Wilson Sonsini Goodrich & Rosati
PROFESSIONAL CORPORATION

WSGR ALERT

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PRESIDENT TO SIGN FINANCIAL OVERHAUL BILL

Corporate Governance and Executive Compensation Update

On July 15, 2010, after months of deliberation, Congress passed a comprehensive financial reform bill, the Dodd-Frank Wall Street Reform and Consumer Protection Act. President Obama is expected to sign the Dodd-Frank Act into law this week. It is the successor to Senator Dodd's previous bill, the Restoring American Financial Stability Act of 2010, which was discussed in the WSGR Alert entitled "Senate Set to Debate Financial Reform Bill," released on March 29, 2010.

While the central focus of the Dodd-Frank Act is aimed at regulating banks and non-bank financial institutions, it also includes corporate governance and executive compensation provisions that will affect all publicly traded companies. This WSGR Alert discusses the corporate governance and executive compensation provisions of the Dodd-Frank Bill, as well as other provisions of note for private companies, venture capital firms, and smaller public companies. Two companion WSGR Alerts address the Securities and Exchange Commission and securities law enforcement provisions of the Dodd-Frank Act: "Enhanced Whistleblower Bounty Provisions of New Financial Reform Law May Prompt Increased SEC Enforcement Activity" and "President to Sign Financial Overhaul Bill—SEC Update."

I. Corporate Governance

A. Proxy Access

The Dodd-Frank Act expands Section 14(a) of the Exchange Act of 1934 (Exchange Act) to grant the Securities and Exchange Commission (SEC) the power to prescribe rules and regulations requiring public companies to include shareholder director nominees in their proxy statements. The Dodd-Frank Act expressly grants the SEC the authority to specify the procedure an issuer must follow when responding to requests by shareholders for director nominations. In addition, it allows the SEC to exempt small issuers from proxy access rules.

Proxy access rules have been debated by the SEC a number of times in the last decade, and are a well-known priority of current SEC Chairman Mary Schapiro.[1] The SEC's attempts to adopt proxy access rules have come under significant criticism, including questions as to whether the SEC has the statutory authority to promulgate the rules.[2] The Dodd-Frank Act settles the issue as to the SEC's statutory authority, and while it does not impose a deadline on SEC rulemaking, Chairman Schapiro recently stated that she is "committed to bringing a proposal back to the Commission to consider final adoption, within a timeframe that would put the rules into effect for the 2011 proxy season."[3]

B. Chairman and CEO Structures

The Dodd-Frank Act also requires the SEC to adopt rules requiring a public issuer to disclose in its annual proxy statement the reasons why its board of directors has chosen the same or different persons to serve as chairman of the board of directors and chief executive officer (or equivalent position). The SEC's December 2009 enhancements to proxy disclosure rules already appear to satisfy this requirement. These rules require companies to include in their proxy statement a description of the board's leadership structure, including disclosure of whether, and why, each company has chosen to combine or separate the positions of principal executive officer and board chairman, and why the company believes that such board leadership structure is the most appropriate.

C. No Requirement that Directors Be Elected by Majority Voting or in Annual Elections

Notably, the Dodd-Frank Act does not require that all public company directors be elected by majority voting or that staggered

[1] See our previous WSGR Alerts concerning proxy access: "Update on Important Considerations for Companies Preparing for the 2010 Proxy Season," December 1, 2009; "Recent Developments and Important Considerations for Companies Preparing for the 2010 Proxy Season," September 14, 2009; and "U.S. Senator Schumer Introduces Shareholder Bill of Rights Act of 2009; SEC Votes to Re-propose Proxy Access Rules," May 22, 2009.

[2] See generally Joseph A. Grundfest, "The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law," *The Business Lawyer,* February 2010. The questions about the SEC's statutory authority are raised by the decision in *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

[3] Remarks at CEO Quarterly Meeting of The Business Roundtable (June 8, 2010).

