SEC Update—Dodd-Frank Act

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Overview

- Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”)
  - The Act was passed by Congress and was signed by President Obama on July 21, 2010
  - There are ten different executive compensation and corporate governance sections in the Act and many have multiple provisions
  - Many provisions require additional SEC rule-making, some of which is still pending

Agenda

- Say on Pay Votes
- Other Executive Compensation Matters
- Compensation Committees
- Corporate Governance Matters
- Other Reforms
- New Proxy Access Rules

Say on Pay Votes

- Two new say on pay advisory vote requirements effective for 2011 proxy season–shareholder meetings occurring on or after January 21, 2011
  - Say-on-pay votes for smaller reporting companies are not required until January 21, 2013
- Requires shareholder advisory vote on executive compensation
  - Vote to approve compensation of the named executive officers as disclosed in the proxy statement
  - Required at least once every three years
  - Non-binding vote
  - Vote to approve a shareholder resolution
    - The SEC provides a non-exclusive example resolution
  - Vote may not be construed as:
    - Overruling a decision by the board
    - Creating or implying any change in or additional fiduciary duty for the board
    - Limiting the shareholders' right to make executive compensation proposals
  - Only one vote required; executives' compensation arrangements do not need to be voted on individually.

Say on Pay Votes–cont.

- Requires shareholder advisory vote on frequency of future say-on-pay votes.
  - Vote on whether future shareholder votes on executive compensation should take place every one, two or three years
  - Requires shareholder vote on frequency of future say-on-pay votes at least once every six years
  - Shareholders vote on the particular number of years they prefer (or abstain)
  - What voting standard should apply?
  - Non-binding vote
  - Issuer may vote uninstructed proxy cards in accordance with management's recommendation on the frequency if the issuer:
    - Includes a recommendation on the frequency in the proxy statement
    - Permits abstentions on proxy card
    - Includes language regarding how uninstructed shares will be voted in bold on the proxy card

Say on Pay Votes–Other

- Companies must disclose in the CD&A whether and, if so, how their compensation policies and decisions have taken into account the results of the most recent say-on-pay vote.
- A Form 8-K must be filed to disclose the company's decision regarding the frequency of say-on-pay votes in light of the results of the shareholders' frequency vote.
  - Must disclose by the earlier of 150 days after the meeting or the 60th day prior to the deadline for submitting Rule 14a-8 shareholder proposals
- Companies must disclose in the proxy statement the current frequency of say-on-pay votes and when the next frequency vote would occur.
- The company may exclude shareholder proposals on the same matters as the say-on-pay votes (e.g., provide for a say-on-pay vote, seeks future say-on-pay votes, or relates to the frequency of say-on-pay votes) if:
  - A single frequency (one, two, or three years) receives support of majority of votes cast
  - Company adopts the frequency

Say on Pay Votes–Results of 2011 Proxy Season

- Approximately 98% of say-on-pay votes have passed.
- Approximately 2/3rds have received 90%+ favorable votes.
- As of mid-May, 26 companies have failed to obtain majority vote on executive compensation.
- ISS influential
  - Recommended “no” votes on 13% of say-on-pay proposals
  - 18% of companies that ISS has recommended against their say-on-pay proposals have not passed

Say on Pay Votes–Results of 2011 Proxy Season

- Litigation Citing Failed Say on Pay Votes - Following the failure to obtain majority votes, the following companies have had shareholder derivative actions filed against them:
  - Jacobs Engineering —
    - At the company's annual meeting in January 2011, stockholders voted against, on a non-binding, advisory basis, the compensation paid and approved an annual say-on-pay vote (the company had recommended a vote every three years).
    - Action filed February 4, 2011 against the company's management alleging "excessive and unwarranted 2010 executive compensation" in the face of "abysmal" dropping revenues and net income.
  - Beazer Homes —
    - At the company's annual meeting in February 2011, stockholders voted against, on a non-binding, advisory basis, the compensation paid and approved an annual say-on-pay vote (which is what was recommended by the company).
    - Shareholder derivative suit filed March15, 2011 against certain employees and directors of the company and its compensation consultants alleging that raises for executives "violated the company's pay-for-performance policy and favored Beazer's CEO and top executives at the expense of the corporation."
- It is too early to tell how these lawsuits will be received by the courts. Directors should continue to act in accordance with their fiduciary duties.

