to a Shareholder Vote on Frequency. The amendment to Form 8-K requires a company to disclose its decision regarding how frequently it will conduct the say-on-pay vote in light of the shareholder vote on frequency. Consider your response in the event the shareholder vote does not favor the company's recommendation on frequency.

Expand Disclosures re Golden Parachute Arrangements. Consider voluntarily expanding the tabular and narrative disclosures concerning golden parachute arrangements to conform to proposed Item 402(t) to avoid the need for a separate say-on-golden parachute vote in a later change-in-control transaction.

Review Golden Parachute Arrangements. Review existing golden parachute arrangements to determine whether the terms are appropriate and consistent with current best practice (e.g., double-trigger arrangements). Consider establishing change-in-control compensation arrangements in advance of any merger transaction so that these arrangements are subject to shareholder approval through the say-on-pay vote as part of the entire executive compensation package, rather than separately in connection with approval of the merger transaction.

Review Compensation Committee Charter. Review and, if necessary, revise the charter, processes, and policies of the compensation committee in light of the proposed executive compensation disclosures.

Evaluate Compensation Consultants. Evaluate the performance of compensation consultants in developing executive compensation programs and disclosures that reflect the Act's policies and will be received favorably by shareholders.

Discretionary Voting by Brokers

Section 957 of the Act amends section 6(b) of the Exchange Act to require national securities exchanges to prohibit any broker who is a member from granting a proxy to vote a security on certain matters unless the beneficial owner of the security has instructed the broker on how to vote. This provision applies to the election of directors (other than an uncontested election of directors of a registered investment company), executive compensation, and "any other significant matter" (as determined by SEC rulemaking).

Under Rule 452 of the New York Stock Exchange (NYSE), brokers are prohibited from discretionary voting on "non-routine" matters such as a merger, but they are permitted to vote uninstructed shares in their discretion on "routine" matters such as the approval of independent auditors. The SEC approved amendments of Rule 452 and the corresponding section 402.08 of the NYSE Listed Company Manual in July 2009 to eliminate broker discretionary voting in the election of directors (other than an uncontested election of directors of a registered investment company),[8] and in September 2010 to eliminate broker discretionary voting on executive compensation, including say-on-pay, say-on-frequency, and say-on-golden parachute votes.[9] The SEC intends to issue proposed rules that define "other significant matters" between April and July 2011.

What to Do Now

Consider Impact on Executive Compensation and Other "Significant Matters." The prohibition relating to discretionary voting on executive compensation may affect the outcome of the say-on-pay, say-on-frequency, and say-on-golden parachute votes discussed above, as well as any other compensation matter or matter determined by the SEC to be a "significant matter."

Review Voting Guidelines of Proxy Advisors. The prohibition relating to discretionary voting on executive compensation and any other matters determined by the SEC to be "significant matters" will increase the influence of proxy advisors and institutional shareholders on these matters. Review the voting guidelines of proxy advisors and key shareholders before seeking shareholder approval of any such matter.

Reconsider Use of a "Notice Only" E-Proxy. Companies with a large retail shareholder base may require get-out-the-vote campaigns, including retaining proxy solicitors, on matters once considered routine. Because voting by retail shareholders tends to be lower in a "notice only" e-proxy solicitation, such companies may need to reconsider the use of a "notice only" e-proxy.

Clawbacks of Incentive Compensation

Section 954 of the Act adds section 10D to the Exchange Act. Section 10D directs the SEC to adopt rules prohibiting a national securities exchange or association from listing a company unless it develops, implements, and discloses a policy regarding the recovery of executive compensation in certain circumstances. The policy must require that, in the event of an accounting restatement due to material noncompliance with a financial reporting requirement under the federal securities laws, the company will recover from any current or former executive officer any incentive-based compensation (including stock options) received during the three-year period preceding the date of the restatement, which is in excess of what would have been paid based on the restated financial statements. There is no requirement of wrongdoing by the executive, the clawback is mandatory and applies to all executive officers, and there is no exemption for smaller reporting companies, controlled companies, or foreign private issuers. Section 954 augments section 304 of the Sarbanes-Oxley Act of 2002 ("SOX"), which requires the CEO and CFO to return any bonus or other incentive or equity-based compensation received during the 12 months following the date of similarly inaccurate financial statements, as well as any profit received from the sale of employer securities during that period, if the restatement was due to misconduct. Unlike section 304, under which only the SEC may seek recoupment, the Act requires the company to seek the return of compensation.

The SEC intends to issue proposed rules regarding the recovery of erroneously awarded compensation between August and December 2011.

Independence of Compensation Committees

Section 952 of the Act adds section 10C to the Exchange Act. Section 10C directs the SEC to adopt rules prohibiting a national securities exchange or association from listing a company that does not comply with certain requirements concerning its compensation committee.

Independence of Compensation Committees. The rules shall require each member of the compensation committee to be independent. In determining "independence," the exchange must consider (1) the source of compensation of a board member, including any consulting, advisory, or other compensatory fee paid by the company; (2) whether a board member is affiliated with the company or a subsidiary or affiliate of the company; and (3) other factors determined by SEC rulemaking.

Independence of Advisors. Section 10C provides that a compensation committee may only select a compensation consultant, legal counsel, or advisor after considering those factors to be identified by the SEC as affecting independence. Such factors shall include the provision of other services to the company, the amount of fees, the policies of the advisor's employer that are designed to prevent conflicts of interest, any business or personal relationship of the advisor with a member of the compensation committee, and any stock of the company owned by the advisor. The committee is not prohibited from retaining advisors who are not independent.

Authority to Retain Advisors and Disclosure. The compensation committee may retain a compensation consultant, legal counsel, or other advisors and shall be directly responsible for their appointment, compensation, and oversight. The company must also provide funding for the reasonable compensation of the committee's advisors. In any proxy or consent solicitation material for an annual meeting occurring on or after July 31, 2011, the company must disclose, in accordance with SEC rules, whether the committee retained a compensation consultant and the nature and manner of addressing any conflict of interest.

The SEC intends to issue proposed rules under section 952 between April and July 2011.

