Hunton & Williams
Corporate and Securities Law Update

July 2010 | Analysis of the Dodd-Frank Wall Street Reform Act

Executive Compensation, Corporate Governance and Enforcement Provisions of the Dodd-Frank Act Affecting Public Companies

On July 15, 2010, the United States Senate approved a comprehensive regulatory reform bill entitled the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The United States House of Representatives approved Dodd-Frank on June 30, 2010. President Obama is expected to sign Dodd-Frank into law on July 21, 2010.

Though the primary focus of Dodd-Frank is on the reduction of systemic risk in financial markets and increased regulation of large financial institutions, Dodd-Frank also contains executive compensation, corporate governance and enforcement provisions that are applicable to most public companies, which are the focus of this client alert.

Most of Dodd-Frank's executive compensation and corporate governance provisions and certain enforcement provisions require further regulatory action to implement. While some provisions specify a deadline for the Securities and Exchange Commission ("SEC") to adopt implementing rules, others do not. The say-on-pay provision will be effective for the 2011 proxy season. It is anticipated that the SEC will move quickly to adopt rules implementing many of the other executive compensation and corporate governance provisions to be effective for the 2011 proxy season as well. It is a priority of SEC Chair Mary Schapiro to adopt proxy access rules that will be effective for the 2011 proxy season.

Corporate Governance and Executive Compensation

Title IX of Dodd-Frank enacts many changes to existing securities laws. Title IX creates new shareholder rights, requires new disclosures by companies and requires changes to compensation practices for executive officers of public companies. Title IX's major changes, as they pertain to public company corporate governance and executive compensation, are discussed below.

Proxy Access

Section 971 of Dodd-Frank amends the Securities Exchange Act of 1934 (the "Exchange Act") to explicitly authorize, but not require, the SEC to issue rules requiring a company to include in its proxy materials shareholder nominees for directors. Dodd-Frank authorizes the SEC to exempt certain companies from any such proxy access requirements and specifically instructs the SEC to consider whether the requirement disproportionately burdens small companies. The authority granted under Dodd-Frank eliminates prior questions as to the SEC's authority to adopt proxy access rules. The SEC proposed proxy access rules in 2009 and, based on comments of SEC Chair Mary Schapiro, is expected to adopt final proxy access rules within a timeframe that would put the rules into effect for the 2011 proxy season.

Although not directly related to its consideration of proposed proxy access rules, the SEC on July 14, 2010, issued a concept release on proxy mechanics. The concept release examines three general areas: (i) accuracy, transparency and efficiency of the voting process; (ii) communications and shareholder participation; and (iii) the relationship between voting power and economic interest. There will be a 90-day public comment period for the concept release after it is published in the *Federal Register*.

Non-Binding "Say-on-Pay" Shareholder Vote on Executive Compensation

Section 951 of Dodd-Frank mandates "say-on-pay" by adding a requirement to the Exchange Act that shareholders receive the opportunity to vote on a non-binding resolution on the compensation of named executive officers[1] at least once every three years. The non-binding resolution must be included in a proxy statement for an annual or other meeting of shareholders for which the SEC's proxy solicitation rules require compensation disclosure. No SEC rulemaking is required to implement this say-on-pay provision. A public company must begin complying starting with its first annual or other meeting occurring more than six months after enactment of Dodd-Frank. The proxy materials for such meeting must contain both the non-binding resolution on compensation and a non-binding resolution to determine whether the say-on-pay vote will occur once every one, two or three years. Following those initial resolutions, shareholders thereafter must vote at least once every six years on the frequency of the say-on-pay shareholder vote. Section 951 grants the SEC authority to exempt companies from these say-on-pay requirements.

Dodd-Frank specifically provides that the non-binding say-on-pay vote will not create or alter any fiduciary duties. Nor will it preclude shareholders' ability to make executive compensation-related proposals. Dodd-Frank requires every institutional investment manager subject to reporting under Section 13(f) of the Exchange Act to report at least annually how it voted on any non-binding shareholder resolution on compensation of named executives. Finally, as noted below, Section 957 codifies the New York Stock Exchange ("NYSE") broker non-vote rule that prevents brokers from exercising voting authority with respect to director elections, executive compensation and any other significant matter, as determined by SEC rulemaking, unless they have received voting instructions from the beneficial owner of the shares.

[1] Named executive officers are those officers for whom executive compensation disclosure is required under Item 402 of the SEC's Regulation S-K, generally the CEO, CFO and the three other most highly compensated executive officers.

