LEGAL UPDATES

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Impacts of the Dodd-Frank Wall Street Reform and Consumer Protection Act on Executive Compensation and Corporate Governance

Service

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Corporate governance and executive compensation continue to undergo heightened scrutiny and enhanced regulatory oversight. The Dodd-Frank Wall Street Reform and Consumer Protection Act, signed by President Obama on July 21, 2010, is the latest catalyst for changes to how public companies manage compensation and risk, and what they are required to disclose concerning these issues. The Act contemplates at least 243 rulemaking proceedings by federal regulators to implement these and other changes that primarily affect financial services institutions.

Less than a week after becoming law, the SEC announced its plans to begin gathering public comments on the topics slated for rulemaking by the Commission. Utilizing a new process through which it will solicit and receive public comments, the SEC established a section on its website with e-mail links associated with the sections of the Act that require rulemaking. The topics are listed in the chronological order in which the Act calls for SEC action. Click here to access the SEC site.

The following summary highlights the new corporate governance and executive compensation standards and disclosure requirements applicable to all public companies.

Executive Compensation

Shareholder vote on executive compensation. Beginning six months after its enactment, the new law requires that issuers provide shareholders with a non-binding so-called “say-on-pay” vote to approve or disapprove the executive compensation that is disclosed according to existing SEC rules. The same vote will be required at least once every three years. The statute also requires that shareholders be given the opportunity, at least once every six years, to cast a non-binding vote on whether they would prefer “say-on-pay” votes to occur every one, two or three years. Both of these votes are required at the first annual meeting occurring more than six months after the law’s enactment, and it is important to note that no SEC action is required for this requirement to take effect. Therefore, issuers should be prepared to comply by the end of this year.

Shareholder approval of golden parachute compensation. Within the same six-month timeframe following the law's enactment, public companies are required to seek a similar non-binding shareholder vote on any compensation that is “based on or otherwise related to” certain merger, acquisition or sale transactions being submitted for shareholder approval, unless the terms of such compensation were already disclosed and approved as part of a prior "say-on-pay" vote. Institutional investment managers will be required to disclose their votes on both the executive compensation and golden parachute provisions. Again, no formal SEC rulemaking is required before this requirement takes effect.

Compensation committee independence. The SEC must adopt rules within one year that require the national securities exchanges and association to prohibit any issuer from listing securities if the issuer has failed to comply with the Commission's rules governing compensation committee independence. The Act sets forth several factors to consider in determining independence, including the source of a board member's compensation and whether or not the board member is affiliated with the issuer. The rules must also provide an opportunity for a company to cure any defects in its compliance with the new standards before it is subject to further enforcement, including potential de-listing from an exchange.

Compensation consultants and legal counsel independence. The Act requires the SEC to adopt rules similar to those applied to compensation committee members to govern the standards for determining the independence of consultants, advisers and legal counsel hired by the compensation committee. Factors to be considered in developing these standards include:

whether the consultant provides other services to the issuer;

the extent to which the consultant's employer receives fees for other services provided to the issuer;

the presence of a business or personal relationship between the consultant and a committee member;

the existence of any conflicts of interest and the consulting firm’s policies designed to prevent such conflicts; and the extent to which the consultant owns the issuer's stock.

The standards must be competitively neutral across all categories of consultants and again, the rules must provide an opportunity to cure any defects in compliance prior to any potential delisting. The Act is careful to recognize that while consultant independence is required, the requirement is not intended to suggest that committees must heed the consultant's advice. The new listing standards must provide, however, that the compensation committee is authorized to retain and oversee any work performed by a consultant and that the company will provide appropriate funding for such consultants as deemed necessary by the compensation committee. Further, each proxy statement for an annual meeting held one year or more after the law's enactment must disclose the retention and any conflicts of interest raised in the work performed by any such consultant, and the resolution of such conflict(s). The rules must require that national securities exchanges and associations prohibit listing the securities of any issuer that fails to comply with the rules.

Executive pay versus company performance. The Act directs the SEC to adopt rules requiring companies to disclose the compensation paid to any executives whose compensation is already subject to disclosure and describe the correlation between what was paid and the company's financial performance, taking into account any change in the value of the stock and dividends and any distributions. Such disclosure may, but will not be required to, include a graphic presentation.

Correlation between CEO compensation and median employee compensation. The SEC is required to amend existing regulations to require issuers to disclose the median of the annual total compensation of all employees (except the CEO) and the CEO's total annual compensation (as disclosed in the Summary Compensation Table), together with a ratio of the CEO's compensation to the median compensation of all other employees.

Compensation "Clawbacks" Upon Certain Restatements. New SEC rules must direct the national securities exchanges and associations to require that all listed companies adopt and disclose policies regarding incentive-based compensation that are based on financial information reported pursuant to securities laws, and enable the company to recover the difference between any incentive compensation paid based on erroneous financial statements and the amount of incentive compensation that should have been paid according to the restated financials. Such policies must provide for a three-year look-back period and recovery of any amounts paid incorrectly during that period.