Enhanced Proxy Disclosure

Pay-for-Performance. Section 953 of the Act adds section 14(i) to the Exchange Act. Section 14(i) directs the SEC to adopt rules requiring disclosure in the proxy or consent solicitation material for an annual meeting of information that shows the relationship between executive compensation actually paid and the financial performance of the company, taking into account any change in the value of stock, dividends, and any distributions. The disclosure applies to the named executive officers and the compensation required to be disclosed under Item 402 of Regulation S-K.

Internal Pay Equity. Section 953 also directs the SEC to amend Item 402 of Regulation S-K to require disclosure of (1) the median of the annual total compensation of all employees except the CEO; (2) the annual total compensation of the CEO; and (3) the ratio of the amount described in clause (1) to the amount described in clause (2). Total compensation is to be determined in accordance with Item 402(c), which specifies how compensation is to be calculated in the Summary Compensation Table. The disclosure includes the compensation of all employees, presumably including full-time and part-time employees, employees on leave, and both U.S. and foreign employees.

Hedging Policy. Section 955 of the Act adds section 14(j) to the Exchange Act. Section 14(j) directs the SEC to adopt rules requiring disclosure in the proxy or consent solicitation material for an annual meeting whether any employee or director or their designees is permitted to purchase financial instruments to hedge any decrease in the value of equity securities of the company, whether such securities were granted as compensation or are held, directly or indirectly, by the employee or director. Item 402(b)(2) of Regulation S-K currently includes a company's policy regarding hedging by the named executive officers among the items that should be included in CD&A.

The SEC intends to issue proposed rules regarding disclosure of pay-for-performance, internal pay equity, and hedging by employees and directors between August and December 2011.

Board Leadership Structure. Section 972 of the Act adds section 14B to the Exchange Act. Section 14B directs the SEC to adopt rules requiring disclosure in the annual proxy statement of the reasons why the company has chosen to combine or to separate the positions of chairman of the board and CEO. The disclosure required by section 14B appears to be included within the disclosure concerning board leadership structure currently required by Item 407(h) of Regulation S-K.

What to Do Now

Develop Individualized Measures of Pay Versus Performance. The SEC will need to identify the metrics for measuring performance, as well as the time periods of those measurements, and determine the tabular, graphical, or narrative form of the required comparison of executive compensation and company performance. This should not constrain companies from developing other metrics for measuring performance, determining the time periods for these measurements, or selecting the tabular, graphical, or narrative means of displaying the relationship between these measures and executive compensation that may be more meaningful to their shareholders than the one-size-fits-all measures, periods, and form of presentation to be contained in the SEC's rules.

Enhance CD&A. Review the CD&A to ensure that it effectively communicates the company's compensation philosophy, the reasons for specific executive compensation decisions, the relationship between executive pay and objective measures of the company's short and long-term performance, any aspects of executive compensation unique to the company, and the rationale for any problematic compensation practices.

Hedging Policy. Upon the issuance of SEC rules regarding disclosure of hedging policies, review or consider adopting policies addressing whether employees, directors, or executive officers can hedge the economic risk of owning the company's securities, and review trading and compliance policies and programs for consistency with such hedging policies.

Whistleblower Incentives and Protection

Section 922 of the Act adds section 21F to the Exchange Act. Section 21F requires the SEC to pay an award to an eligible whistleblower who voluntarily provides the SEC with original information about a violation of the federal securities laws that leads to a successful action resulting in monetary sanctions exceeding $1 million. The amount of the award will be between 10% and 30% of the monetary sanctions collected in connection with the action and certain related actions and will be determined by the SEC in its discretion after considering, among other factors, the significance of the information and the degree of assistance provided by the whistleblower. Section 21F applies to all securities laws enforced by the SEC, including the Foreign Corrupt Practices Act. Section 21F also expands the protections available to whistleblowers under SOX and provides whistleblowers who have been subject to retaliation with a private right of action. The Act substantially increases the incentives for employees and others to report violations to the SEC and likely will increase the number of these reports and related SEC investigations.

On November 3, 2010, the SEC proposed a new Regulation 21F (consisting of Rules 21F-1 to 21F-16) to implement the whistleblower incentive program established by the Act, but not the related provisions regarding enhanced protection for whistleblowers against retaliation.[10] As of the date of this article, the SEC has not issued final rules.

"Whistleblower." Proposed Rule 21F-2(a) defines a "whistleblower" as an individual who, alone or jointly with others, provides information to the SEC relating to a potential violation of the securities laws. A whistleblower must be an individual, not a company or other entity. Proposed Rule 21F-8 sets forth categories of individuals who would not be eligible for an award, including certain government employees, foreign officials, a person convicted of a crime related to the SEC action or a related action, a person who obtained the information through an audit of the company's financial statements and would be required to disclose the information under section 10A of the Exchange Act, and a person who knowingly and willfully makes any false statements. The proposed rules do not exclude a whistleblower who has not been convicted of a crime but against whom civil judgments, cease and desist orders, collateral bars, or other penalties have been imposed.

"Voluntary Submission." Proposed Rule 21F-4(a)(1) defines a submission as "voluntary" if the whistleblower provides the SEC with the information before receiving a formal or informal request, inquiry, or demand (a "request") from the SEC, Congress, any other federal, state, or local authority, or any self-regulating organization or the Public Company Accounting Oversight Board ("PCAOB"). Because a request directed to an employer is also considered to be directed to all employees who possess documents or information within the scope of the request, a submission by these employees will not be considered voluntary unless first provided to the employer who then fails to provide the information to the requesting authority in a timely manner. The list of authorities contained in the proposed rule does not include an employer's personnel (such as legal, compliance, or audit staff) conducting an internal investigation, compliance review, or audit. Therefore, a submission would be considered voluntary (and eligible for an award) if made by an employee after he or she was questioned by such persons about a potential violation, unless the information is within the scope of a request directed to the employer by one of the designated authorities. Disclosure also would not be considered voluntary if the individual has a pre-existing legal or contractual duty to report the potential violation, such as an employee of a regulatory agency, an independent auditor who has a duty under section 10A of the Exchange Act, and a person under a pre-existing agreement to assist a regulatory authority.

"Original Information." Proposed Rule 21F-4(b) defines "original information" as information that is:

- derived from the whistleblower's "independent knowledge" or "independent analysis;"
- not already known to the SEC from any other source (unless the whistleblower is the original source); and
- not deduced from an allegation made in a judicial or administrative hearing, in a governmental report, hearing, audit, or investigation, or from the news media (unless the whistleblower is the original source).