Non-Binding "Say-on-Pay" Shareholder Vote on Executive Compensation Relating to Business Combinations ("Golden Parachutes")

Section 951 of Dodd-Frank requires that any proxy solicitation materials for a meeting at which shareholders are asked to approve a business combination or disposition of substantially all of a company's assets must:

(i) contain clear, simple disclosure of any agreements that the soliciting person has with any named executive officer of the company (or the acquiring company, if the company is not the acquiring company) concerning any compensation that relates to the transaction being voted on;

(ii) disclose the aggregate total of all such compensation that may be paid to any named executive officer, and the conditions under which it may be paid; and

(iii) provide for a separate, non-binding shareholder vote to approve any such compensation, unless the agreements or understandings were subject to an earlier non-binding shareholder vote on named executive compensation.

This provision will be applicable to any solicitation occurring more than six months after enactment of Dodd-Frank. The SEC is required to adopt rules describing the type of disclosure required in proxy statements in connection with a shareholder vote on golden parachute compensation. As with the non-binding shareholder votes on named executive compensation, Dodd-Frank specifically provides that (i) the golden parachute vote does not create or change any fiduciary duties; (ii) every institutional investment manager subject to reporting under Section 13(f) of the Exchange Act must report at least annually how it voted on such resolutions; and (iii) the SEC may exempt companies from the vote requirement.

Broker Discretionary Voting

Section 957 of Dodd-Frank requires that national securities exchanges preclude a broker from granting a proxy to vote shares in the case of a vote on the election of directors, executive compensation or any other "significant matter" (as determined in the rules of the SEC), unless the beneficial owner of the shares has specifically instructed the broker how to vote. The NYSE had already eliminated broker discretionary voting for director elections starting with the 2010 proxy season. Any FINRA or AMEX member that is also a NYSE member is already subject to the NYSE rule on broker discretionary voting. Because most large brokerage firms are NYSE member organizations, the prohibition affects companies listed not only on the NYSE but also companies listed on other national exchanges such as NASDAQ. Section 957 of Dodd-Frank will extend the prohibition to say-on-pay votes, among other matters.

Independent Compensation Committee Requirement

Similar to the requirements under the Sarbanes-Oxley Act of 2002 for enhanced audit committee independence, Section 952 of Dodd-Frank requires the SEC to issue rules within 360 days of enactment requiring national securities exchanges to prohibit the listing of any equity security of a company if its board of directors does not have an "independent" compensation committee. In determining the definition of "independent," national securities exchanges must consider (i) the source of director compensation, including any consulting, advisory or other compensatory fee paid to the director by the company, and (ii) whether the director is affiliated with the company or its subsidiaries or affiliates. Section 952's independent compensation committee requirement does not apply to, among other entities, a "controlled company"[2] or a foreign private issuer that provides annual disclosure to shareholders as to why they do not have an independent compensation committee. The SEC may also permit national securities exchanges to create exemptions from the independence requirements, taking into account the potential impact on smaller companies.

Section 952 also requires the SEC to issue rules directing national securities exchanges to adopt listing standards containing explicit authority for compensation committees to engage their own independent advisors. The compensation committee must have direct responsibility for the appointment, compensation and oversight of the compensation consultant, legal counsel or other advisor. Compensation consultants, legal counsel and other advisors need not be independent, but the compensation committee is required to consider factors affecting such advisors' independence, including (i) whether the advisor provides other services to the company, (ii) the amount of fees paid by the company as a percentage of total revenue of the compensation consultant, legal counsel or other advisor, (iii) the policies and procedures of the compensation consultant, legal counsel or other advisor that are designed to prevent conflicts of interest, (iv) whether the advisor has a business or personal relationship with a member of the compensation committee, and (v) any stock of the company owned by the compensation consultant, legal counsel or other advisor. The company's proxy materials for any annual meeting, or special meeting in lieu of an annual meeting, occurring one year after the enactment of Dodd-Frank must disclose whether the compensation committee has retained or obtained the advice of a compensation consultant, whether the work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.

Additional Compensation Disclosures

Pay for Performance Disclosure. Section 953 of Dodd-Frank directs the SEC to adopt rules that require companies to provide in any proxy statement for an annual meeting disclosure that shows the relationship between executive compensation actually paid by the company and the company's financial performance, which disclosure may be included in a graphic representation.

Internal Pay Ratio Disclosure. Section 953 also directs the SEC to adopt rules that require disclosure of (i) the median total annual compensation of all employees of the company other than the CEO; (ii) the total annual compensation of the company's CEO; and (iii) the ratio of the two amounts.

Dodd-Frank did not specify a timeline for the SEC to adopt these two disclosure rules.

Disclosure of Hedging by Employees and Directors.

