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Greensboro office:
2000 Renaissance Plaza
230 North Elm Street
Greensboro, NC 27401
Phone (336) 373-8850

Raleigh office:
1600 Wachovia Capitol Center
150 Fayetteville Street
Raleigh, NC 27601

www.brookspierce.com

Send address changes to Kathryn Whitaker at kwhitaker@brookspierce.com

The Financial Reform Act: New Corporate Governance and Executive Compensation Provisions

by Jean C. Brooks

One month after federal regulatory banking authorities released their Guidance on Incentive Compensation (the "Guidance"), President Obama signed into law The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act"). Included among the provisions of this massive legislation are several provisions that will impact the executive compensation and corporate governance and securities law disclosure requirements of all public companies. In addition to incorporating the Guidance, financial institutions which are also public companies have additional regulations to digest and implement. The Brooks Pierce Legal News dated July 16, 2010, discusses the Guidance and can be obtained at www.brookspierce.com.news-publications-46.html.

Some of the provisions of the Act are effective immediately; others will require rulemaking by the SEC and/or federal banking regulatory authorities. Many of the new requirements will impact the 2011 annual reporting season. Summarized below are the executive compensation, corporate governance and securities disclosure provisions of the Act.

Executive Compensation Provisions

<u>Say-On-Pay</u>

Beginning in the 2011 proxy season, all public companies must provide their shareholders the opportunity, in a non-binding advisory vote, to vote on the compensation of executive officers which is disclosed under Item 402 of Regulation S-K ("Say-On-Pay"). A separate vote will be required to determine whether the Say-On-Pay vote takes place every one, two or three years. The SEC has the authority to exempt small issuers from this requirement. It is unclear whether the SEC will use this exemptive authority given that all financial institutions, regardless of size, who received funds under the Trouble Asset Relief Program ("TARP") are required to provide the non-binding Say-On-Pay vote to shareholders.

<u>Say-On-Golden Parachute</u>

If any golden parachute compensation has not previously been approved as part of a Say-On-Pay vote, companies must solicit shareholder approval of golden parachute compensation through a separate non-binding vote at a meeting where shareholders are asked to approve a merger or similar transaction that triggers golden parachute payments ("Say-On-Golden Parachute").

What to do now:

- Consider retaining proxy solicitation firms to get the necessary shareholder vote since broker discretionary voting on compensation matters is eliminated by the Act (as discussed below).
- Begin to focus on achieving majority support from shareholders on the Say-On-Pay vote.
- Critically evaluate whether proxy statement disclosures effectively communicate the rationale behind executive pay decisions. An unbalanced arrangement can be moved toward balance by adding or modifying features that cause the amounts ultimately received by employees to appropriately reflect risk and risk outcomes.
- Anticipate potential concerns that could arise in the event of a Say-On-Pay Golden Parachute vote and address concerns now by reviewing employment, severance and change-in-control agreements to determine if they need to be revised or limited.

Compensation Committee

Independence. The Act contains a number of provisions regarding the composition and operation of compensation committees of public companies' boards of directors. The provisions will be given effect through SEC regulations directing the national stock exchanges and national securities association (the "exchanges") to prohibit listing of any security of any issuer that does not have an independent compensation committee meeting the requirements of new Section 10C of the Securities and Exchange Act of 1934, as amended (the "Exchange Act"). The new requirements are similar to the independence requirements for audit committee members currently in effect. In other words, the independence standards will include consulting, advisory and other compensatory fees paid by the issuer to a member of the committee. The SEC's rules will permit the exchanges to exempt a particular relationship with respect to members of a compensation committee based on the size of an issuer and other relevant factors.

The SEC has until July 16, 2011 to issue final rules pursuant to the Act's mandate regarding compensation committees, compensation consultants and related disclosure.

Compensation Consultants and Other Advisers. New Section 10C of the Exchange Act will permit a compensation committee to engage compensation consultants, legal counsel and other advisers (the "adviser") only after considering their independence based on the following factors:

- other services provided to the company by the adviser;
- the amount of fees received by the adviser from the company as a percentage of its total revenue;
- the conflict of interest policies of the adviser;
- any business or personal relationship between the adviser and a member of the compensation committee; and
- the adviser's ownership of the company's stock.

The compensation committee will be directly responsible for the appointment, compensation, and oversight of the work of the advisers. However, the committee is not required to follow the recommendations of the adviser and must continue to exercise its own judgment as to compensation matters. Companies must provide funding for the reasonable compensation of advisers retained by the compensation committee.