The proposed rules define "independent knowledge" as factual information not derived from publicly available sources, whether widely disseminated (such as corporate press releases and filings, media reports, and information on the Internet) or not widely disseminated (such as court filings and documents obtained through Freedom of Information Act requests). The whistleblower does not need direct, first-hand knowledge of a potential violation; the knowledge may be deduced from facts or other information conveyed to the whistleblower by third parties. "Independent analysis" means the whistleblower's own examination and evaluation, whether done alone or in collaboration with others, of information that may be generally available but which reveals information that is not generally known or available to the public.

Information will not be considered to be derived from independent knowledge or independent analysis if obtained:

- through a communication subject to the attorney-client privilege (unless disclosure is permitted by the SEC attorney conduct rules or state bar ethics rules);
- through the legal representation of a client when the disclosure to the SEC is for the whistleblower's own benefit (subject to the same exceptions);
- through an engagement required under the securities laws by an independent public accountant if the information relates to a violation by the client;
- by a person with legal, compliance, audit, supervisory, or governance responsibilities if the information was communicated to that person with the reasonable expectation that he or she would take steps to respond appropriately to the violation, unless the company does not disclose the information to the SEC within a "reasonable time" or proceeds in "bad faith;"
- from a company's legal, compliance, audit, or similar function, unless the company does not disclose the information to the SEC within a "reasonable time" or proceeds in "bad faith;"
- in a manner that violates federal or state criminal law; or
- from any individual described above.

These exclusions are intended in part to address the concern that the whistleblower provisions not incentivize individuals with the responsibility for internal compliance, including lawyers and accountants, to abuse their positions to claim awards.

In determining whether a company acted in "bad faith," the SEC will consider, among other things, whether the company destroyed documents or interfered with witnesses. The determination of what is a "reasonable time" will depend on all the facts and circumstances, but where an ongoing fraud poses a substantial issue of harm to investors, a reasonable time for disclosing violations to the SEC may be almost immediate. A whistleblower may not claim that the company did not disclose information to the SEC in a reasonable time if the whistleblower played a role in causing the delay.

The original information requirement means that only the first person to submit particular information to the SEC is eligible for an award, thereby encouraging employees to bypass internal compliance programs to be the first in line to claim the statutory incentive. To address this concern, the proposed rules provide that if a person submits information in an internal investigation and within 90 days provides the same information to the SEC, the SEC will consider the information to have been submitted as of the date the information was initially provided in the internal investigation.

Successful Enforcement. Proposed Rule 21F-4(c) provides that information will be considered to have led to "successful enforcement" if:

- the information caused the SEC to open an investigation, reopen one that had been closed, or inquire concerning new or different conduct as part of an existing investigation, and the information *significantly contributed* to the success of the action; or
- the information was related to conduct already under investigation by the SEC or other designated authority, and the information would not otherwise have been obtained and was *essential* to the success of the action.

Information will have "significantly contributed" to the success of an action if its high quality, reliability, and specificity had a meaningful relationship to the SEC's ability to successfully complete its investigation and either obtain a settlement or prevail in litigation.

Unsupported tips would not be sufficient. It would be rare for information regarding an ongoing investigation to be considered "essential."

Monetary Sanctions. Proposed Rule 21F-4(e) defines "monetary sanctions" to mean any money, including penalties, a disgorgement, and interest, ordered to be paid or deposited into a disgorgement fund as a result of an SEC action or a related action, including federal and state proceedings and proceedings brought by designated regulatory authorities or self-regulating organizations that are based on the same original information.

Amount of Award. If all the conditions of the proposed rules are met, the SEC is authorized to pay an award of between 10% and 30% of the total monetary sanctions collected in successful SEC and related actions. Where multiple whistleblowers are entitled to an award, the SEC will determine the award percentage for each whistleblower, which may differ from the percentage awarded in related actions. Proposed Rule 21F-6 provides that the SEC will take into consideration the following general criteria in determining the amount of the award: (1) the significance of the information to the success of the SEC action or related action; (2) the degree of assistance provided by the whistleblower; (3) the SEC's "programmatic interest" in deterring violations of the securities laws by incentivizing whistleblowers to provide information that leads to successful enforcement actions; and (4) whether an award enhances the SEC's ability to enforce the federal securities laws, protect investors, and encourage the submission of high quality information by future whistleblowers.

In its proposing release (but not in the proposed rules themselves), the SEC identifies the following additional considerations as being relevant in determining the amount of an award:

- the character of the enforcement action, including whether its subject matter is a priority, whether the misconduct involves regulated entities or fiduciaries, the severity and duration of the violations, the number of violations, and the ongoing nature of the violations;
- the dangers to investors presented by the violations;
- the timeliness, degree, reliability, and effectiveness of the whistleblower's assistance;
- the time and resources conserved as a result of that assistance;
- whether the whistleblower encouraged others to assist the SEC;
- any unique hardships experienced by the whistleblower as a result of assisting in the enforcement action;
- the degree to which the whistleblower took steps to prevent the violations;
- the efforts undertaken by the whistleblower to remediate the harm caused by the violations;
- whether the information related to only a portion of the successful claims brought in the SEC or related action;
- the culpability of the whistleblower; and
- whether the whistleblower reported the potential violation through effective internal compliance procedures before reporting the violation to the SEC.

The SEC's final determination of whether and to whom to make an award may be appealed to a U.S. Court of Appeals, but its final determination as to the amount of an award or its allocation among multiple whistleblowers may not be appealed.

Confidentiality, Anonymity, Immunity. Proposed Rule 12F-7 provides that the SEC will not disclose information that could reasonably be expected to reveal the identity of the whistleblower except when disclosure is required to a defendant or respondent in a federal court or administrative action, or to a designated regulatory authority in order to protect investors and accomplish the purposes of the Exchange Act.

Proposed Rule 21F-9 establishes a procedure by which a whistleblower who wishes to make an anonymous submission may do so through an attorney who must certify that he or she has verified the identity of the whistleblower. Anonymous whistleblowers must disclose their identities through the procedure contained in proposed Rule 21F-10 before receiving payment of an award. To deter frivolous or abusive claims, information must be submitted under penalty of perjury.

