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DODD-FRANK ACT GOVERNANCE AND COMPENSATION REQUIREMENTS: A "PUNCH LIST" OF ACTION ITEMS

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act")[1], enacted earlier this summer, imposes significant new corporate governance and executive compensation requirements that apply not just to financial institutions, but to public companies generally. Since many public companies begin in the fall to focus on the upcoming proxy season, this client alert is intended to provide a "punch list" of potential governance and compensation action items management and boards of directors should consider in order to comply with the Act's new requirements.

Companies should keep in mind that compliance with the new requirements is a moving target. Although some of the Act's new requirements are effective immediately, others are subject to extensive rulemaking by the Securities and Exchange Commission ("SEC") and stock exchanges (e.g., NYSE and Nasdaq) that will occur over the next few months – which will mean that companies will need to continuously monitor and update their policies and disclosures to comply with the newly-enacted rules. The SEC recently issued a tentative timeframe for rulemaking in many of these areas, and these dates are noted below.[2]

The principal actions companies should be focusing on include the following:

- Proxy access: Last month, in response to express authority given to it under the Act, the SEC adopted new rules enhancing the ability of shareholders to nominate directors of corporate boards.[3] Under the new rules, in certain circumstances, shareholders owning at least three percent of the company's voting power for at least three years (and who meet other requirements) will be able to have their nominees included in the company proxy materials that are sent to all voters. Additionally, shareholders will be able to use the shareholder proposal process to establish procedures to include shareholder director nominations in company proxy materials that may be even more shareholder-friendly than those required by the new SEC rules.

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[1] See Subtitles E and G for the executive compensation and corporate governance provisions in the final version of the Act at: http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173ENR/pdf/BILLS-111hr4173ENR.pdf. For a summary of the Act's governance and compensation provisions applicable to public companies generally, see our client alert at http://www.wcsr.com/resources/pdfs/cs072210.pdf.

[2] The SEC's tentative timeframe may be found at: http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml#0910.

[3] The SEC proxy access press release, including a link to the 451-page adopting release, is available at http://www.sec.gov/news/press/2010/2010-155.htm (August 25, 2010). Our client alert discussing the SEC's new proxy access rules may be found at http://www.wcsr.com/resources/pdfs/cs090910.pdf.

- *Effective date*: The new proxy access rules will be effective on November 15, 2010, although smaller reporting companies will not be subject to the new rules for three additional years.

- *What to do now*: Assess vulnerability to nominations by shareholders and prepare accordingly: e.g., review shareholder base, review nomination criteria and procedures and consider whether amendments to advance notice bylaws, director qualification bylaws, corporate governance guidelines and/or nominating committee charter are necessary, and identify proxy advisory firm(s) that may assist with a potential proxy fight.

- Say on Pay: The Act includes two requirements for a non-binding shareholder vote on executive compensation, often referred to as a "say on pay" (or "SOP") vote.

  - First, (i) not less often than once every three years, a company must give its shareholders an opportunity to cast a non-binding vote on its executive compensation program, and (ii) at least once every six years, the shareholders also must vote to determine whether this say on pay vote will occur every one, two or three years.

  - Second, any company seeking shareholder approval of an M&A transaction must (i) disclose, and (ii) provide its shareholders with a non-binding vote regarding, golden parachute arrangements for the benefit of its named executive officers (and the aggregate amount of compensation that would be paid), unless such arrangements previously have been the subject of a non-binding say on pay vote.

  - *Effective date*: The SEC has indicated that it will propose new rules regarding the SOP requirements in the fourth quarter of 2010 and adopt final rules during the first quarter of 2011.

  - *What to do now*:

  - Companies should reassess their compensation programs and policies – and related disclosures – to identify potentially problematic pay practices that could impact the SOP vote. In terms of compensation design, companies need to reassess each element of their compensation programs to identify – and possibly reduce or eliminate – controversial pay practices, such as perquisites, gross-ups, overly generous severance and employment agreements and single trigger change in control provisions. On the flip side, companies that have not implemented best practices pay features that are favored by investors and proxy advisory groups, such as performance-based vesting, clawback policies and stock ownership and "hold til retirement" policies, should consider doing so. (As discussed below, companies will now be required to have clawback policies in place.) Similarly, if a company has "positive" compensation practices in place or has eliminated problematic pay practices, this should be touted in its disclosures. From a disclosure standpoint, the compensation story a company presents in next year's proxy statement will likely be its most effective weapon in setting the stage for a favorable SOP vote. In particular, companies should strive for clear and concise Compensation Discussion and Analysis (CD&A) disclosure to assist readers in understanding the company's compensation program.

  - Companies also should review the proxy guidelines of their largest shareholders and proxy advisory firms such as RiskMetrics Group ("RMG") to determine whether they have potentially problematic pay practices that may impact such firms' recommendations regarding SOP and director nominees. In this new age of "shareholder engagement," many companies will need to enhance their dialogue with key investors, which will require coordinated internal efforts with management, including investor relations, legal and other representatives. Direct director contact with investors is also being touted by some commentators as a "sign of the times," although companies will need to proceed carefully in light of Regulation FD and other legal concerns. Companies should consider whether a policy regarding shareholder communications is appropriate.