Say on Pay Votes–Results of 2011 Proxy Season

- ISS is recommending and many institutional shareholders are voting for annual advisory votes.
- Latest breakdown of company recommendations for the Say on Pay frequency vote in proxy statements (base on 2,177 companies)
  - 51% recommended an *annual* vote
  - 4% recommended a *biennial* vote
  - 43% recommended a *triennial* vote
  - 4% made *no* recommendation
  - For meetings for which results have been reported, approximately 90% of votes have favored *annual* frequency
  - Trend is for companies to recommend *annual* vote

Say on Pay Vote–Golden Parachutes

- Act requires disclosure of, and advisory vote on, golden parachute agreements and other compensation that relates to the subject transaction.
  - Applies to any shareholder meeting occurring on or after April 25, 2011 at which shareholders are asked to approve an acquisition, merger, consolidation or sale of substantially all assets
  - Non-binding vote
  - Issuer must disclose to shareholders in clear and simple terms any agreements or understandings with any named executive officer concerning any type of compensation (whether present, deferred or contingent) that is based on or otherwise relates to the Transaction and the aggregate total of such compensation that may be paid or become payable on such Transaction
    - For votes by the target company's shareholders, disclosure covers agreements between target company and its NEOs and agreements between such NEOs and the acquiring company, but the advisory vote would apply only to agreements between the target company and its NEOs.
    - For votes by the acquiring company's shareholders, the disclosure covers agreements between that company and its NEOs and the target company's NEOs, but only the agreements between the acquiring company and its named executive officers would be subject to an advisory vote of the acquiring company's shareholders

Say on Pay Vote–Golden Parachutes

- Tabular disclosure of golden parachute compensation

Name (a)	Cash ($) (b)	Equity ($) (c)	Pension/ NQDC ($) (d)	Perquisities/ Benefits ($) (e)	Tax Reimbursement ($) (f)	Other ($) (g)	Total ($)(h)
PEO							
PFO							
A							
B							
C							

- Footnote disclosure of:
  - Each separate item of compensation
  - Amounts attributable to “single trigger” arrangements and “double trigger” arrangements
- No tabular disclosure of:
  - Previously-vested equity awards
  - Bona fide post-transaction employment agreements to be entered into in connection with the transaction

Say on Pay Vote–Golden Parachutes

- Narrative disclosure of:
  - Material conditions or obligations related to payment (e.g., noncompete, nonsolicitation or confidentiality agreements)
  - Specific circumstances that would trigger payment
  - Whether payment is lump sum, duration of payments, who would make the payments, and other material factors
- If previously subject to a Say on Pay vote and the required disclosure was made, no Say on Golden Parachutes vote is required (though the related disclosure is still required)
  - Regardless of outcome of vote
  - New agreements or amendments to existing agreements after the Say on Pay vote would still need to be disclosed and voted on

Other Executive Compensation Matters– Disclosure of Shareholder Vote

- SEC has proposed rules that require every institutional investment manager that files Form 13F disclose annually how they voted on say-on-pay votes.
  - Applies to managers with more than $100 million of registered equity securities (in aggregate) under management

Other Executive Compensation Matters– Pay Versus Performance Disclosure

- SEC must establish rules requiring proxy statement disclosure of the relationship between executive compensation actually paid and the financial performance of the company.
  - The information can be presented in either graphic or narrative form
  - Financial performance can take into account any change in value of the stock of the company and any dividends paid
  - Final rules expected to be adopted between August-December 2011.

Other Executive Compensation Matters– CEO Pay Disparity Ratio

- SEC must amend executive compensation disclosure rules to require disclosure of:
  - The annual compensation of the CEO (calculated under the executive compensation disclosure rules)
  - The median total annual compensation of all employees other than CEO (calculated in same manner as executive compensation disclosure rules)
  - The ratio of the median of the compensation of all employees (other than the CEO) to the CEO's compensation
- Final rules expected to be adopted between August-December 2011.
- Need to ensure procedures are in place to calculate compensation of employees in accordance with executive compensation disclosure rules.