Proposed Rule 21F-14 makes it clear that an individual who has participated in wrongdoing will not be immune from prosecution by virtue of providing assistance to the SEC. However, the SEC will take into consideration the whistleblower's cooperation in accordance with its Policy Statement Concerning Cooperation by Individuals in its Investigations and Related Enforcement Actions.[11]

Under Proposed Rule 21F-15, in determining whether the $1 million threshold has been met and the amount of an award, the SEC will not take into account any amounts paid by the whistleblower or a company whose liability is based substantially on conduct that the whistleblower directed, planned, or initiated.

Communications with Whistleblower. Proposed Rule 12F-16 provides that no one may impede a whistleblower from communicating directly with the SEC about potential violations, including by attempting to enforce a confidentiality agreement. If a whistleblower is a director, officer, member, agent, or employee of a company that has counsel, and has initiated communications with the SEC relating to a potential violation, the SEC may communicate directly with the whistleblower regarding the subject of the communication without seeking the prior approval of the company's counsel (notwithstanding any professional responsibility rules to the contrary).

Procedures. Proposed Rules 21F-9 to 21F-11 set out the procedures and forms for submitting to the SEC tips and claims for awards, as well as a process to contest a preliminary determination of a claim.

Internal Compliance Programs and Self-Reporting. The proposed rules do not require that a whistleblower first provide information about a potential violation to an internal compliance program before submitting it to the SEC. In crafting Regulation 21F, however, the SEC sought to avoid undermining effective internal programs by providing that:

- if a whistleblower first reports a potential violation to an internal compliance program or another regulatory authority and within 90 days reports the same information to the SEC, the submission to the SEC will be considered to have been made as of the date of the earlier report, thereby allowing an employee to report information internally first without losing his or her "place in line" for an award;
- in determining the amount of the award the SEC may, but is not required to, consider whether a whistleblower first reported the potential violation internally; and
- upon receiving a whistleblower complaint, the SEC anticipates contacting the company, describing the nature of the allegations, and giving the company the opportunity to investigate and report back. The SEC would take into consideration the company's cooperation.

The proposed rules create significant pressure on companies to report to the SEC potential violations uncovered in internal investigations by providing that:

- if a company has already received a request for information, a subsequent whistleblower submission may still be considered "voluntary" if the company failed to provide to the SEC the information received from the whistleblower within a reasonable time;
- a person with legal, compliance, audit, supervisory, or governance responsibilities who receives information with the reasonable expectation that he or she would take steps to cause the company to respond appropriately to the violation can be a whistleblower if the company does not disclose the information to the SEC within a reasonable time; and
- a person who receives information through an internal legal, compliance, or audit process can be a whistleblower if the company does not disclose the information to the SEC within a reasonable time.

If a company fails to self-report a potential violation of the federal securities laws, in-house lawyers, internal auditors, and compliance personnel, and any person who learns of the potential violation from them, all can become whistleblowers.

Prohibition Against Retaliation. The Act expands the protection available under section 806 of SOX to a whistleblower who has suffered retaliation.

Section 922(h) of the Act makes it unlawful for an employer to discharge, demote, suspend, threaten, harass, or discriminate against a whistleblower for (1) providing information to the SEC; (2) initiating, testifying in, or assisting in any SEC action; or (3) making any disclosure protected under SOX or any other law subject to the SEC's jurisdiction. A whistleblower who has been subject to retaliation may bring an action in federal court for, among other remedies, reinstatement, double back pay with interest, and reimbursement of litigation costs, expert witness fees, and reasonable attorneys' fees. The action may not be brought more than six years after the retaliation occurred or more than three years after the facts are known or reasonably should have been known by the employee, but in no event may the action be brought more than ten years after the retaliation. These protections apply even if the whistleblower's tip does not lead to a successful action or fails to qualify for an award.

The Act permits a whistleblower who suffers retaliation to bypass the OSHA claims process established under SOX and proceed directly to federal court, expands the remedies available under SOX for retaliation, and lengthens the period in which an action alleging retaliation may be brought. In addition, section 929A of the Act amends SOX to make it clear that the whistleblower protections of SOX apply to employees of any subsidiary or affiliate whose financial information is included in the consolidated financial statements of a reporting company.

In the release proposing Regulation 21F, the SEC sought comment on whether it should promulgate rules to implement the anti-retaliation provisions of the Act and, if so, what specific rules it should promulgate. As of the date of this article, the SEC has not proposed any such rules.

What to do Now

Review Internal Processes to Ensure a Timely Response. The proposed rules emphasize the importance of responding timely to any notice of potential violations. A prompt response may increase the likelihood that employees will first notify the company of a potential violation, as well as preclude persons entrusted with administering the internal compliance program from being eligible to receive an award.

Strengthen Internal Compliance Programs. A corporate commitment to ethical conduct will decrease the likelihood of misconduct. Further, whistleblowers are often employees whose concerns were not adequately addressed through internal compliance programs. A robust internal compliance program may eliminate the need for a concerned employee to report a potential violation to the SEC. Early detection also allows the company to address problems before they grow out of control. Companies should establish a culture of compliance by regularly communicating the importance of compliance, providing employees with periodic training on hotline procedures and compliance issues, ensuring that employee concerns are addressed promptly, establishing an anonymous third-party system to accept complaints and inform employees about the steps being taken to address their concerns, training managers to respond to complaints in a thoughtful and respectful manner, developing non-retaliation policies and procedures, and developing guidelines to ensure prompt and consistent decision making about whether and how to investigate potential violations.

Develop Self-Reporting Guidelines. The proposed rules create significant pressure on companies to promptly report to the SEC potential violations uncovered in internal investigations. Companies should consider the relative weight of the various factors that contribute to a decision to self-report, including the potential for remediation, the effect of the violation on the company's public disclosures, and the reasons for the violation.

Guard Against Retaliation Claims. The whistleblower protection provisions of the Act increase the importance of ensuring that the company avoids even the appearance of having retaliated against a whistleblower. Review internal procedures for handling whistleblower complaints to confirm the effectiveness of safeguards against retaliation, enhance exit interviews for departing employees to uncover allegations of potential violations of the federal securities laws or of retaliation, reconsider retention policies for employee performance records in light of the expanded statute of limitations on actions alleging retaliation, and extend whistleblower policies to employees of subsidiaries and affiliated companies.

