Securities Alert: Financial Reform Bill is Signed by President Obama

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On July 21, 2010, after months of debate and controversy, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") into law. This Client Alert focuses on the aspects of the Act that will most directly impact our publicly traded clients: changes relating to *corporate governance* and *executive compensation*. Many of these provisions are not self-effectuating, but instead will require the Securities and Exchange Commission (the SEC) to engage in the process of issuing rules to implement the intent of Congress. Accordingly, many of the specific details of these changes remain to be determined, and most will not take effect until at least six months from now. However, companies should start now to think about ways in which they may need to adjust their disclosure controls and procedures, annual meeting processes, and compensation practices in order to comply with the Act.

Executive Compensation

Say on Pay Becomes a Reality

Shareholders of U.S.-registered public companies will now join shareholders of public companies in the United Kingdom, Australia, Sweden, and other countries in having an advisory vote on senior executive compensation, or a "say on pay." This provision of the Act will require public companies to include a non-binding resolution in their proxy statements to approve compensation for their named executive officers, at least once every three years.

The requirement would relate to "a proxy or consent or authorization for an annual or other meeting of the shareholders for which the proxy solicitation rules of the [SEC] require compensation disclosure."

Companies would also be required to include a separate vote in their proxy statements, at least once every six years, as to how frequently shareholders want to have the advisory vote on executive compensation: once a year, once every other year, or once every three years.

All companies will be required to include both the executive compensation approval vote and the frequency vote in their proxy statements for the first annual or other meeting occurring "after the end of the six-month period beginning on the date of enactment" of the Act. Accordingly, these votes will be required for most companies during the 2011 annual meeting proxy season.

Say on Pay Extends to "Golden Parachute" Compensation

The Act also includes a separate requirement for shareholders to vote on **"**golden parachute compensation." This provision will require a vote regarding compensation arrangements for the named executive officers of an issuer in connection with an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all the assets of an issuer, unless the golden parachute compensation has already been the subject of a prior advisory vote on executive compensation. Golden parachute compensation is "any type of compensation (whether present, deferred, or contingent) that is based on or otherwise relates to" a merger, acquisition, or sale transaction. The Act does not further define or describe the kinds of arrangements that will qualify as golden parachute compensation. However, we can surmise that this concept will, at the least, cover traditional severance arrangements, change-in-control provisions, and accelerated vesting of options or restricted stock, as long as such arrangements are "based on or otherwise relate to" a merger, acquisition, or sale transaction.

Under this section of the Act, in any proxy or consent solicitation that is subject to the SEC's proxy rules at which shareholders are asked to approve an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all the assets of an issuer:

- the soliciting entity must disclose any agreements that such person has with any named executive officers of the issuer concerning any golden parachute compensation that is based on or otherwise relates to the transaction, and the aggregate amount of such compensation that may (and the conditions on which it may) become payable to such named executive officer, and
- the solicitation materials for the transaction must include a separate non-binding vote to approve the golden parachute compensation arrangements, unless the arrangements have previously been subject to a shareholder vote.

These provisions do *not* limit the ability of shareholders to make their own proposals regarding executive compensation matters, which means that companies can still be subject to proposals brought by shareholders regarding other aspects of compensation packages for their executive officers.

The SEC is not directed by the Act to issue rules implementing the say on pay requirements, either for general compensation arrangements or for "golden parachute" compensation arrangements. However, the Act does provide that the SEC "may" exempt certain classes of issuers from the requirements, taking into account whether these requirements would "disproportionately burden small issuers." Accordingly, these rules will be in effect for the 2011 annual meeting proxy season unless the SEC takes action to exempt some issuers.

The Act also specifies that broker discretionary voting will not be allowed in connection with say on pay related votes. This means that a broker who holds shares on behalf of its customers will be required to receive instructions from those underlying beneficial owners as to how they wish their shares to be voted on these proposals, and that if the broker does not receive such instructions, the shares will not be able to be voted on the proposals at shareholder meetings.

Proxy Access

Addressing another area of longstanding controversy among public companies, activist shareholders, and the SEC, the Act provides that the SEC "may" issue rules permitting the use by a shareholder of an issuer's own proxy materials for the purpose of nominating individuals to serve on the issuer's board of directors, under terms and conditions to be determined by the SEC. Given that SEC Chairman Mary Schapiro has indicated that implementation of proxy access is a top priority of the SEC, issuers can be assured that the SEC will not decline this invitation.

The Act itself does not contain any substantive conditions or restrictions on shareholders' right to use a company's proxy materials to propose their own director nominees, thus leaving the details of proxy access to be worked out by the SEC as part of the rulemaking process. The SEC has, on several occasions (including as recently as June 2009), previously proposed rules that would have implemented a proxy access right for shareholders, but those rules became bogged down in the rulemaking process due to the controversial nature of the proposals and were never implemented.[1] We expect that the rules to be issued under the Act will likely include some of the same conditions as have been proposed in prior iterations of proxy access rulemaking, including requirements that shareholders have held at least a minimum threshold percentage of a company's shares for a minimum threshold amount of time in order to take advantage of the right. Some lobbyists and lawmakers had attempted to include various threshold conditions on the right, including minimum ownership amounts, directly in the Act, but those limits were removed in the House-Senate conference committee discussions surrounding the Act.

The Act directs the SEC, as part of its rulemaking process, to take into account whether the rules would disproportionately burden small issuers. Final rules on proxy access are expected to take effect for the 2011 annual meeting proxy season.