Other Executive Compensation Matters– Clawback Policy

- SEC must establish rules directing national securities exchanges to require companies to implement an executive compensation clawback policy.
  - Final exchange listing standards expected to be adopted between August-December 2011
- Clawback policy:
  - Applies when–restatement of financial statements due to material noncompliance with any financial reporting requirement under securities laws
  - Applies to–recovery from current or former executive officers who received incentive-based compensation during three-year period before restatement
  - Clawback amount–incentive compensation actually paid less what would have been paid under restated financial statements
- No misconduct required by executive officers
- Unlike SOX § 304, policy applies to all executive officers, not just CEOs and CFOs

Other Executive Compensation Matters– Disclosure of Hedging Policy

- SEC must establish rules requiring a company to disclose in its proxy statement whether directors or employees are permitted to hedge or offset any decrease in the market value of company equity securities.
  - Disclosure rule, not a substantive requirement
  - Final rules expected to be adopted between August-December 2011.
- Item 403 of Regulation S-K already requires disclosure of pledges of company securities by executive officers and directors.
- Most companies already address hedging in their insider trading policies.

Compensation Committees–Independence

- SEC proposed rules direct national securities exchanges to require that listed company compensation committee members be independent.
  - Comment period was over May 19th and final exchange listing standards expected to be adopted between August-December 2011
- Factors for securities exchanges to take into account in defining independence:
  - The source of compensation of the board member, including any consulting, advisory or other compensatory fee paid by the company to that member
  - Whether a member of the board is affiliated with the company, its subsidiary or affiliate of a subsidiary
- The new standards will be in addition to the independence standards already applicable to compensation committee members pursuant to:
  - Existing listing standards
  - Section 16 of the Exchange Act
  - Section 162(m) of the Internal Revenue Code
  - State law

Compensation Committees–Independence

- The new compensation committee independence requirements will not apply to:
  - Controlled companies (issuers that are listed on a national securities exchange of which more than 50% of the voting power for election of directors is held by an individual, a group or another issuer)
  - Limited partnerships, bankrupt companies and open-ended mutual funds
  - Companies not listed on a national securities exchange, such as OTCBB or pink sheets

Compensation Committees–Compensation Consultants

- Compensation committee of listed companies must:
  - Have the authority to retain a compensation consultant or other advisors that report directly to the compensation committee.
  - Be provided with the funding to retain a compensation consultant or other advisors
- SEC proposed rules require proxy statement disclosure regarding the following for meetings at which directors are being elected:
  - whether a company retained a compensation consultant
  - whether the compensation consultant's work raised any conflict of interest
  - if so, the nature of the conflict and how the conflict was addressed

Compensation Committees–Compensation Consultants

- The listing requirements to be implemented will also require that a compensation committee must take into account independence factors determined by SEC when selecting a compensation consultant, legal counsel, or other advisors.
- Independence factors must include:
  - The provision of other services to the company by the consultant or advisor
  - The amount of fees from the company as a percentage of total revenues received by the consultant or advisor
  - The consultant's or advisor's procedures to manage conflicts
  - Any business or personal relationship of the consultant or advisor with the members of the compensation committee
  - Any stock of the company owned by the advisor
- Companies should evaluate the independence of current compensation committee members to determine whether any changes to the composition of the committee should be made.

Corporate Governance Matters

- Broker discretionary voting authority
  - Brokers prohibited from exercising discretionary voting authority on:
    - Director elections–effective immediately
    - Executive compensation–effective immediately
    - Any other significant matter determined by SEC–SEC to issue rules
  - The NYSE already prohibits its member firms from exercising discretionary authority with respect to director elections and approval of equity compensation plans (or material amendments thereto)
- Chairman/CEO disclosures
  - Requires SEC to adopt rules requiring disclosure of:
    - Whether Chairman and CEO are same person
    - Why or why not
  - Similar disclosure already required by Item 407(h) of Regulation S-K