Proxy Access

Section 971 of the Act amends section 14(a) of the Exchange Act to expressly authorize, but not require, the SEC to issue rules requiring a company's proxy solicitation materials to include a director nominee submitted by a shareholder. This provision does not mandate the adoption of any specific rules regarding proxy access; it is intended only to preclude a successful legal challenge to the SEC's authority to adopt proxy access rules based on the lack of specific legislative authority. The SEC promptly adopted Rule 14a-11 and related amendments to the federal proxy rules[12] to permit long-term holders of a substantial percentage of the voting power to:

- nominate one or more persons for election to the board of directors; and
- include the nominees in the company's proxy solicitation materials.

In addition, the SEC amended Rule 14a-8 to remove barriers to the ability of shareholders to include in the company's proxy materials proposals that would amend the company's governing documents to include proxy access procedures that are more liberal than those provided by Rule 14a-11.

The stated purpose of Rule 14a-11 is to facilitate the exercise of the shareholders' traditional state law rights to nominate and to elect directors without having to resort to expensive proxy contests and thereby lead to boards that are more accountable and responsive to shareholder interests.

Effective Date. Rule 14a-11 and related amendments to the SEC's rules were scheduled to take effect on November 15, 2010. On September 29, 2010, Business Roundtable and the U.S. Chamber of Commerce filed a petition with the U.S. Court of Appeals for the D.C. Circuit seeking review of Rule 14a-11,[13] and they filed a motion with the SEC to stay the effectiveness of the rule. The petitioners asserted that the SEC had failed to review the rule's impact on "efficiency, competition, and capital formation" as required by the Exchange Act, arbitrarily overruled state law by establishing a federal proxy access regime, and violated the First and Fifth Amendments by forcing companies to fund and carry election-related speech opposed by their boards of directors. On October 4, 2010, the SEC granted the motion to stay Rule 14a-11 and related rule amendments pending resolution of the petition by the court and joined the petitioners in asking the court to expedite its review.[14] The briefing schedule approved by the court effectively ensures that proxy access will not be effective until the 2012 proxy season at the earliest.

Companies Subject to the Rule. Rule 14a-11 applies to companies that are subject to the federal proxy rules, including investment companies registered under the Investment Company Act of 1940, controlled companies, and those companies that voluntarily register a class of equity securities under section 12(g) of the Exchange Act. Smaller reporting companies will be subject to the rule, but on a deferred basis as discussed below. Companies that are subject to the proxy rules solely because they have a class of debt registered under section 12 of the Exchange Act, as well as foreign private issuers who are exempt from the proxy rules, are exempt from the new proxy access rule. The new rule also will not apply to a company that voluntarily continues to file Exchange Act reports when neither section 13(a) nor section 15(d) requires (e.g., to comply with a covenant contained in an indenture relating to outstanding debt securities).

Ownership Threshold. The nominating shareholder (or a group of shareholders acting together) must hold in the aggregate at least 3% of the total voting power of the securities entitled to vote on the election of directors on the date the nominating shareholders file notice of their intent to use the proxy access rules on Schedule 14N (described below). When determining the total voting power held by the nominating shareholders, those securities over which the nominating shareholders have both the power to vote (or direct the voting) and to dispose of (or direct the disposition of), directly or through any person acting on their behalf, are included among the securities held by the nominating shareholders. Any securities that have been loaned by the nominating shareholders to another person are excluded in determining the securities held by the nominating shareholders unless the lender has the right to recall the loaned securities and will do so upon being notified that any of its nominees will be included in the company's proxy materials. Securities that are the subject of a short position or have been borrowed also are excluded from the securities held by the nominating shareholders. If a company has more than one class of securities entitled to vote on the election of directors, the ownership threshold will be determined as a percentage of the voting power of only those classes that would vote together on the election of the persons nominated by the nominating shareholders.

Holding Period. The nominating shareholders must have held the minimum amount of securities (adjusted for stock splits, reclassifications, and similar adjustments) used to satisfy the 3% ownership threshold continuously for at least three years as of the filing date of the Schedule 14N and must continue to hold that amount of securities through the date of the meeting at which their nominees are to be elected.

Number of Nominees. The company must include a number of shareholder nominees that represents up to 25% of the total number of the company's directors, rounded down to the nearest whole number, but in no event less than one. The number of directors that shareholders may nominate is not reduced if the members of only one class of a staggered board are to be elected; however, any continuing director who previously was elected as a shareholder nominee pursuant to Rule 14a-11 will be counted against the number of shareholder nominees the company is required to include in its proxy materials. Where the company has multiple classes of securities and each class is entitled to elect a specified number of directors, the company must include the number of nominees that the nominating shareholders' class is entitled to elect up to 25% of the board of directors, but in no event less than one nominee. Where more than one eligible shareholder (or group) submits nominees, the company must include the nominees of the nominating shareholders (or groups) in the order of their qualifying voting power, up to the total number of nominees required to be included. If the nominating shareholder (or group) with the next highest qualifying voting power submitted more nominees than there are remaining slots, the nominating shareholder (or group) will have the option to specify which of its nominees would be included in the company's proxy materials.

Neither the composition of the nominating shareholder group nor the nominees may be changed to correct a deficiency identified in the company's notice to the nominating shareholders. The nominating shareholders will not be permitted to substitute another shareholder or nominee to satisfy the requirements.

If a nominating shareholder (or group) withdraws or is disqualified after the company provides notice of its intent to include the nominees in its proxy materials, the company must include the nominees of any other eligible nominating shareholders (or groups) in the order of their qualifying voting power until it includes the maximum number of nominees required to be included or exhausts the list of nominees. If a nominee withdraws or is disqualified after such notice, the same order of priority will be used to select a replacement candidate. Once the company has begun printing its proxy materials, it will not be required to include substitute nominees, and it may furnish additional materials that either omit the withdrawn or disqualified nominee or disclose to shareholders the change.[15]

Eligibility. The nominating shareholder (and each member of the group) may not use Rule 14a-11 if it is holding any securities with the purpose or effect of changing control of the company or to gain a number of seats that exceeds the maximum number of nominees the company could be required to include under this rule. The nominating shareholder (and each member of the group) also may not be a member of any other group engaged in solicitations or other nominating activities, may not conduct a solicitation in relation to its nominees or the company's nominees (other than a solicitation exempt under Rule 14a-2(b)(8) discussed below), and may not participate in another person's solicitation in connection with the subject election of directors. The rule does not contain any restrictions on the relationships between the nominee and the nominating shareholders; but, once elected, a shareholder nominee will owe the same fiduciary duties to act in the best interests of the company and its shareholders as any other director.