  - Companies also will need to determine whether they should recommend that the SOP vote occur every one, two or three years. Some investor groups have suggested they will favor a triennial vote because of the internal labor that would be involved for annual SOP analysis. Likewise, some commentators suggest that a triennial vote may be more likely to promote long-term growth and provide shareholders with a better opportunity to consider multi-year, long-term compensation practices. However, it remains to be seen which approach will be predominant – or whether the SEC will require preliminary proxy filings as a result of SOP being on the ballot (which would impact a company's proxy season timetable).

- <u>Compensation Committee Authority/Independence and Compensation Consultant Independence</u>:

  - *Compensation Committee Independence*: The Act requires that listed companies' compensation committees consist exclusively of independent directors. The Act also directs the SEC and stock exchanges to define "independent" by taking into account certain specified factors, including (i) any consulting, advisory or other compensatory fee paid by the company to the director and (ii) whether the director is affiliated with the company, a subsidiary or an affiliate of a subsidiary. We expect the final requirements may be similar to the current "heightened independence" standard for audit committee members.

  - *Independence and Retention of Compensation Consultants and other Advisors*: The Act also imposes a series of new requirements related to the independence, retention and compensation of compensation consultants and other compensation committee advisors. First, under stock exchange listing standards mandated by the Act, a compensation committee may only select a compensation consultant, legal counsel or other adviser after consideration of specific factors bearing on such person's or firm's independence (e.g., the provision of other services by the firm, the fees received by the firm, conflicts of interest policies established by the firm, business or personal relationships of the adviser with a member of the compensation committee, and stock of the company owned by the adviser).

    Second, the Act provides that the compensation committee must be directly responsible for the appointment, compensation and oversight of the work of compensation consultants, legal counsel and other advisors and requires companies to provide for appropriate funding to compensate consultants, legal counsel and other advisors.

    Third, the Act also requires proxy statement disclosure (starting in July 2011) regarding whether the compensation committee has hired a compensation consultant (but not other advisers) and any conflicts of interest of the consultant.

- *Effective Date:* The SEC has indicated that it intends to propose new rules in this area during the fourth quarter of 2010 and adopt final rules between April and July 2011. The new rules must be in place within 360 days after enactment of the Act.

- *What to do now*:

- Analyze independence of compensation committee members, e.g., by reviewing responses to most recent D&O questionnaires for possible relationships.

- Revise D&O questionnaires to address new independence standards.

- Analyze engagements with advisers and consultants to compensation committee.

- Consider impact on legal counsel, to the extent such counsel advises both company and compensation committee.

- Amend compensation committee charter (and possibly nominating committee charter and/or corporate governance guidelines) to (i) incorporate the committee independence requirement and (ii) address compensation committee authority over, and considerations/procedures for, hiring and compensating consultants and advisers.

- Revise proxy statement disclosures to address compensation consultant conflicts of interest.

- <u>Clawback Policies</u>:

  - The Act requires stock exchanges to issue listing standards that will require listed companies to adopt (and disclose) policies (often referred to as "clawback policies") to recover compensation awarded based on financial information that is later discovered to be erroneous due to a restatement of a company's financial statements that was required because of material noncompliance with applicable financial reporting requirements. The clawback policies must apply to compensation (including stock options) received by any current or former executive officer of the company during the three-year period preceding the date the company is required to prepare an accounting restatement, to the extent such compensation is in excess of the compensation that would have been paid under the restated financial statements. The Act's clawback provisions are broader than those imposed under the Sarbanes-Oxley Act of 2002 (which only applies to the CEO and chief financial officer and only looks back one year). As a result, many companies will need to adopt or revise existing clawback policies.

  - *Effective Date*: The Act does not provide a specific timeframe for the exchanges to adopt these rules, but the SEC has indicated that new rules should be proposed between April and July 2011.

  - *What to do now*:

  - Revisit the scope of any current clawback policy to consider whether amendments are necessary or, if no policy exists, adopt a new policy within the timeframe imposed under final rules (once issued).

- Consider the effect of the Act's clawback requirements on clawback provisions in plans and agreements, which may address other conduct as well (e.g., violation of restrictive covenants or company policies).

- Comply with the new disclosure requirement, which requires disclosure of the company's policy on incentive-based compensation that is based on corporate financial information.

- Compensation Disclosures: The Act adds three disclosure requirements with respect to executive compensation.

  - Clear description of pay vs. performance: First, the Act requires the SEC to establish rules requiring companies to include in their proxy statements a "clear description" of executive compensation, including information showing the relationship between compensation actually paid to its executives and the financial performance of the company, taking into account any change in the value of the company's shares, dividends of the company and any distributions. This disclosure may be a graphic representation.

  - Internal pay equity: The Act also requires the SEC to adopt rules requiring companies to disclose in their proxy statements (i) the median of annual total compensation of all employees other than the CEO, (ii) the annual total compensation of the CEO and (iii) the ratio of these two numbers (calculated in accordance with the rules applicable to summary compensation table calculations).