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boards be eliminated, as some draft legislation would have required.

II. Executive Compensation

A. Say-On-Pay

The Dodd-Frank Act requires that, at least once every three years, shareholders of public companies must be given a separate non-binding vote to approve compensation of executives as disclosed in the annual proxy statement. In addition, once every six years, a separate shareholder vote will be required to determine whether the foregoing vote on executive compensation will occur every one, two, or three years. This requirement becomes effective for the first annual or other meeting of shareholders occurring six months following enactment (i.e., in January 2011). At such a meeting, the proxy consent must include separate resolutions for both of the votes described above.

B. Golden Parachute Approval

The Dodd-Frank Act requires that proxy statements filed in connection with shareholder approval of an acquisition, merger, consolidation, or disposition transaction will be required to include additional "golden parachute" disclosures and a separate non-binding shareholder vote on any golden parachute payments to be made to named executive officers. Such a vote would not be required if the agreements or understandings have previously been subject to the "say-on-pay" shareholder executive compensation vote described above. The new disclosure rules, to be issued by the SEC, will require disclosure of any agreements or understandings with named executive officers concerning any type of compensation based on or otherwise relating to such a transaction, including an aggregate total of all such compensation that may be paid or become payable. The provision is effective for annual or other meetings of shareholders to approve such transactions that occur six months following enactment (i.e., in January 2011).

The shareholder votes described above will not be binding on an issuer or its board of directors and the results may not be construed as overruling a previous decision of the board or creating or implying any additional fiduciary duty owed by the board to company shareholders. The law grants the SEC authority to exempt classes of issuers, including smaller reporting issuers, from the voting and disclosure voting rules.

Institutional investment managers subject to Section 13(f) of the Exchange Act will be required to report how they voted in any shareholder say-on-pay or golden parachute votes, unless such vote is otherwise required to be reported publicly by SEC rules.

C. Compensation Committee Independence and Appointment of Advisors

The Dodd-Frank Act also requires that, within 360 days following enactment (i.e., by July 2011), the SEC must issue rules prohibiting the listing on national securities exchanges of any equity security of an issuer that does not comply with the following requirements:

- Members of the compensation committee of the board of directors must be independent of the issuer, with the factors considered for determination of independence to include both the source of compensation (including any fees paid by the company) to the committee member and whether the committee member is affiliated with the company or any subsidiary or affiliate of the company. (These are the same factors that are currently used to determine the higher audit committee independence standards.)
- Compensation committees will only be able to select a consultant, legal counsel, or other advisor after taking into consideration factors to be identified by the SEC, including, at a minimum: (1) the total services provided to the company by the entity that employs such consultant, legal counsel, or other advisor; (2) the amount of fees paid by the company to the entity that employs the consultant as a percentage of total revenue of such entity; (3) the policies and procedures adopted by the entity employing the consultant, legal counsel, or other advisor that are designed to prevent conflicts of interest; (4) any business or personal relationships that such consultant, legal counsel, or other advisor has with a member of the compensation committee; and (5) any stock of the company that the consultant, legal counsel, or other advisor owns.
- If a compensation committee retains a consultant, legal counsel, or other advisor, the committee will be solely responsible for the appointment, compensation, and oversight of such advisor. The company will be required to provide the appropriate funding to the compensation committee to ensure that the compensation committee can retain any such consultant, legal counsel, or other advisor.
- Beginning one year after the enactment, disclosure will be required in the annual proxy statement indicating whether the compensation committee retained or obtained the advice of a consultant, as well as whether retaining such consultant has raised any conflicts of interest.

D. Disclosure of Executive Pay in Relation to Company Performance and Internal Pay Equity

The Dodd-Frank Act requires the SEC to adopt rules mandating a public company to disclose in its annual proxy statement the relationship between the executive

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compensation actually paid and the company's financial performance, taking into account any change in the value of the company's stock, dividends, and other distributions.