Compensation Committees: Still in the Spotlight

Compensation committees of boards of directors come in for additional focus under the Act, notwithstanding extensive changes to compensation-related disclosures implemented by the SEC in 2006. The Act directs the SEC to issue rules requiring stock exchanges to revise their listing requirements to provide that each member of the compensation committee of a listed issuer must be "independent," under a new definition to be formulated by the SEC.[2]

The new independence formulation must take into account:

- the source of compensation of directors who serve on compensation committees, including "any consulting, advisory or other compensatory fee paid by the issuer to such director," and
- whether the director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.

In addition, the Act provides that compensation committees must have the authority to retain, compensate, and oversee the work of compensation consultants, independent legal counsel, and other advisers to the committee. Under the Act, a compensation committee may only select a compensation consultant, legal counsel, or other adviser after taking into consideration factors, to be identified in rulemaking by the SEC, that "affect the independence" of the consultant, counsel, or adviser. Those factors shall include: an analysis of whether the consultant, counsel, or adviser provides other services for the issuer; the amount of fees received for those services; policies and procedures of the consultant, counsel or adviser designed to prevent conflicts of interest; amounts of stock owned by the consultant, counsel or adviser; and any business or personal relationship of the consultant, counsel or adviser with a member of the compensation committee.

Issuers will also be required to note, in any proxy statements or consent solicitations for annual meetings of shareholders occurring more than one year after enactment of the Act, whether the compensation committee retained or obtained the advice of a compensation consultant, and whether the work of the compensation consultant "raised any conflict of interest."

The SEC is directed to issue rules to require that the stock exchanges shall prohibit the listing of any issuer that is not in compliance with these provisions not later than 360 days after the passage of the Act.

Pay for Performance and Pay-Parity Disclosures

In light of ongoing concern on the parts of institutional shareholders and others relating to levels of executive compensation as compared to corporate performance, the Act provides that the SEC shall issue rules requiring additional disclosure surrounding corporate performance and pay equity. The Act does not specify a time frame for the issuance of rules on this topic.

Companies will be required to disclose the ratio of the median annual total compensation of all employees to the compensation of the CEO, both in registration statements filed under the Securities Act of 1933, as amended, and proxy statements for annual meetings of shareholders. In addition, the SEC must adopt rules requiring disclosure in annual meeting proxy statements of "information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares…which may include a graphic representation." It is as yet unclear what form this "graphic representation" will be required to take, and whether this will resemble the stock performance graph currently required by Item 201(e) of Regulation S-K, or be based on some other measure of performance.

Clawbacks on Executive Compensation

The Act also directs the SEC to require the stock exchanges to adopt listing standards regarding "clawbacks" of "erroneously awarded compensation."

Companies will be required, as a condition of listing (or remaining listed) on a stock exchange, to develop and implement policies relating to recovery of compensation from executive officers under certain circumstances. Specifically, if a company is required to restate its financial statements due to material noncompliance with any financial reporting requirement under the securities laws, the company must recover, from any current or former executive officer of the issuer who received incentive-based compensation (including stock options) during the three-year period preceding the restatement, the amount of such compensation that exceeds what the officer would have been entitled to receive under the financial statements as restated.

This provision is significantly broader than the clawback provision contained in Section 304 of the Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley provision applies only to an issuer's chief executive officer and chief financial officer, relates only to a 12-month period following the issuance of financial statements, and only applies if there is "misconduct" involved (not mere "noncompliance") in connection with the restatement.[3] Specific details of the clawback policies required by the Act will need to be provided by the SEC in rulemaking on this topic; the Act does not specify a deadline for the issuance of these rules.

Whistleblower "Bounties"

The Act provides for a "bounty" to be paid to whistleblowers in connection with securities-related actions brought by the SEC. This section, which is subject to rulemaking by the SEC to be completed within 270 days of passage of the Act, provides that a whistleblower who "voluntarily provided original information to the Commission that led to the successful enforcement" of a judicial or administrative action under the securities laws, resulting in monetary sanctions exceeding $1 million, will receive an "award" of not less than 10% and not more than 30% of what has been collected of the monetary sanctions. The amount of the award shall be within the SEC's discretion.

No Majority Voting in Director Elections

Despite much debate as to whether to require director elections to be decided by a majority vote of stockholders, the final Act does not impose such a requirement. Many larger public companies have already amended their governing documents, in response to demands by shareholder activist groups and others, to provide that a majority vote will be necessary to decide director elections. However, this remains a matter for companies to decide using their own discretion.

Other Changes

In light of the ongoing assessment of the costs and benefits for smaller public companies of compliance with the internal control requirements of the Sarbanes-Oxley Act of 2002, the Act provides that smaller reporting companies (those with less than $75 million in public float) would be exempt from the requirement to have auditor attestation of internal controls (Section 404(b) of Sarbanes-Oxley). The Act also directs the SEC to study ways of "reducing the burden" of Section 404(b) compliance on companies with market capitalizations of between $75 and $250 million.

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As noted above, the SEC is now charged with issuing rules to implement various sections of the Act relating to executive compensation, proxy access and corporate governance. In many cases, the Act calls for these changes to take effect no later than six months from the date on which the Act became law. Mintz Levin will continue to update its clients and friends with regard to the rules and the effects of the multiple changes in this area as they develop.

Endnotes

[1] "Facilitating Shareholder Director Nominations," Release Nos. 33-9046; 34-60089; IC-28765; File No. S7-10-09 (June 10, 2009), 74 FR 29024 (June 18, 2009).

[2] The Act provides that certain kinds of issuers will be exempt from these requirements, including a controlled company (one that is more than 50% owned by an individual, a group, or another issuer) and a foreign private issuer that discloses in annual filings the reasons why it does not have an independent compensation committee.

[3] Section 304 of Sarbanes-Oxley provides that "[i]f an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the issuer shall reimburse the issuer for (1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12-month period."

For assistance in this area please contact one of the attorneys listed below or any member of your Mintz Levin client service team.

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