Other Reforms

- Regulation D
  - Exclude value of primary residence when determining whether an individual is an accredited investor
    - Exclude mortgage debt except to extent debt exceeds value of primary residence
    - Effective upon adoption of Act with Final SEC rules to be adopted May-July 2011
    - Update accredited investor questionnaires
- SEC to establish rules prohibiting "bad actors" from relying on Rule 506 to exempt offerings
  - Barred by a state securities, banking or insurance authority or federal banking authority
  - Conviction in connection with purchase or sale of securities or making of false filing with SEC
  - Final rules expected to be adopted between August-December 2011.
- Regulation FD
  - SEC amended Regulation FD to eliminate exception for disclosures to credit rating agencies

Other Reforms–cont.

- Beneficial Ownership
  - SEC may shorten 10-day period for filing Schedule 13D and Form 4
  - Owners of security-based swaps may be deemed owners of underlying equity securities to extent swaps provide incidents of ownership comparable to direct ownership of the equity security
    - Final rules expected to be adopted between May-July 2011
- Internal Control Over Financial Reporting
  - Companies that are not large-accelerated filers or accelerated filers are exempt from Section 404(b) requirements for an external audit of internal controls.
  - In April 2011 the SEC released the results of its study of the effects of Section 404(b) on mid-sized companies ($75m to $250m market cap).
    - The SEC decided not to recommend expanding the exemption from 404(b). The current exemption already applies to 60% of reporting issuers.
    - The study found that (a) the costs of complying with 404(b) have declined (due to experience, SEC guidance and AS 5), (b) investor groups prefer the extra review and (c) there is no evidence that providing a broader exemption will encourage companies to list in the U.S.

Proxy Access–Effective Date

- SEC adopted Proxy Access rules in August 2010
- The new rules require certain public companies to include in their proxy materials
  - a shareholder's director nominees (new Rule 14a-11) and
  - shareholder proposals to amend the company's governing documents to establish different criteria for proxy access nominations (amendment to Rule 14a-8).
- Rules were to be effective for 2011 proxy season
  - For smaller reporting companies (generally companies with a public float of less than $75 million), new Rule 14a-11 would become effective for 2014 proxy season
- In October 2010 the SEC issued an order to stay effectiveness of rules pending resolution of lawsuit filed in federal court
  - The Business Roundtable and U.S. Chamber of Commerce have asserted that the new proxy access rules are arbitrary and capricious; do not promote efficiency, competition and capital formation; exceed the SEC's authority; and are unconstitutional.
  - D.C. Circuit Court of Appeals heard oral arguments in April 2011.

Proxy Access–New Rule 14a-11

- New Rule 14a-11 creates a process under which any public company to which the rule applies that receives a notice from an eligible shareholder or group of shareholders to nominate one or more directors will be required to include those nominees in its proxy materials so long as certain requirements are met.
  - The SEC states in the adopting release that
    - Rule 14a-11 does not apply if state or foreign law or the company's governing documents (e.g., charter, bylaws, certificate of designations, etc.) completely prohibit the company's shareholders from nominating directors
    - However, Rule 14a-11 applies regardless of whether state law or a company's governing documents prohibit inclusion of shareholder director nominees in company proxy materials or set share ownership or other terms that are more restrictive than Rule 14a-11 under which shareholder director nominees will be included in company proxy materials.
- The following is a summary of the key provisions of the rule (covered in the slides that follow):
  - Shareholder eligibility requirements
  - Director nominee eligibility requirements
  - Maximum number of director nominees
  - Shareholder notice requirements

Proxy Access–New Rule 14a-11

- Eligible Shareholders:
  - 3% + 3 years
    - 3% of total voting power entitled to elect directors
    - 3 years–held shares at least 3 years
  - Must hold both investment power and voting power
  - Cannot hold shares for purpose of:
    - Changing control of the company
    - Gaining more board seats than permitted under proxy access rules
  - Shareholders may aggregate holdings with other shareholders