  - Hedging policies: The Act also requires companies to disclose whether any employee or director of the company is permitted to purchase financial instruments designed to hedge or offset any decrease in the market value of the company's securities held by the employee or director (whether granted as compensation or otherwise held).

  - *Effective Date*: Although the Act does not provide a specific timeframe for the SEC to adopt rules regarding these disclosures, the SEC has indicated that it plans to propose new rules between April and July 2011.

  - *What to do now*:

  - Analyze how executive compensation will compare with performance as measured by stock price and other metrics.

  - Assess ability to make required internal pay equity computations for all employees and then formulate factors that explain disparity.

  - Consider adding supplemental disclosure comparing CEO pay to other named executive officers/executive officer group (which many shareholder groups and commentators view as more meaningful) and discuss internal pay equity analysis in CD&A.

  - Revisit the scope of any current hedging policy (e.g., as part of insider trading policy or code of ethics) to consider whether amendments are necessary (for instance, to include all employees, not just directors and executive officers). If no policy exists, adopt a new policy or be prepared to disclose the absence of a policy.

- <u>Disclosure of Chief Executive Officer/Chairman Structure</u>: The Act requires that the SEC adopt rules mandating companies to disclose in their proxy statements whether the company has chosen the same person to serve as CEO and chairman and the reasons for that structure. This provision should not result in any significant new disclosures because the SEC's current proxy disclosure rules already require companies to discuss the rationale for their leadership structure.

    - *Effective date*: The SEC is required to issue rules by January 17, 2011.

    - *What to do now*: Companies should be sure that their disclosures comply with existing proxy requirements and re-assess whether additional disclosures are needed once the SEC acts on this provision.

- <u>Broker Non-Votes</u>:

    - The Act requires stock exchanges to prohibit broker discretionary voting with respect to director elections, executive compensation or any other "significant matter" (as determined by the SEC). NYSE Rule 452 currently prohibits broker discretionary voting regarding the election of directors,[4] but the Act expands the prohibition on broker discretionary voting to include executive compensation matters, including the new SOP vote required by the Act.

    - *Effective date*: This section of the Act is effective immediately. In addition, the SEC has indicated that it intends to propose rules defining "other significant matters" for these purposes between April and July 2011.

    - On September 9, 2010, the SEC approved on an accelerated basis a NYSE rule change to Rule 452 prohibiting brokers from voting uninstructed shares if the matter voted on relates to executive compensation. This includes votes on (i) say on pay, (ii) the frequency of say on pay, (iii) say on golden parachutes and (iv) any other matter concerning executive compensation. The SEC at this time did not extend the broker non-vote restriction to any other significant matter although it has authority to do so under the Act.

    - *What to do now*:

    - Evaluate shareholder base to determine if broker non-vote restrictions are likely to affect approval of company executive compensation and other proposals.

    - Consider improving investor communications and/or engaging proxy solicitation firms.

- <u>Whistleblower provisions ("Bounty Program")</u>:

    - The Act provides financial incentives to encourage whistleblowers to report securities laws violations to the SEC. If the SEC recovers at least $1,000,000, the whistleblower will be entitled to an award of between 10% and 30% of the monetary sanctions imposed by the SEC and in related governmental actions. The awards will be payable from a new SEC fund consisting of monetary sanctions obtained in its

[4] See our client alert regarding the changes to the NYSE rules prohibiting broker discretionary voting in director elections at: http://www.wcsr.com/resources/pdfs/cs070609.pdf.

enforcement actions generally. The Act also enhances remedies for retaliation by the employer, including expanding a whistleblower's private right of action and providing for damages equal to twice the whistleblower's back pay. This provision may have the unintended consequence of incentivizing the whistleblower to bypass a company's internal whistleblower process and go directly to the government since an award is available only if the whistleblower provides "original information" — i.e., information not already known to the SEC.

- *Effective date:* The SEC has indicated that it intends to propose rules regarding the whistleblower provisions during the fourth quarter of 2010 and adopt final rules in the first quarter of 2011.

- *What to do now:*

- Revisit whistleblower policies and procedures to ensure they provide a robust compliance program and to confirm that they have adequate anti-retaliation provisions.

- Develop incentives to encourage employees to follow internal reporting procedures.

- <u>Other Action Items</u>:

In addition to the items noted above, companies should review and revise their disclosure controls and procedures in response to the Act's new requirements, for instance, to ensure that new proxy disclosure requirements are met.

Conclusion

Public companies should start now to assess the impact of the Act's new requirements on their corporate governance and executive compensation policies and their disclosure practices. In many instances, it will be prudent for boards to be given more than a single opportunity to consider governance and compensation changes that may be necessary as a result of the Act's new requirements. If you have questions concerning this alert, please contact Jane Jeffries Jones (http://www.wcsr.com/lawyers/janejeffries-jones), the principal drafter of this alert, or you may contact the Womble Carlyle attorney with whom you usually work or one of our Corporate and Securities attorneys at the following link: http://www.wcsr.com/profSearch?team=corporateandsecurities.