Hedging Disclosures. The Act amends the Securities and Exchange Act to require companies to disclose whether any board member or employee is permitted to purchase financial instruments designed to hedge or offset any decrease in the market value of the company's securities that are either granted as compensation to, or are otherwise held by, the director or employee.

Executive compensation disclosures for financial institutions. Federal regulators have nine months to jointly enact rules to (1) require all nonbank financial companies supervised by the Federal Reserve and bank holding companies with assets of $1 billion or more to disclose their incentive-based compensation structures; and (2) prohibit any incentive-based compensation structures at such institutions that the regulators determine encourages inappropriate risks by providing “excessive compensation” or that could lead to material financial loss to the institution.

Broker votes. The Securities and Exchange Act is amended to prohibit brokers from voting on a director election, executive compensation or any other “significant matter” identified by the SEC, absent instructions from the beneficial owners of the issuer’s shares held by the broker. This prohibition, like the parallel revision to NYSE Rule 452 adopted last year, does not apply to uncontested director elections of any investment company registered under the Investment Company Act.

Corporate Governance

Proxy access. The Act amends the Securities and Exchange Act to permit, but not require, the SEC to adopt rules relating to shareholders’ ability to nominate directors in public company proxy statements, and setting the terms and conditions that a shareholder must satisfy in order to do so. This provision changes little in the short run, since the SEC was already engaged in an ongoing project to amend its proxy rules to provide proxy access for director nominations for shareholders who meet certain requirements, including prescribed minimum thresholds for share ownership.

CEO and Chairman Structures. Within 180 days after the law’s enactment, the SEC must issue rules requiring issuers to disclose the reasons it has decided to retain or replace the chairman of the board of directors and the CEO in the annual proxy. Since the SEC already adopted substantially equivalent rules in December 2009, this provision should not effect any practical change to the current proxy rules.

Risk committee requirement. The Federal Reserve is directed to issue regulations within one year that require publicly traded nonbank financial institutions to establish a risk committee, comprised of independent directors and at least one risk management expert who will be responsible for overseeing the company's risk management practices. The Federal Reserve is required to impose the regulations on bank holding companies with total consolidated assets of at least $10 billion, and may apply them to institutions holding less.

What This Means To You

It is important for companies to identify and understand which requirements will automatically go into effect regardless of further rulemaking by the SEC or other regulators and which will remain pending until the agencies issue their final determinations. Many of the rules impact issuers who will hold their annual meetings in the first quarter of 2011. However, without some further direction from the SEC, it will be difficult for companies to prepare for the new disclosures.

Several of these uncertainties include:

"Golden parachutes." "Golden parachutes" are normally understood to apply only to payments in connection with a termination of employment following a sale, merger or acquisition of assets. However, the Act refers to incentive compensation that is "based on or relates to" an M&A transaction, which could apply to any bonus or other incentive compensation paid to a named executive officer for successful completion of the deal.

"Clawbacks." The Act provides no indication as to what the SEC will expect companies to adopt as part of their mandatory "clawback" policy aside from the provisions identified in the Act.

Section 402 disclosure. Likewise, the impact of the ambiguous requirement to provide a "clear description" of any compensation required to be disclosed by the issuer under Item 402 of regulation S-K will depend on how the SEC implements this new rule.

Exemption for smaller issuers. Except for the disclosures concerning executive compensation, the Act permits the SEC and national securities exchanges to exempt certain issuers from these sections after taking into account, among other considerations, whether the requirements disproportionately burden smaller issuers. The SEC generally characterizes small entities as those that have a public float of less than $75 million or annual revenues of less than $50 million. Yet until the final rules are issued, the impact on small companies will remain uncertain.

Prohibition of broker votes on "other significant matters." It remains to be seen to what extent, if any, the SEC will exercise its additional discretion to prohibit broker discretionary voting on "other significant matters."

Proxy access. The SEC's proposed proxy access rules have been pending for over a year, so the immediate impact of the Act's authorization to adopt such rules is negligible. The SEC sought public comment on a number of potential limitations to proxy access, including, among others, whether public companies should be allowed to "opt out" of a proxy access rule with the approval of their shareholders, and whether the rule should exclude companies that have adopted "majority voting" in uncontested director elections or have adopted an alternate version of proxy access for director nominations. The SEC is likely to resolve these and other proxy access issues through the pending rulemaking very soon.

Shareholder resolutions. The law gives no direction on the form to be used for the newly required shareholder resolutions on executive compensation and golden parachute provisions.

Until the SEC provides further guidance on these and other open issues, companies will have to use the language in the Act, historical experience and good judgment to guide their preparation for compliance with these new requirements.

The Act contemplates at least 10 rulemaking proceedings associated with the corporate governance and executive compensation requirements. These, in addition to resolving residual ambiguities left by the new mandates, will take time. We will continue to monitor developments in the rulemaking process and other implementation activities. Please contact your Husch Blackwell Sanders attorney or one of the attorneys listed below for additional information about these or any other corporate governance issues.

Contact Info
If you have any questions about this or other investment management matters, please contact your Husch Blackwell Sanders attorney.

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