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What Foreign Private Issuers Need to Know About the Corporate Governance and Disclosure Provisions of the Dodd-Frank Act

In an effort to reform the U.S. financial system and reduce systemic risk, Congress passed, and on July 21, 2010 the President signed into law, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). While the legislation will have its greatest effect on the U.S. financial system and on financial institutions operating in the United States, the Act also contains a number of provisions that will have a significant effect on corporate governance of companies listed on U.S. exchanges (both financial institutions and non-financial institutions). Other provisions of the Act will have an effect on disclosure practices and potential liability of companies with reporting obligations to the U.S. Securities and Exchange Commission (the "SEC").

This alert addresses the provisions of the Act that will impact foreign private issuers that are listed in the United States or otherwise have SEC reporting obligations. We note that various provisions of the Act will apply only to companies that are subject to the SEC's proxy rules (which apply to domestic reporting companies and those non-U.S. companies that either do not qualify as foreign private issuers or do qualify but have voluntarily subjected themselves to the U.S. proxy rules). For ease of reference, we refer below to all of these as "domestic SEC reporting companies."

We note that because the United States, unlike an increasing number of other jurisdictions, tends to allow companies organized in jurisdictions outside the United States but listed in the United States to follow home country corporate governance requirements and practices, the impact of the Act on foreign private issuers is expected to be far less significant than was the case for the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act").

Overview of the Act's Corporate Governance and Disclosure Reforms

The Act, among other things,

- authorizes the SEC to adopt a proxy access regime that will enable shareholders to nominate candidates for election to the board of directors of domestic SEC reporting companies;
- imposes a requirement that domestic SEC reporting companies provide for *non-binding* say-on-pay (with the vote to be held at least once every three years, as determined by the shareholders at least once every six years) and say-on-golden parachute votes (at the time a business combination or sale of all or substantially all assets is voted upon);
- places further limits on broker discretionary votes cast at shareholder meetings of listed companies;

- mandates additional executive compensation disclosure by domestic SEC reporting companies in respect of "pay versus performance" and "internal pay equity;"
- directs the SEC to require that U.S. stock exchanges incorporate in their listing standards independence and other requirements for compensation committees of all listed companies (subject to certain exceptions);
- exempts SEC reporting companies other than “accelerated” and “large accelerated” filers from the requirement to obtain auditor attestations in respect of their internal control over financial reporting;
- directs the SEC to require that U.S. stock exchanges incorporate in their listing standards obligations applicable to all listed companies to develop, implement and disclose policies to “clawback” incentive-based compensation paid following certain accounting restatements, which are broader in scope than those applicable under the Sarbanes-Oxley Act;
- directs the SEC to require domestic SEC reporting companies to disclose in annual proxy statements why they have chosen to have one person act as both Chairman of the Board and CEO or to have two people fill those roles;
- imposes new disclosure obligations on domestic SEC reporting companies concerning hedging by directors and employees of the value of equity securities of the company;
- establishes new protections and incentives for whistleblowers;
- adds “recklessness” to the standard for claims of aiding and abetting securities law violations in actions brought by the SEC;
- withdraws a provision that permitted credit ratings to be included in SEC registration statements without triggering the requirement that the provider of the rating consent to its use;
- raises the possibility of changes to beneficial ownership reporting requirements on Schedule 13D for shareholders holding more than 5% of the voting stock of an SEC reporting company; and
- directs the SEC to promulgate new disclosure rules for SEC reporting companies involved in extractive industries and for SEC reporting companies for which so-called “conflict minerals” are necessary to the functionality or production of products manufactured by the company.

Changes that Impact Foreign Private Issuers

As was the case with the Sarbanes-Oxley Act, certain provisions of the legislation apply directly, while others direct the SEC to adopt new rules or to cause the U.S. stock exchanges to amend their listing rules.

The following are provisions that do, or may well, apply to foreign private issuers:

Compensation Committees Requirements

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, the Act adds a new Section 10C of the Exchange Act. This new provision requires the SEC to direct the national securities exchanges to require that each member of the compensation committees of U.S. listed companies be independent, to require that the compensation committee be given adequate funding and certain oversight responsibilities and to set forth certain independence considerations for compensation committee advisers.

Foreign private issuers that provide annual disclosures of the reasons why they do not have an independent compensation committee are not subject to the independence requirements, but are subject to the other requirements in respect of compensation committees. Foreign private issuers that are "controlled companies" (companies where more than 50% of its shares are controlled by a single individual, group or other issuer) are not subject to any of the foregoing compensation committee requirements. The SEC has authority to exempt companies from these requirements based on relevant factors, such as the size of the company.

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 compensation committees, subject to the exceptions described above. 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 the consultant and other advisers. Companies would be required to provide appropriate funding for the retention of such advisers. When engaging compensation consultants, legal counsel or other advisers, however, compensation committees must consider certain independence factors to be determined by the SEC, 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. These factors must be competitively neutral among categories of consultants and advisers. The Act further specifies that the engagement of consultants or advisers under these new rules will in no way require the compensation committees to act in accordance with the consultant or adviser's recommendations.

Internal Control Attestation Requirements

One provision of the Act modifies a requirement under Section 404 of the Sarbanes-Oxley Act that companies obtain an auditor attestation in respect of internal control over financial reporting. That requirement no longer applies to any SEC reporting company that is neither an "accelerated" filer nor a "large accelerated" filer.