SEC rules will allow a reasonable opportunity to cure defects that would lead to a violation of the rules and the exchanges will have the authority to exempt issuers from the rules based on whether such rules would disproportionally burden small issuers.

Disclosure. In each proxy statement filed by an issuer for an annual meeting on or after July 21, 2011, (the one year anniversary date following enactment of the Act), issuers must disclose whether:

- the compensation committee has retained or obtained the advice of a compensation consultant (but not a legal adviser);
- the consultant's work raised any conflicts of interest; and
- how any such conflicts are being addressed.

What to do now:

- Review whether any possible conflicts exist with respect to compensation committee members, the standard used for audit committee members.
- Even though companies must wait for the SEC to clarify the advisers' independence rules, begin to evaluate the company's relationship with its advisers for potential conflict and independence issues.

Executive Compensation Disclosure

The Act requires the SEC to amend its executive compensation disclosure rules to include "pay versus performance" and "internal pay disparity" disclosure.

Pay Versus Performance. These yet to be issued rules will require clear disclosures showing the relationship between compensation for the issuer's named executive officers that was actually paid and the issuer's financial performance, taking into account any change in value of the stock and any dividends or distributions. The new rules may include disclosure of the required information in a graphical format.

Internal Pay Disparity. These SEC rules will require each public company to disclose in its filings:

- the median of annual total compensation of all employees, other than the CEO;
- the annual total compensation of the CEO; and
- the ratio of these two amounts.

Total compensation must be determined in accordance with Item 402(c) of Regulation S-K.

The Act does not prescribe a time period in which the SEC must adopt rules implementing the "pay versus performance" or "internal pay disparity" disclosure requirements.

What to do now:

- Begin to gather relevant data to examine how financial performance relates to executive compensation practices.
- Take steps necessary to prepare to collect and analyze compensation data required by Item 402 of Regulation S-K on all employees for the internal pay disparity disclosure. Also, be prepared to explain the reasons which contributed to the ratio, especially if that ratio will differ materially from others in the peer group.

Clawback

New Section 10D of the Exchange Act requires the SEC to direct the exchanges to prohibit the listing of issuers who do not adopt “clawback” policies to recover compensation under certain circumstances. The policy must provide for:

- disclosure of the issuer’s policy for incentive-based compensation that is based on the financial information required to be reported under the securities laws; and
- recovery from any current or former executive officer who received incentive-based compensation (including stock options) during the three-year period preceding the date on which the issuer is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws.

The amount of the recovery will be the amount paid to the executive officer in excess of what the executive would have been entitled to based on the restated financial information. Unlike the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”), the new rules (i) will apply to all executive officers, not just the CEO and CFO, (ii) will encompass a three-year look-back period, rather than one; and (iii) will apply to any restatements, not just those involving misconduct. The clawback provision under TARP requires only a material inaccuracy in the issuer’s financial statements and/or performance metrics rather than misconduct or a restatement. The Guidance also contains clawback provisions which may differ from those the SEC develops.

The Act does not prescribe a time period in which the SEC must adopt rules implementing the Act’s clawback provisions.

What to do now:

- While awaiting SEC rules, begin developing a clawback policy, or reviewing and revising an existing policy, that takes into account Sarbanes-Oxley, TARP, if applicable, the Act and the Guidance.
- Consider getting executive officers to acknowledge in writing the clawback provisions under the Act and agree to repay any compensation should the clawback obligation arise.

Additional Disclosures and Compensation Prohibitions for Regulated Financial Institutions

Federal banking regulators are required to issue guidance or regulations no later than April 21, 2011, on incentive compensation paid by “covered” institutions with more than $1 billion in assets. Covered institutions include depository institutions, registered broker-dealers, credit unions, investment advisers, Fannie Mae, Freddie Mac and any other financial institution the federal banking regulators determine should be covered.

Covered financial institutions are required to disclose to their respective regulators the structure of all incentive-based compensation arrangements in a manner that allows regulators to determine whether such arrangements provide excessive compensation, fees, or benefits to executive officers, other employees, directors, principal shareholders or could result in a material loss to the financial institution. The Act requires the federal banking regulators to prohibit incentive compensation arrangements that in their judgment encourage “inappropriate risks” by financial institutions either by paying excessive compensation or creating the possibility of material financial loss.