Section 955 of Dodd-Frank directs the SEC to amend the proxy rules to require each company to disclose in any proxy statement for an annual meeting whether any employee or director is permitted to purchase financial instruments designed to hedge against or offset any decrease in value of equity securities granted as compensation or otherwise held by the employee or director. Many insider trading policies of public companies already prohibit directors and executive officers and/or all employees from trading in publicly-traded company derivative securities or engaging in short sales with respect to company securities. Dodd-Frank did not specify a timeline for the SEC to adopt these rules.

Disclosure Regarding the Positions of Chairman and CEO

Dodd-Frank does not require companies to have a separate chairman and CEO, but Section 972 requires the SEC to issue rules requiring a company to disclose in its annual

[2] A "controlled company" is a listed company that has more than 50 percent of its voting power held by an individual, a group or another issuer.

proxy statement the reasons why the company chooses to either combine or separate the positions of chairman of the board and CEO. The SEC issued rules effective for the 2010 proxy season, which appear to already cover this disclosure required by Dodd-Frank.

Determination of Beneficial Ownership and Initial Reporting Deadlines

Dodd-Frank amends Sections 13 and 16 of the Exchange Act so that security-based swap positions will give rise to beneficial ownership of a security for the purposes of reporting and short-swing profit disgorgement liability only to the extent that the SEC determines, by rule, that the security-based swap provides "incidents of ownership comparable to direct ownership of the equity security." The SEC's current test for beneficial ownership relates to the power to vote or dispose of a stock.

Section 929R of Dodd-Frank amends Sections 13(d) and 16(a) of the Exchange Act to allow the SEC to establish a period shorter than 10 days for the filing of an initial Section 13(d) beneficial ownership report and for the filing of an initial Section 16(a) statement of beneficial ownership.

Sarbanes-Oxley 404(b) Exemptions for Smaller Companies

Section 989G of Dodd-Frank exempts non-accelerated filers and smaller reporting companies from Section 404(b) of the Sarbanes-Oxley Act, which requires a public company's external auditors to provide an attestation report on the company's internal controls over financial reporting. Dodd-Frank also requires the SEC to study how to reduce the Section 404(b) compliance burden for companies with market capitalizations between $75 million and $250 million, and whether an exemption from or a reduction in the compliance burden imposed by Section 404(b) would encourage more listings on U.S. securities exchanges. Section 989I of Dodd-Frank requires the GAO to study and report to Congress, within three years of enactment, on the impact of the amendments to Section 404 of the Sarbanes-Oxley Act. Among other things, the report must analyze whether the exemption from Section 404(b) changes the frequency of financial statement restatements by affected firms, the cost of capital for affected firms and investor confidence in the integrity of the financial statements of affected firms.

Certain Enforcement Reforms

Incentive Compensation Clawbacks

Section 954 of Dodd-Frank directs the SEC to require national securities exchanges to adopt listing standards so that listed companies must develop and implement policies to "claw back" executive compensation in the event of a financial restatement. The policies must require that, in the event the company is required to prepare an accounting restatement due to material noncompliance with financial reporting requirements under the securities laws, the company will recover from any current or former executive officer who received incentive-based compensation during the three-year period preceding the date on which the company is required to prepare a restatement the amount of such incentive-based compensation that exceeds what would have been paid to the executive officer under the restated financial statements. The Dodd-Frank clawback requirement goes beyond the similar provision in the Sarbanes-Oxley Act, which applies only to a company's CEO and CFO, has only a 12-month look-back and applies only if noncompliance results from misconduct. Dodd-Frank did not specify a timeline for the SEC to adopt these rules.

Enhanced Whistleblower Incentive and Protection

Section 922 of Dodd-Frank adds new Section 21F to the Exchange Act, which requires the SEC, in any action in which it levies sanctions in excess of $1 million, to compensate a whistleblower who provides original, independently derived information that leads to such monetary sanctions with between 10 percent and 30 percent of the amount of the sanctions. Section 922 prohibits the SEC from providing an award to a whistleblower who is convicted of a criminal violation related to the provided information; who gains the information by auditing financial statements as required under the securities laws; who fails to submit information to the SEC as required by an SEC rule; or who is an employee of the Department of Justice or certain other regulatory and law enforcement agencies.

Dodd-Frank prohibits employers from retaliating or otherwise discriminating against a whistleblower because of any lawful act done by the whistleblower. Also, Dodd-Frank provides for a private cause of action by a person who alleges retaliation or discrimination in violation of the above, allowing for relief that includes reinstatement with the same seniority, two times the amount of back pay owed to the individual and compensation for litigation and expert fees.

Dodd-Frank requires the SEC to issue final regulations implementing these whistleblower provisions within 270 days after enactment.