In addition, public companies will be required to disclose in their annual proxy statement the ratio of the annual total compensation paid to the chief executive officer and the median of the annual total compensation paid to all other employees. Annual total compensation for this purpose shall be determined in accordance with the rules currently in place for preparing the Summary Compensation Table.

The Dodd-Frank Act does not impose deadlines on either of these SEC rulemaking requirements.

E. Clawback Policy

The Dodd-Frank Act directs the SEC to issue rules prohibiting the listing on any national securities exchanges of companies that do not adopt a policy for: (i) disclosure of the issuer's policy on incentive-based compensation based on financial information required to be reported under the securities laws, and (ii) recovery from any current or former executive officer of any incentive-based compensation (including stock options) awarded during the three-year period prior to an accounting restatement resulting from material noncompliance of the issuer with financial reporting requirements. This "clawback" policy would require recovery of incentive compensation awarded in excess of the incentive-based compensation that would have been paid under the accounting restatement and will have far greater implications and reach than the current clawback provisions of the Sarbanes-Oxley Act of 2002, which, among other things, apply only to a company's chief executive officer and chief financial officer, and require the recovery of compensation only if the accounting restatement results from misconduct. The Dodd-Frank Act does not impose a deadline on such SEC rulemaking.

F. Disclosure of Hedging

The Dodd-Frank Act directs the SEC to require disclosure in a company's annual proxy statement as to whether any employee or member of the company's board of directors is permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities that are: (1) granted to such person by the company as part of compensation paid to such person, or (2) held, directly or indirectly, by such person. The Dodd-Frank Act does not impose a deadline on such SEC rulemaking.

III. Broker Discretionary Voting

The Dodd-Frank Act also amends the Exchange Act to require the SEC to ban broker discretionary voting on director elections, executive compensation proposals, and "any other significant matter, as determined by the Commission, by rule." NYSE Rule 452 already was recently amended to disallow discretionary broker voting in uncontested director elections.[4] The Dodd-Frank Act will now also prohibit broker discretionary voting on executive compensation matters, such as the say-on-pay votes described above. The Dodd-Frank Act does not impose a deadline on SEC rulemaking on broker discretionary voting.

IV. Regulation D Filings

The Dodd-Frank Act does not require, as had been proposed, that the SEC review Regulation D filings within 120 days. Regulation D exempts from the registration requirements of the Securities Act of 1933 certain issuances of unregistered securities from companies to accredited investors, including angel investors, venture capitalists, and private equity funds. The requirement that the SEC review such filings potentially would have affected a company's ability to consider the issued securities as "covered securities" exempt from state regulation unless the SEC separately reviewed and found that the issuer made a good-faith attempt to comply with applicable rules and regulations related to the filing.

The Dodd-Frank Act does require certain amendments to Regulation D, including an amendment to the definition of an "accredited investor" to exclude the value of an investor's primary residence. It would retain the $1 million threshold for determining whether an investor is accredited under Regulation D for a period of four years following enactment of the bill. Following that four-year period, the SEC would be required to review the threshold for determining whether an investor is accredited under Regulation D at least once every four years.

V. Venture Capital Exemption to Registration for Investment Advisors

The Dodd-Frank Act expands the number of investment advisors that will need to register with the SEC pursuant to the Investment Advisors Act of 1940 by removing a commonly used current exemption. The Dodd-Frank Act does, however, exempt from such registration investment advisors solely to one or more venture capital funds and directs the SEC to adopt rules defining "venture capital fund" for this purpose no later than one year following enactment (i.e., by July 2011). The rules, however, will require venture capital funds to maintain appropriate records and provide to the SEC the annual and other reports that the SEC determines to be in the public interest.

[4] See our previous WSGR Alert concerning NYSE Rule 452, "SEC Eliminates Discretionary Broker Voting for Uncontested Director Elections," July 15, 2009.