Incentive-Based Compensation Clawback

The Act adds a new Section 10D of the Exchange Act that requires the SEC to direct the national securities exchanges to require listed "issuers" to develop and implement policies providing for 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 goes beyond the clawback provision contained in the Sarbanes-Oxley Act, which applies only to compensation received by the CEO and CFO during the 12-month period following the first issuance of the restatement and only if the restatement resulted from misconduct.

As the Act refers to "issuers" it is unclear whether the SEC can, or would, exclude foreign private issuers from these requirements, even though they represent a further "federalization" of corporate governance matters, and even though clawback remedies might best be left to contractual provisions in employment agreements or terms of compensation plans. The Act furthers a trend in which compensation can be clawed back even though the officers in question were not directly involved in the actions that gave rise to the restatement. We note, for example, that in June the SEC defeated a motion to dismiss in an action against a CEO under the Sarbanes-Oxley Act clawback provision (*SEC v Jenkins)*, in which it is seeking the return of bonus payments and proceeds of stock sales from the CEO notwithstanding the fact that it did not charge the CEO with any wrongdoing. The court rejected the notion that the misconduct triggering clawback must be the officer's, focusing instead on the misconduct of the company, acting through the efforts of its officers and employees.

Use of Credit Ratings in Registration Statements

The Act includes an immediately effective requirement that nullifies Rule 436(g) under the Securities Act of 1933. Rule 436(g) provided that a credit rating assigned to a class of debt securities, convertible debt securities or preferred stock by a nationally recognized statistical rating organization would not be considered to be a part of an SEC registration statement prepared or certified by an "expert." This meant that credit ratings agencies were not required to provide written consents as a condition to the inclusion of their ratings in registration statements, and were not subject to liability under Section 11 of the Securities Act.

Corporate issuers often refer to ratings of their debt securities or preferred stock in their registration statements, prospectuses and periodic reports filed under the Securities Exchange Act of 1934. As a result of the nullification of Rule 436(g), these issuers generally must either obtain the consent of the relevant rating agencies (which may not be possible because a number of rating agencies have indicated their unwillingness to provide such consents) or remove the ratings information from their registration statements and other documents included or incorporated by reference in their registration statements.

Note, however, that under SEC Compliance and Disclosure Interpretations (see Question 233.04 relating to the Securities Act rules), consent of a credit rating agency would not be required if the disclosure is related only to changes to a credit rating, liquidity of the registrant, the cost of funds for a registrant or the terms of agreements that refer to credit ratings.

The SEC has provided guidance to corporate issuers and temporary relief, in the form of a no-action letter, to issuers of asset-backed securities to address some of the transition issues triggered by the nullification.

Disclosure Regarding Conflict Minerals

As part of an effort that is gaining adherents in a variety of jurisdictions to reduce the level of violence in the Democratic Republic of Congo ("DRC") and adjacent countries by targeting trade in minerals that are used to finance the conflict in the DRC, the Act directs the SEC to promulgate rules requiring annual disclosure as to whether "conflict minerals" necessary to the functionality or production of product manufactured by the company originated in the DRC or an adjoining country. These rules will also require those companies that do disclose origination of conflict minerals in the DRC or an adjoining country to submit to the SEC (and post on their corporate web site) a report covering the reporting company's diligence in respect of the source and chain of custody of such minerals, together with an independent private sector report, certified by the company. These reports are also to include a description of products manufactured by the company that are not "conflict free," facilities used to process conflict minerals, efforts to determine the origin of the conflict minerals and country of origin of conflict minerals.

"Conflict minerals" include coltan, cassiterite, gold, wolframite, or their derivatives, or other minerals designated by the U.S. Secretary of State to be financing conflict in the DRC. A product is "conflict free" for purposes of the Act if it does not contain conflict minerals that directly or indirectly finance or benefit armed groups in the DRC or an adjoining country.

Disclosure Obligations for those in Extractive Industries

The Act requires the SEC to promulgate rules requiring reporting companies engaged in resource extraction (commercial development oil, natural gas or minerals) to disclose in an annual report to the SEC information relating to any "payments" made to foreign governments (including companies owned by foreign governments) or the federal government for the purpose of commercial development of oil, natural gas or minerals). Payments include taxes, royalties, fees, bonuses, production entitlements or any other material benefits SEC determines is part of commonly recognized revenue streams for resource extraction. The SEC will make a compilation of the information publicly available online.

In addition, the Act requires operators of coal or other mines to disclose certain information relating to mine safety. As general matter, these disclosure requirements relate to actions taken by U.S. federal mining regulators pursuant to the Federal Mine Safety and Health Act. Accordingly, to the extent that a foreign private issuer's mining operations are not within the jurisdiction of either of these regulators, this section does not create any additional disclosure requirements. There is, however, an exception to this in the requirement to disclose the "total number of mining-related fatalities" for each coal or other mine for which the issuer or a subsidiary of the issuer is an operator. This disclosure requirement is not modified by reference to regulation or regulatory action under the Federal Mine Safety and Health Act and as a consequence, should be disclosed by foreign private issuers until the SEC clarifies whether these rules apply to both U.S. domestic companies and to foreign private issuers. This section of the Act becomes effective 30 days after the Act's enactment (i.e., on August 20, 2010).

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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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