Joint and Several Liability for Control Persons

Section 929P of Dodd-Frank clarifies that the SEC may impose joint and several liability against control persons under Section 20(a) of the Exchange Act.

Liability for Aiding and Abetting Violations of the Securities Act

Section 929O of Dodd-Frank provides the authority for the SEC to impose aiding and abetting liability on persons who "recklessly" provide substantial assistance to someone who violates the Exchange Act. Previously, the SEC was generally required to show that such assistance was provided "knowingly." In addition, Sections 929M and 929N of Dodd-Frank provide for aiding and abetting liability under the Securities Act of 1933, the Investment Company Act of 1940 and the Investment Advisers Act of 1940.

Impact on Foreign Private Issuers

A number of the provisions of Dodd-Frank apply to foreign private issuers, such as the whistleblower provisions, changes to Section 13 beneficial ownership reporting and changes to broker discretionary voting. However, because foreign private issuers are exempt from U.S. proxy rules, the provisions of Dodd-Frank implemented through the U.S. proxy rules are inapplicable to foreign private issuers, including proxy access, say-on-pay and say-on-golden parachute payments, executive compensation disclosure, hedging disclosure, and chairman and CEO structure disclosure. Also, foreign private issuers that provide annual disclosures to shareholders of the reasons that the foreign private issuer does not have an independent compensation committee are not required to have a fully independent compensation committee.

Conclusion

Many of the specific requirements imposed by Dodd-Frank will depend on the final rules that will be adopted by the SEC and the stock exchanges. Once adopted, however, there will likely be only a small period of time before they become effective for the 2011 proxy season. Thus, companies should begin to consider changes to their corporate governance practices that might be required or advisable, such as confirmation of compensation committee member independence, review of compensation consultant independence and preparation of clawback and employee hedging policies. In particular, companies that will be providing a say-on-pay proposal for the first time should review their current executive compensation practices and consider plans for managing shareholder relations. Finally, given the new whistleblower incentive, companies also should consider whether there is a need to strengthen internal compliance programs and controls.

Hunton & Williams Offices

Atlanta
Bank of America Plaza, Suite 4100
600 Peachtree Street, NE
Atlanta, Georgia 30308-2216
(404) 888-4000

Austin
111 Congress Avenue, Suite 1800
Austin, Texas 78701-4068
(512) 542-5000

Bangkok
34th Floor, Q. House Lumpini Building
1 South Sathorn Road
Thungmahamek, Sathorn
Bangkok 10120 Thailand
+66 2 645 88 00

Beijing
517-520 South Office Tower
Beijing Kerry Centre
No. 1 Guanghua Road
Chaoyang District
Beijing 100020 PRC
+86 10 5863 7500

Brussels
Park Atrium
Rue des Colonies 11
1000 Brussels, Belgium
+32 (0)2 643 58 00

Charlotte
Bank of America Plaza, Suite 3500
101 South Tryon Street
Charlotte, North Carolina 28280
(704) 378-4700

Dallas
1445 Ross Avenue, Suite 3700
Dallas, Texas 75202-2799
(214) 979-3000

Houston
Bank of America Center, Suite 4200
700 Louisiana Street
Houston, Texas 77002
(713) 229-5700

London
30 St Mary Axe
London EC3A 8EP
United Kingdom
+44 (0)20 7220 5700

Los Angeles
550 South Hope Street, Suite 2000
Los Angeles, CA 90071-2627
(213) 532-2000

McLean
1751 Pinnacle Drive, Suite 1700
McLean, Virginia 22102
(703) 714-7400

Miami
1111 Brickell Avenue, Suite 2500
Miami, Florida 33131
(305) 810-2500

New York
200 Park Avenue
New York, New York 10166-0091
(212) 309-1000

Norfolk
500 East Main Street, Suite 1000
Norfolk, Virginia 23510-3889
(757) 640-5300

Raleigh
One Bank of America Plaza Suite 1400
421 Fayetteville Street
Raleigh, North Carolina 27601
(919) 899-3000

Richmond
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, Virginia 23219-4074
(804) 788-8200

San Francisco
575 Market Street, Suite 3700
San Francisco, California 94105
(415) 975-3700

Washington
1900 K Street, NW
Washington, DC 20006-1109
(202) 955-1500

If you have questions about this legislation or other matters of corporate law, please contact:

Allen C. Goolsby
(804) 788-8289
agoolsby@hunton.com

J. Steven Patterson
(202) 419-2101
spatterson@hunton.com

T. Justin Moore, III
(804) 788-8464
jmoore@hunton.com

Gary E. Thompson
(804) 788-8787
gthompson@hunton.com