The Act while not defining “excessive” compensation, does direct regulators to the compensation standards listed in Section 39(c) of the Federal Deposit Insurance Act (“FDIA”). Among other factors, Section 39(c) takes into account the combined value of all benefits provided to the individual, the financial condition of the institution and compensation levels of peer institutions.

What to do now:

- Begin to develop clear descriptions of the company’s incentive-based compensation arrangements.
- Review the compensation factors in Section 39(c) of the FDIA.
- Compare the company’s incentive compensation arrangements to others in the company’s peer group.

Corporate Governance Provisions

Proxy Access

The Act amends Section 14(a) of the Exchange Act to authorize, but does not require, the SEC to issue rules allowing shareholders to use proxy solicitation materials for the purpose of nominating directors. The SEC already has published proposed proxy access rules. These proposed rules would allow a shareholder or group of shareholders (if beneficial ownership standards are satisfied) to nominate directors and have those nominees included in the company’s proxy materials.

The Act authorized the SEC to exempt certain issuers after taking into account whether the requirements would disproportionately burden small issuers.

Board Leadership Structures

The Act directs the SEC to issue rules requiring public companies to disclose in their annual proxy statements the reasons why they have chosen the same person, or different people, to serve as chairman and chief executive officer. The Act's requirement is similar to the rules adopted by the SEC in December 2009, and should not require the SEC to significantly alter its current rule.

Risk Committees

The Act directs the Federal Reserve to require publicly-traded, non-bank financial institutions regulated by the Federal Reserve and publicly-traded bank holding companies with at least $10 billion in assets to establish a separate risk committee of the board of directors. In addition, the Federal Reserve is authorized to issue regulations requiring publicly-traded bank holding companies with less than $10 billion in assets to form risk committees. The risk committee rules must be adopted by the Federal Reserve no later than July 21, 2012 to be effective no later than October 21, 2012.

Risk committees will be required to:

- oversee the financial institution's risk management practices;
- include a number of independent directors as directed by the Federal Reserve, based on the institutions' size of assets, complexity of operations and other criteria; and
- include at least one risk management expert on the committee with experience in identifying, assessing and managing risk at large, complex financial institutions.

What to do now:

- Consider establishing a risk management committee. Risk management is the new "hot topic" for federal banking regulators and the Federal Reserve is likely to require institutions below the $10 billion in assets to establish risk management committees.Explore education opportunities for board members to gain knowledge about risk management.

Hedging Policy. The Act directs the SEC to adopt rules requiring each issuer to disclose in its annual proxy statement whether its employees or directors may purchase financial instruments that are designed to hedge or offset decreases in the value of securities granted to employees or directors as part of employee compensation or other securities held directly or indirectly by employees or directors. The Act does not prescribe a time period in which the SEC must issue rules for implementing the provisions of the Act.

What to do now:

- Consider updating the company's insider trading policy with respect to hedging activities.

Other Provisions

Limited Discretionary Voting by Brokers. The Act requires the SEC to issue rules requiring the exchanges to prohibit brokers from using their own discretion to vote shares not beneficially owned by them on:

- the election of directors;
- any executive compensation matters (including Say-On-Pay and Say-On-Golden-Parachutes); and
- any other matter determined by the SEC to be significant.

The Act does not prescribe a time period in which the SEC must adopt rules limiting discretionary voting by brokers.

Auditor Attestation Regarding Internal Controls. The Act eliminates the auditor's attestation report for non-accelerated filers required under Section 404(b) of Sarbanes-Oxley. Additionally, the SEC is to study ways to reduce the burden of Section 404(b) compliance on companies with a market capitalization between $75 million and $250 million.

Conclusion

Undoubtedly, the focus of Congress and the regulators is on executive compensation, corporate governance and risk management. Expect many of the SEC's rulemaking to become effective for the 2011 annual reporting season. Even without the final SEC rules, the Act itself gives enough detail in the areas of executive compensation, corporate governance and securities law disclosure to allow companies to begin the process of gathering and analyzing data in anticipation of the new regulations.

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Should you have any questions about how the Act will affect you and your business, please contact one of the attorneys in our financial institutions practice. They may be reached by calling the Greensboro office at (336) 373-8850 or the Raleigh office at (919) 839-0300.

Bob Singer
bsinger@brookspierce.com

Ben Davis
bdavis@brookspierce.com

Randy Underwood
runderwood@brookspierce.com

Iain MacSween
imacsween@brookspierce.com

Jean Brooks
jbrooks@brookspierce.com

Sue Young
syoung@brookspierce.com