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Corporate Governance and Executive Compensation Provisions in the Dodd-Frank Act

On June 25, 2010, a House and Senate conference committee negotiating the blueprint for the reform of the U.S. financial system agreed on text of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The Act as embodied in the conference report is currently scheduled to be approved by Congress this week before being sent to President Obama for signature.

The Act includes a number of significant corporate governance and executive compensation provisions that will apply to all U.S. public companies. We discuss these measures below and will be covering other aspects of this legislation in separate client memoranda. A copy of the entire Act is available here; however, for ease of use, we have excerpted the relevant corporate governance and executive compensation provisions here.

Corporate Governance Reforms

- *Proxy access (Section 971).* The Act affirms that the SEC may promulgate rules permitting the use by a shareholder of company proxy materials to nominate director candidates. The Act does not require the SEC to adopt proxy access rules and it explicitly authorizes the SEC to exempt companies from any requirements that it does adopt after taking into account considerations such as whether the requirements would disproportionately burden small companies. A late proposal by Senate conferees to include a 5 percent ownership requirement and a two-year holding period was defeated in conference. We expect that the SEC will take final action in this area soon after the Act is signed into law in light of Chairman Schapiro's recent statements confirming that she expects proxy access to be in effect for the 2011 proxy season.

- *No majority voting for director elections.* In a compromise with the House version of the financial reform bill, the requirement for all public companies to adopt majority voting has been eliminated. Under the Senate version of the bill, companies would have been required to accept the resignation of any director who receives less than a majority vote in an uncontested election, unless the board unanimously declined to accept the resignation. Notwithstanding the elimination of the majority voting requirements from the Act, companies should continue to evaluate whether this standard is appropriate for their boards because majority voting will remain on the wish lists for shareholders and corporate governance activists. Shareholder proposals requesting companies to adopt majority voting continue to be among the top corporate governance shareholder proposals submitted in 2010 and will likely continue until there is significant adoption of majority voting across all public companies. Currently, majority voting is the predominant standard at larger companies. According to ISS data, approximately 70% of the S&P 500 (as compared to approximately 37% of the S&P 1500) have a majority voting standard.

- *Chairman and CEO disclosures (Section 972).* The Act amends Section 14B of the Securities Exchange Act of 1934 to direct the SEC to issue rules requiring companies to disclose in their annual proxy statements the reasons why the company has chosen to combine or separate the board chair and CEO positions. Similar disclosure is required under current SEC rules, so it is unclear whether this provision will result in any additional disclosure requirements.

- *Broker discretionary voting (Section 957).* The Act amends Section 6(b) of the Exchange Act to require that the national securities exchanges prohibit proxy voting by a broker in connection with the election of directors (other than a vote with respect to the uncontested election of a member of the board of any registered investment company), executive compensation or any other significant matter, as determined by the SEC, unless the beneficial owner of the security has specifically instructed the broker to vote in such way. Broker discretionary voting was eliminated by the New York Stock Exchange for director elections starting this proxy season, and this new provision will extend the prohibition to say-on-pay votes, among other matters.

- *Risk committees at certain non-bank financial companies and bank holding companies (Section 165).* The Act requires that public non-bank financial companies supervised by the Federal Reserve and bank holding companies with assets of $10 billion or more establish a risk committee. Non-bank financial companies supervised by the Federal Reserve are those companies that have been designated by the soon-to-be-established Financial Stability Oversight Council as systemically important and that are substantially engaged in activities in the United States that are financial in nature (other than bank holding companies or their subsidiaries). The Federal Reserve may at its option extend these requirements to bank holding companies with assets of less than $10 billion.

  The Act specifies that these risk committees must be responsible for the oversight of the enterprise-wide risk management practices of the company and must include (i) such number of independent directors as the Federal Reserve determines appropriate (based on the nature of operations, size of assets and other appropriate criteria related to the company) and (ii) at least one risk management expert having experience in identifying, assessing and managing risk exposures of large, complex firms.

  This requirement represents a dilution of the proposal set forth in the Shareholder Bill of Rights Act introduced by Senators Schumer and Cantwell last year, which would have mandated risk committees for all U.S. listed companies.

- *Smaller public company exemption from Sarbanes-Oxley internal control requirements (Section 989G).* In a late addition by the conference committee, the Act exempts smaller public companies that are not "accelerated filers" or "large accelerated filers" from compliance with the internal control auditor attestation requirements of Section 404(b) of the Sarbanes-Oxley Act of 2002 and directs the SEC to study ways of reducing the burden of Section 404(b) compliance on companies with market capitalizations between $75 million and $250 million.