Neither the nominee nor the nominating shareholders may have an agreement with the company regarding the nomination of the nominee prior to filing the Schedule 14N. This provision is designed to prevent collusion between the company and friendly shareholders to nominate candidates the board approves; but, the prohibited agreements would not include any unsuccessful negotiations to have a shareholder's candidate included in the company's proxy materials as a management nominee or negotiations limited to whether the company is required to include the shareholder nominee in the proxy materials pursuant to the rule. If, however, the company agrees to include a shareholder nominee in the company's proxy materials as a company nominee, that nominee will count toward the 25% maximum number of shareholder nominees, provided that the nominating shareholders have filed a Schedule 14N before beginning the discussions with the company concerning the nomination. This provision unfortunately may discourage good faith dialogue until a shareholder files its Schedule 14N.

The nominee's candidacy or, if elected, board membership, may not violate any applicable federal or state law or rule of a national securities exchange or association (other than rules regarding independence), subject to a limited right to cure. The nominee must meet the objective criteria (but not the subjective criteria) for independence of the national securities exchange or association generally applicable to directors of the company. The company may disclose in its proxy statement its belief that a nominee would not meet the director qualification requirements or the subjective criteria for independence. A nominee who fails to meet a director qualification requirement in the company's governing documents must be included in the proxy materials, but under state law would not be entitled to take his or her seat, if elected. If a nominee is elected and the board determines that he or she is not independent, the board member would be included among the non-independent directors for purposes of applicable exchange listing standards.

Schedule 14N. The nominating shareholders must file a notice of intent to use the proxy access rules on Schedule 14N with the SEC no earlier than 150 calendar days and no later than 120 calendar days before the anniversary of the date the company mailed its proxy materials for the prior year's annual meeting. If the company did not hold an annual meeting during the prior year, or if the date of the meeting has changed by more than 30 calendar days from the prior year, then the company must disclose under new Item 5.08 of Form 8-K the date by which a nominating shareholder must file the Schedule 14N, which date shall be a reasonable time before the company anticipates mailing its proxy materials. The Schedule 14N must be transmitted to the company and any securities exchange on the date it is filed with the SEC. Schedule 14N must include specified information demonstrating that the nominees and the nominating shareholders satisfy the eligibility requirements of the rule, the extent and nature of any relationships between the nominees and the nominating shareholders, whether to the best knowledge of the nominating shareholders the nominees satisfy any board qualification requirements in the company's governing documents and the objective criteria for independence of the national securities exchange or association applicable to the company, and any supporting statements. The nominating shareholders would be liable for any statement contained in the Schedule 14N which, at the time and in light of the circumstances in which it is made, is false or misleading with respect to any material fact or that omits to state any material fact necessary to make the statements therein not false or misleading, regardless of whether that information is ultimately included in the company's proxy statement.

Statement of Support. The company is required to include in its proxy materials a statement of support by the nominating shareholders of up to 500 words for each nominee. The company will not be responsible for any information provided by the nominating shareholders and included in the company's proxy materials. The company may include in the proxy materials a statement of support for management's nominees.

Dispute Resolution. If the company includes a shareholder nominee, it must notify the nominating shareholders no later than 30 calendar days before it files its definitive proxy materials with the SEC. If the company excludes a shareholder nominee or a supporting statement, it must notify the nominating shareholders no later than 14 calendar days after the close of the 30-day period for the submission of shareholder nominations, including an explanation of the basis for its determination. The nominating shareholders will have 14 calendar days after receipt of this deficiency notice to respond and cure any defects in the nomination. If the company determines that it still may exclude the nominee or supporting statement, it must notify the SEC and the nominating shareholders of its intent to do so and the basis for its determination no later than 80 calendar days before filing its definitive proxy materials with the SEC. The nominating shareholders will have 14 calendar days after receipt of the company's notice to submit a response. The company also may seek the informal view of the SEC's staff on its determination to exclude a shareholder nominee or statement of support (a "no action" request). The company must seek at the outset a no-action letter with respect to each nominee it believes it can exclude. Promptly after receiving the staff's statement (if provided), the company must provide notice to the nominating shareholders whether it will include the nominees. The company may also challenge a nomination through litigation. The company may not exclude a nominee or statement of support on the basis that, in the company's view, the Schedule 14N contains materially false or misleading statements; such disputes must be addressed through negotiation, disclosure or, if necessary, litigation. The burden is on the company to demonstrate that it may exclude a shareholder nominee or statement of support. The exclusion of a shareholder nominee or a statement of support, except as permitted by the rule, is a violation of the rule. When the form of proxy includes a shareholder nominee, it must require that shareholders vote for each nominee separately and not vote for management's nominees as a group.

Mandatory. If applicable state law or the company's governing documents prohibit shareholders from nominating candidates for the board of directors, the company will not be subject to Rule 14a-11. Shareholders, however, could seek to amend a prohibition contained in the company's governing documents by submitting a proposal under Rule 14a-8. If applicable state law or the company's governing documents set share ownership or other requirements that are more restrictive than Rule 14a-11, a shareholder who meets the requirements of the rule would be able to submit its nominees for inclusion in the company's proxy materials. If applicable state law or the company's governing documents are more permissive than Rule 14a-11, a shareholder may choose to proceed under either the rule or the alternate procedure, but must meet all of the requirements of whichever procedure it selects and may not "pick and choose" elements of different procedures. A company is not required to opt into Rule 14a-11 and may not opt out of the rule unless governing law or the company's governing documents completely prohibit shareholders from nominating directors. The rule applies even though the company is engaged in, or anticipates being engaged in, a concurrent proxy contest, provided that a nominating shareholder (or group) may not engage in a non-Rule 14a-11 solicitation or participate in another person's solicitation in connection with the election of directors.