Proxy Access–New Rule 14a-11

- Eligible Director Nominees
  - A shareholder nominee's candidacy and, if elected, board membership must not violate federal, state or foreign law, or the rules of the applicable national securities exchange.
  - The nominee must satisfy the objective independence standards of the applicable national securities exchange.
    - Nominees do not, however, have to be independent of the shareholders who nominate them.
  - Neither the nominee nor the nominating shareholder (including any member of the nominating shareholder group) may have any agreement with the company regarding the nomination.
- Maximum Number of Director Nominees
  - A company must include a number of shareholder-nominated director nominees that represents no more than 25% of the company's board of directors (rounded down), but no less than 1 director.
    - If the number of nominees submitted exceeds this, then priority is given to the nominees from the nominating shareholder or shareholder group holding the greatest percentage of securities eligible to vote in the election of directors.
    - For companies with classified boards, this limit is calculated based on the total number of board seats even though not all of the directors may be up for election at the meeting.

Proxy Access–New Rule 14a-11

- Shareholder Notice Requirements
  - A nominating shareholder or group must file a new Schedule 14N with the SEC
  - Schedule 14N requires nominating shareholders to make certain disclosures, including:
    - the amount of securities held by the nominating shareholder and the length of time those securities have been held;
    - a statement of the shareholder's intent to hold those securities;
    - a certification that the shareholder is not holding the company's securities with the purpose, or effect, of changing control of the company or to gain control of the board; information about the nominating shareholder; and
    - a statement of support for each nominee that is no longer than 500 words per nominee.
  - A Schedule 14N must also be filed when:
    - A shareholder communicates with other shareholders to form a group for nominating directors
    - Written communications in support of nominee
    - Report final results of election and intent regarding continued ownership of shares

Proxy Access–New Rule 14a-11

- Timeline
  - Schedule 14N must be filed between 150-120 days before anniversary of mailing date of last year's proxy statement
  - If company seeks to exclude nominee:
    - Notice to nominating shareholder within 14 days after 120-day deadline
    - Nominating shareholder has 14 days after receiving such notice to respond and correct any deficiencies
    - If company still believes it can exclude, must give notice to SEC no later than 80 days before filing definitive proxy statement
  - If company decides to include nominee, must notify nominating shareholder at least 30 days before filing definitive proxy statement

Proxy Access–Amendment to Rule 14a-8

- Rule 14a-8(i)(8) currently allows a company to exclude shareholder nominations or procedures for such nominations or elections.
  - Amended Rule 14a-8(i)(8) enables shareholders, under certain circumstances, to include in company proxy materials (i) proposals that would amend a company's governing documents regarding nomination procedures and (ii) disclosures related to shareholder nominations, provided that the proposal does not conflict with state law or Rule 14a-11.
    - Shareholder proposals could expand proxy access rules (e.g., lower percentage threshold, shorten holding period)
    - Shareholder proposals cannot limit proxy access rules
- The SEC codified certain prior staff interpretations that outline certain circumstances where companies have the right to exclude proposals related to elections and nominations for directors:
  - If it would disqualify a nominee who is standing for election
  - If it would remove a director from office before the end of his or her term
  - If it questions the competence, business judgment or character of one or more nominees or directors;
  - If it seeks to include a specific individual in the company's proxy materials for election to the board of directors or
  - If it otherwise could affect the outcome of the upcoming election of directors

Proxy Access–Next Steps

Companies should evaluate the impact of the rules and consider the following:

- Assess the Company's Shareholder Base–Determining which of the company's three percent or greater shareholders might be interested in nominating a director, and which shareholders below three percent might be expected to solicit the formation of a group to nominate directors
- Review corporate governance, management and executive compensation issues to determine whether there are problem areas that could be addressed
- Improve shareholder engagement to exchange views on compensation and other matters
- Review corporate governance and nominating committee charters, as well as bylaws, to determine if changes need to be made
  - Assess the adequacy of director qualification standards
  - Review majority voting provisions
  - Review advance notice provisions for director nominations
  - Amend governing documents to avoid conflicts with Rule 14a-11
- Consider impact on shareholder rights plan (poison pill)
- Consider available strategies for contending with directors nominated as a result of proxy access, including how to work with proxy advisory firms in such cases
- Create a Proxy Calendar
- Consider Board Size and Constitution
- Evaluate Change in Control Provisions in Agreements and Applicable Regulations