Executive Compensation Reforms

- *Say-on-pay (Section 951).* The Act creates a new Section 14A(a) of the Exchange Act that requires companies to include in any proxy, consent or authorization for any shareholder meeting for which the SEC mandates compensation disclosure, a separate non-binding resolution subject to shareholder vote to approve the company's executive compensation as disclosed in those materials. In a change from earlier versions of the legislation, the Act permits shareholders to elect to have a say-on-pay vote every two years or three years as opposed to annually, with a requirement that companies seek a shareholder vote to determine the frequency of such say-on-pay vote at least every six years. The Act further specifies that the shareholder vote would not be binding on the company's board of directors and could not be construed as overruling any company or board decision, changing or creating any additional fiduciary duties for the company or board or limiting the ability of shareholders to submit executive compensation proposals for inclusion in the company's proxy materials. The SEC has authority to exempt companies from the say-on-pay requirements after taking into account, among other considerations, whether they would disproportionately burden smaller companies.

- *Say-on-golden parachutes (Section 951).* In a compromise with the House version of the financial reform bill, the Act incorporates the House bill's requirements for a "say-on-golden parachutes." New Section 14A(b) of the Exchange Act requires soliciting persons to include the following items in any proxy or consent solicitation for which the SEC mandates compensation disclosure and that seeks shareholder approval of an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all of the assets of a company:

  - "clear and simple" disclosure of any agreements that the soliciting person has with any named executive officers of the subject company or the acquirer (if the subject company is not the acquirer) concerning any compensation (present, deferred or contingent) that is based on or otherwise relates to such business combination and the aggregate total of all such compensation that may be paid to or on behalf of such executive officer (including the conditions of such payment); and

  - a separate resolution subject to shareholder vote to approve such agreements, unless the agreements have already been subject to a vote pursuant to say-on-pay requirements.

  As with say-on-pay, the say-on-golden parachute requirements would be non-binding on the company's board of directors, have the same rules of construction as described above and be subject to SEC exemptive authority.

- *Disclosure of say-on-pay and say-on-golden parachute votes by institutional investors (Section 951).* The Act requires institutional investment managers subject to Section 13(f) of the Exchange Act to disclose their say-on-pay and say-on-golden parachute voting records at least annually unless otherwise required by the SEC.

- *Compensation committees (Section 952).* In legislation that is reminiscent of the audit committee independence and other requirements that were enacted as Section 10A of the Exchange Act pursuant to the Sarbanes-Oxley Act of 2002, the Act adds a new Section 10C of the Exchange Act that requires the SEC to direct the national securities exchanges to require that all members of compensation committees of U.S. listed companies be independent and that compensation committees be given certain oversight responsibilities and adequate funding to carry out those responsibilities.

  While the Act does not require companies to have compensation committees per se (meaning, for example, that NASDAQ companies that do not have compensation committee structures may be able to continue that practice pending further rulemaking from the exchange), those companies that do must have fully independent committees. Further, in determining independence for this purpose, the Act requires the securities exchanges to consider certain factors, including the source of compensation for the director (such as any consulting, advisory or other compensatory fees paid by the company) and whether the director is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company.

  The Act further provides that compensation committees will have the sole discretion to hire compensation consultants, legal counsel and other advisers and shall be directly responsible for the appointment and compensation, and oversight of the work, of these advisers. Companies will be required to provide appropriate funding for the retention of such advisers. When engaging compensation consultants, legal counsel or other advisers, compensation committees must consider certain independence factors to be determined by the SEC (which factors must be competitively neutral among categories of advisers), including (i) what other services the employer of the consultant or adviser provides to the company, (ii) the amount of fees the employer of the consultant or adviser receives from the company as a percentage of revenue for such employer, (iii) the policies and procedures related to conflicts of interest of the employer of the consultant or adviser, (iv) any business or personal relationships between the consultant or adviser and the members of the compensation committee and (v) any stock of the company owned by the consultant or adviser. The Act further specifies that the engagement of advisers under these new rules will in no way require compensation committees to act in accordance with the adviser's recommendations.

  Also, in any proxy or consent solicitation for an annual meeting, companies will have to disclose (i) whether the compensation committee used any compensation consultants and (ii) whether any such compensation consultant identified any conflicts of interest and, if so, how the conflict is being addressed by the company.

Controlled companies, limited partnerships, companies in bankrupt proceedings, registered investment companies and foreign private issuers that provide annual disclosures of the reasons why they do not have an independent compensation committee are not subject to these requirements. The SEC also has authority to exempt companies from these requirements based on relevant factors, such as the size of the company, and must provide for appropriate cure periods for any failure to meet these requirements.

Finally, the Act requires the SEC to conduct a study of the use of compensation consultants and the effects of such use and to report the results of the study to Congress no later than two years after the Act's enactment.

- *Pay-for-performance and pay-parity disclosures (Section 953).* The Act amends Section 14 of the Exchange Act to direct the SEC to issue rules that require companies to disclose in any proxy or consent solicitation material for an annual shareholder meeting a "clear description" of any executive compensation arrangement required to be disclosed by Item 402 of Regulation S-K, including the relationship between executive compensation actually paid and a company's financial performance, taking into account any change in the value of the company's stock and dividends and other distributions. This disclosure could include a graphic representation of the required information It is unclear what additional disclosure would be required as a result of this provision since similar disclosure is already currently required under SEC rules.