Amendments to Rule 14a-8. Prior to the adoption of the new proxy access rules, Rule 14a-8 permitted a company to exclude shareholder proposals to amend the company's organizational documents to establish a procedure for including shareholder nominees in the company's proxy materials. Rule 14a-8(i)(8) has been amended to remove that basis for exclusion, provided the proposal does not conflict with state law or SEC rules. Accordingly, a shareholder may propose amendments to the company's organizational documents to provide for proxy access procedures that are more liberal (but not those that are more restrictive) than those provided by Rule 14a-11, such as a reduced ownership threshold, shorter holding period, or greater number of shareholder nominees. A nominating shareholder relying on a procedure under state law or the company's governing documents to include a nominee in the company's proxy materials must provide disclosures concerning the nominee and the nominating shareholder on Schedule 14N. Shareholders submitting such a proposal would continue to be subject to the current requirements of Rule 14a-8.

Amendments to Rule 14a-2. The SEC also amended Rule 14a-2 to permit shareholders to solicit other shareholders to form a nominating group for Rule 14a-11 purposes and to campaign for shareholder nominees.

Rule 14a-2(b)(7) permits certain oral and written communications in connection with the formation of a nominating group, provided the soliciting shareholder is not holding the company's securities with the purpose or effect of changing control of the company or to gain a number of seats that exceeds the maximum number of nominees the company could be required to include under Rule 14a-11. Written communications may include no more than a statement of the shareholder's intent to form a nominating group, identify the proposed nominee(s) (or, where no nominee(s) have been identified, the characteristics of the nominee(s) that the shareholder intends to nominate, if any), the percentage of voting securities that the soliciting shareholder holds or the aggregate percentage held by any group to which the shareholder belongs, and contact information. Oral solicitations are not limited in content. All written solicitation materials must be filed with the SEC under Schedule 14N on the day first used, and a notice of commencement of oral solicitations must be filed with the SEC under Schedule 14N prior to commencement. Shareholders also may rely on existing exemptions, including the exemption for solicitations of no more than ten shareholders provided by Exchange Act Rule 14a-2(b)(2) or the exemption for certain communications in an electronic shareholder forum under Exchange Act Rule 14a-2(b)(6).

Rule 14a-2(b)(8) permits certain written and oral solicitations by a nominating shareholder (or group) in support of its nominees or for or against company nominees after receiving notice from the company that it will include the nominees in its proxy materials, provided the shareholder (or group) is not seeking proxy authority. Written solicitations must include specified disclosures, including the identity of the nominating shareholder or group, a description of its direct or indirect interests by security holdings or otherwise, and a specified legend. These written communications must be filed with the SEC under Schedule 14N on the day first used. There is no filing requirement for oral communications in support of nominees. A shareholder may begin these communications immediately upon being notified that its nominee(s) will be included in the company's proxy materials. This rule is the only exemption upon which a Rule 14a-11 nominating shareholder or group may rely for solicitations in support of their nominees or for or against company nominees.

These exemptions will be lost retroactively if the shareholder or group subsequently engages in a non-Rule 14a-11 nomination or solicitation or becomes a member of a group with persons engaged in soliciting or other nominating activities. The retroactive loss of the exemptions is designed to prevent exempt Rule 14a-11 solicitations from being used as a first step in a contest for control. These exemptions do not extend to nominations made pursuant to applicable state law or procedures specified in the company's governing documents.

Miscellaneous. In addition to the deadline for submitting shareholder proposals already required to be disclosed under Rule 14a-5, companies must disclose the deadline for submitting nominees for inclusion in the proxy materials for the company's next annual meeting, whether pursuant to Rule 14a-11, an applicable state law provision, or the company's governing documents. A shareholder may nominate previously unsuccessful candidates, provided the conditions of Rule 14a-11 are satisfied each year.

Smaller Reporting Companies. Rule 14a-11 will not become effective for smaller reporting companies (generally those with a public float of less than $75 million) until three years after the date the rule becomes effective for all other companies. This three-year period will provide the SEC the opportunity to consider whether adjustments to the rule would be appropriate for smaller reporting companies, such as requiring a higher ownership threshold. However, this three-year delay will not apply to the liberalization of Rule 14a-8 and accordingly, smaller reporting companies may experience shareholder proposals to amend the governing documents to permit immediate proxy access.

What to Do Now

Enhance Shareholder Communications. Expand your outreach to key shareholders to understand their views on the company's results of operations, executive compensation, and corporate governance. Review the quality of your public discussions concerning results of operations, the specific skills that each director brings to the board, and the reasons underlying specific executive compensation decisions.

Address Shareholder Concerns. Identify and resolve shareholder concerns that if left unattended could evolve into shareholder proxy proposals or director nominations. Once a proposal or nomination has been submitted, it becomes more difficult to amicably resolve. Even if you elect not to address an issue, this process will identify areas of vulnerability and thereby facilitate the development of a response if a proposal or nomination is submitted.

Assemble a Response Team. Assemble a response team, including an investor communications firm, proxy solicitation firm, and a legal firm experienced in proxy contests. Develop a calendar that includes the mailing date of last year's proxy materials, the 30-day period in which notice of a shareholder nomination must be received by the company, the date on which the company must notify a nominating shareholder (or group) of its determination to exclude a shareholder nominee or supporting statement, and the other milestones contained in the proxy access rules. Discuss strategies for addressing shareholder nominations.

Review Advance Notice Bylaws. Review your advance notice bylaw provisions in light of the time periods and information requirements set forth in Rule 14a-11. The time period for submitting nominations under Rule 14a-11 trumps the advance notice bylaw provisions. Consider adding a savings clause to any existing bylaw to provide that a notice valid under the rule will be valid under the bylaw or expressly exclude nominations made under the rule from the application of the bylaw. Many practitioners believe that the notice period specified in the rule (commencing 150 days before the anniversary of the mailing date of the prior year's proxy materials and continuing until 120 days before that anniversary) would be considered unreasonably long under Delaware law, precluding a simple amendment of the time periods in the bylaw to conform to those in the rule. Furthermore, many bylaws require information concerning the nominee and the nominating shareholder that goes beyond that required by the rule.