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VI. Exemption from Sarbanes-Oxley Section 404(b) for Non-accelerated Filers

The Dodd-Frank Act amends Section 404(b) of the Sarbanes-Oxley Act of 2002 to exempt non-accelerated filers (generally, public companies with a non-affiliated market capitalization of under $75 million) from having their independent registered public accounting firm conduct an audit of their internal control over financial reporting. While management of a non-accelerated filer is currently required to conduct a review of a company's internal controls and report on its review in the company's annual report on Form 10-K, SEC rules have up to now postponed the implementation of the separate audit of internal controls for non-accelerated filers by the independent auditor. The Dodd-Frank Act makes this postponement permanent, which will save non-accelerated filers the time and expense of a separate internal control audit. In addition, the Dodd-Frank Act requires the SEC to conduct a study on how the SEC could reduce the burden of the requirement to audit internal controls on companies with a market capitalization between $75 million and $250 million and to submit the study to Congress within nine months of the Dodd-Frank Act's enactment (i.e., by April 2011).

What You Should Do Now

We suggest that you:

- Update your board of directors, compensation committee, and nominating committee on the corporate governance and executive compensation matters discussed above.

- Monitor rulemaking developments at the SEC, particularly concerning proxy access and the executive compensation matters discussed above. You may wish to comment on the proposed rules that the SEC promulgates in connection with the Dodd-Frank Act's requirements. Even before the rules are proposed and finalized, consider what policies, practices, and disclosures at your company may need to be revised in light of the Dodd-Frank Act's requirements.

- Prepare now for proxy access and say-on-pay votes by knowing the composition of your shareholder base and being aware of changes to the base. For example, what percentage of your shareholders are institutional investors and what percentage are retail investors? Which institutional investors have long-term investment strategies with respect to your company and which have short-term strategies? How have your institutional investors voted on say-on-pay votes during the 2010 proxy season? Understanding the composition of your shareholder base can help guide decisions about engaging with your shareholders, both during the year as well as during proxy solicitations. Having an ongoing relationship with a proxy solicitor can be useful here, as they can assist in these analyses.

- Consider hiring a proxy solicitor in connection with your next annual shareholder meeting to help secure the vote on management's proposals, including the required say-on-pay proposals. Also, discuss with your counsel and proxy solicitor the advisability of ordering a "non-objecting beneficial owner" (NOBO) list in connection with the annual meeting to facilitate communications and direct solicitation with street-name shareholders. You may need to budget for additional costs relating to follow-up mailings and telephone solicitation of retail investors.

- Take a more comprehensive, year-round view of shareholder engagement and director elections. For example, understand what board actions would cause a proxy advisory group, such as RiskMetrics, to recommend voting against a director nominee at an annual meeting. Since many proxy advisory groups recommend voting against director nominees as a result of perceived corporate governance concerns, consider periodically conducting a review of your company's corporate governance policies and procedures.

- Review current compensation arrangements with executive officers, as well as existing proxy disclosures of such arrangements, in light of the executive compensation matters discussed above and consider whether changes are necessary. Also, review your compensation committee composition and the policies and practices of your compensation committee on retention of advisors in light of the rulemaking the Dodd-Frank Act requires. Even though the SEC will need to adopt rules on many of the executive compensation matters discussed above, it is not too early to begin thinking about these matters in connection with your 2011 proxy season and beyond.

Conclusion

The SEC is expected to engage in rulemaking related to many of the topics discussed above. In addition, multiple bills addressing executive compensation, corporate governance standards, disclosure requirements, and other related governance issues still are pending in the U.S. Senate and House of Representatives, although it is not clear whether any of those issues will be addressed by the current Congress. Wilson Sonsini Goodrich & Rosati will continue to monitor these developments.

For any questions or more information on these or any related matters, please contact Ralph J. Barry, Katharine A. Martin, Richard Cameron Blake, Michael Montfort, your regular Wilson Sonsini Goodrich & Rosati contact, or any member of the firm's corporate and securities practice, employee benefits and compensation practice, or securities litigation practice.

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