  Companies are also required to disclose (i) the median annual total compensation of all employees, other than the CEO, (ii) the annual total compensation of the CEO and (iii) the ratio of the median total annual employee compensation to that of the CEO.

- *Executive compensation clawbacks (Section 954).* The Act adds a new Section 10D of the Exchange Act that requires the SEC to direct the national securities exchanges to require companies to develop and implement policies providing for (i) the disclosure of company policies on incentive-based compensation based on financial information required to be reported under the securities laws and (ii) the clawback of incentive-based compensation paid to current or former executive officers following a restatement due to material non-compliance of the company with financial reporting requirements under securities laws. These policies must apply to incentive-based compensation (including stock options) paid during the three-year period preceding the restatement, and the recovery would be the amount in excess of what otherwise would have been paid to the officer. The Act expands the clawback provision contained in the Sarbanes-Oxley Act of 2002, which applies only to compensation received by the CEO and CFO and then only during the 12-month period following the first issuance of the restatement and only if the restatement resulted from misconduct.

- *Hedging disclosure (Section 955).* The Act amends Section 14 of the Exchange Act to require companies to disclose in any proxy or consent solicitation material for an annual shareholder meeting whether any employee or director of the company or any of their designees is permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities of the company (including prepaid variable forward contracts, equity swaps, collars and exchange funds) that are granted as compensation or otherwise held by the employee or director.

- *Covered financial institution compensation restrictions (Section 956).* The Act directs the "appropriate federal regulators" of "covered financial institutions" to require each institution to disclose to the appropriate regulator the structures of its incentive-based compensation arrangements so that a determination can be made as to whether that structure provides the institution's executive officers, employees, directors or principal shareholders with excessive compensation, fees or benefits or could lead to material financial loss to the bank holding company. No reporting of the actual compensation of particular individuals would be required. "Covered financial institutions" includes bank holding companies, registered broker-dealers, insured credit unions, investment advisers and any other financial institution that the appropriate federal regulators jointly by rule determine should be treated as a covered financial institution for these purposes. "Appropriate federal regulators" include the Federal Reserve, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the National Credit Union Administration Board, the SEC and the Federal Housing Finance Agency.

  Further, the appropriate regulators must jointly issue rules to prohibit any incentive-based payment arrangement that they determine will encourage inappropriate risks by the covered financial insitutions by providing their executive officers, employees, directors or principal shareholders with excessive compensation, fees or benefits or that could lead to material financial loss to the institution.

Timing/Applicability

Most of the Act's executive compensation and corporate governance provisions require further regulatory action for implementation. While some provisions include a specified deadline for regulatory action, many provisions do not have explicit deadlines, leaving it open to interpretation as to when the respective regulators must act. We set forth below more detail as to the regulatory actions necessary, if any, to implement the particular provision and any applicable deadlines to such action. Unless otherwise specified, these provisions of the Act generally apply to all U.S. public companies, subject to any exemptive authority that the SEC might have in the rule making process. The Act will generally not apply to foreign private issuers.

Corporate Governance	Action Required	Deadline for Action/Effect
Proxy access	SEC may establish rules	None specified
Chairman/CEO disclosures	SEC to establish rules	SEC to act no later than 180 days after enactment
Broker discretionary voting	None specified	None specified
Risk committees at financial institutions	Federal Reserve to establish rules	Two years after enactment, with rules to take effect no later than two years and three months after enactment
Smaller public company exemption from Sarbanes-Oxley internal control requirements	SEC to study the effects of Section 404(b) on mid-size companies	Exemption is effective for non-accelerated filers upon enactment. The SEC must report the results of its study to Congress no later than nine months after enactment

Executive Compensation	Action Required	Deadline for Action/Effect
Say-on-pay vote and frequency of say-on-pay vote	None specified	Both votes are required for the first applicable shareholder meeting occurring six months after enactment
Say-on-golden parachutes	None specified	Required for the first applicable shareholder meeting occurring six months after enactment
Disclosure of say-on-pay and say-on-golden parachute votes by institutional investors	None specified	None specified
Compensation committees	SEC to direct stock exchanges to develop listing standards	SEC to act no later than 360 days after enactment, except that compensation consultant disclosure must be included in proxy materials for an annual meeting occurring on or after the date that is one year after enactment, suggesting that the SEC must act in time for such disclosures to be effective one year after enactment
Pay-for-performance and pay-parity disclosures	SEC to establish rules	None specified
Executive compensation clawbacks	SEC to direct stock exchanges to develop listing standards	None specified
Hedging disclosures	SEC to establish rules	None specified
Covered financial institution compensation requirements	Federal regulators jointly to establish rules	Regulators to act no later than nine months after enactment

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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