Review Majority Voting Policies. A majority voting policy generally provides that in an uncontested election of directors, any nominee who receives more "withhold" votes than "for" votes must tender his or her resignation for consideration by the nominating committee. An "uncontested" election typically is one in which the number of nominees does not exceed the number of directors to be elected. Accordingly, Rule 14a-11 may restore plurality voting in an election in which a shareholder has made use of the rule. A majority voting policy should be reviewed and, if necessary, revised to ensure that it does not apply if a shareholder makes an effective nomination under Rule 14a-11.

Review Director Qualification Requirements. A nominee who fails to meet a director qualification requirement in the company's governing documents nevertheless must be included in the proxy materials, but under state law would not be entitled to take his or her seat. The company's director qualifications should be reviewed in light of the possibility that a shareholder nominee may be elected, and consideration should be given to including a mandatory retirement age, term limits, a limitation on the number of public company boards of which a director may be a member, requirements tailored to regulated industries (such as defense, gaming, financial institutions, and broadcasting), and limitations occasioned by antitrust concerns. To bar a nominee from taking his or her seat, a director qualification must be included in the company's governing documents and not merely in a board policy.

Review Committee Charters. Review and, if necessary, revise the charters, processes, and policies of the corporate governance and nominating committees to align with Rule 14a-11 the committees' processes and policies for reviewing and making recommendations concerning shareholder nominees.

Review Board Confidentiality Policies. Review any existing board confidentiality policy or, if you do not have such a policy, consider adopting a comprehensive policy that would require board discussions to be maintained in confidence.

Develop an Integration Process for New Directors. The traditional nominating process provides the existing directors, management, and director nominees the opportunity to get to know one another. A board confronted with a newly elected member nominated through Rule 14a-11 must rapidly integrate the new director to minimize the disruption to the board.

Assess the Confluence of Recent Developments in Governance. Consider the impact of proxy access in conjunction with other recent developments in corporate governance, including majority voting campaigns, limitations on discretionary voting by brokers, say-on-pay, and enhanced proxy statement discussion of executive compensation decisions. For example, Rule 14a-11 will be particularly potent if the board fails to adequately respond to a negative say-on-pay vote or if the company has questionable executive compensation or corporate governance practices. ■

Endnotes

1 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2 *See* Shareholder Approval of Executive Compensation and Golden Parachute Compensation, Release No. 33-9178, 34-63768, 76 Fed. Reg. 6, 010 (Jan. 25, 2011); and Reporting of Proxy Votes on Executive Compensation and Other Matters, Release No. 34-63123, IC-29463, 75 Fed. Reg. 66,622 (Oct. 18, 2010).

3 Instruction to Rule 14a-21(a) provides the following non-exclusive example that would satisfy Rule 14a-21(a): "RESOLVED, that the compensation paid to the company's named executive officers, as disclosed pursuant to Item 402 of Regulation S-K, including the Compensation Discussion and Analysis, compensation tables and narrative discussion, is hereby APPROVED." The SEC has issued CD&Is on new Rule 14a-21 confirming that (1) the say-on-frequency vote does not need to be in the form of a resolution, (2) the proxy statement may use a plain English equivalent to "pursuant to Item 402 of Regulation S-K," such as "pursuant to the compensation disclosure rules of the SEC, including the CD&A, the compensation tables and any related material disclosed in this proxy statement," and (3) the say-on-frequency vote may use the words "every year, every other year, or every three years, or abstain," instead of "every 1, 2, or 3 years, or abstain." "

4 Note that the company may vote uninstructed proxy cards in accordance with management's recommendation for the say-on-frequency vote only if the company follows the existing requirements of Rule 14a-4 to (1) include a recommendation for the say-on-frequency vote in the proxy statement, (2) permit abstention on the proxy card, and (3) include language regarding how uninstructed shares will be voted in bold on the proxy card.

5 Item 8 of Schedule 14A and Item 11 of Form 10-K currently require disclosure in both annual reports and annual meeting proxy statements of information specified in Item 402(j) of Regulation S-K about payments that may be made to named executive officers upon termination of employment or in connection with a change in control. The information required by Item 402(t) is more comprehensive than that required by Item 402(j).

6 Because such arrangements are beyond the scope of the disclosure required by section 14A(b)(1), they would not be subject to the shareholder advisory vote required by section 14A(b)(2) discussed below.

7 Information regarding future employment agreements is subject to disclosure pursuant to Item 5(a) of Schedule 14A (to the extent that such agreements constitute a "substantial interest" in the matter to be acted upon) and Item 5(b)(xii).

8 *See* Order Approving Proposed Rule Change, as modified by Amendment No. 4, to Amend NYSE Rule 452 and Corresponding Listed Company Manual Section 402.08 to Eliminate Broker Discretionary Voting for the Election of Directors, Except for Companies Registered under the Investment Company Act of 1940, and to Codify Two Previously Published Interpretations that Do Not Permit Broker Discretionary Voting for Material Amendments to Investment Advisory Contracts with an Investment Company, Release No. 34-60215, SR-NYSE-2006-92, 74 Fed. Reg. 33,293 (July 1, 2009).

9 *See* Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change to Amend NYSE Rule 452 and Listed Company Manual Section 402.08 to Eliminate Broker Discretionary Voting on Executive Compensation Matters, Release No. 34-62874, SR-NYSE-2010-59, 75 Fed. Reg. 56,152 (Sept. 9, 2010).

10 *See* Proposed Rules for Implementing the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Release No. 34-63237, 75 Fed. Reg. 70,488 (Nov. 3, 2010).

11 *See* 17 C.F.R. § 202.12.

12 *See* Facilitating Shareholder Director Nominations, Release No. 33-9136, 34-62764, 75 Fed. Reg. 56,668 (Aug. 25, 2010).

13 *Business Roundtable, et al. v. SEC*, No. 10-1305 (D.C. Cir. filed Sept. 29, 2010).

14 *See* In the Matter of the Motion of the Business Roundtable and the Chamber of Commerce of the United States of America for Stay of Effect of Commission's Facilitating Shareholder Director Nominations Rules, Release No. 33-9149, 34-63031 (Oct. 4, 2010).

15 *See id.* note 486: "We note that pursuant to Exchange Act Rule 14a-4(c)(5) a completed proxy card containing a disqualified or withdrawn nominee or nominees could, under certain circumstances, confer discretionary authority to vote on the election of a substitute director or directors."