Dodd-Frank Act Makes Significant Changes in Governance Rules for Public Companies

On July 21, 2010, the President signed into law the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Act"). While the new law is a sweeping overhaul of the United States' financial regulatory system, this memorandum provides a particular focus on the corporate governance implications for public companies. Much of what is included in the Act's provisions on this subject has been the subject of extensive debate and discussion the past several years. As a result, the sections of the Act summarized below represent a summing up of how these issues have been addressed in the overall context of the remedial nature of the Act's approach to the financial crisis of the past few years. While further rulemaking by the Securities and Exchange Commission ("SEC") and national securities exchanges will be required to implement the Act's corporate governance provisions, the scope and substance of those rules are mandated by the Act.

Among other things, the Act requires:

- corporations to afford shareholders the opportunity to cast nonbinding votes on the compensation of certain executives;
- additional executive compensation disclosures;
- the adoption of policies to recover erroneously awarded executive compensation;
- that the compensation committee of a board of directors meet certain independence standards;
- disclosure of whether hedging is permitted by employees and directors;
- new rules for brokers voting by proxy;
- disclosures regarding Chairman and CEO structures; and
- the SEC to consider providing greater shareholder access to proxy solicitation materials.

I. EXECUTIVE COMPENSATION: NEW RULES FOR SHAREHOLDER VOTES, DISCLOSURES, CLAWBACKS, AND CERTAIN FINANCIAL INSTITUTIONS[1]

A. *Non-Binding Shareholder Votes on Executive Compensation*

Annual meeting and other proxies: The Act requires public companies, at least once every three years, to include in their proxy or consent or authorization for an annual or other meeting of shareholders for which SEC rules require compensation disclosure ("proxy materials") a separate resolution subject to shareholder

[1] *See* the Act § 951 (adding new Exchange Act Section 14A).

vote to approve the compensation of executives. At least once every six years, shareholders must vote to decide whether votes on this resolution will occur every one, two or three years. The first proxy materials for an annual or other meeting of shareholders occurring after January 20, 2011 must include both of these resolutions.

Merger proxies: The Act also requires public companies to hold shareholder votes on "golden parachute" compensation. Specifically, it requires public companies to include, in any proxy materials for a meeting of the shareholders occurring after January 20, 2011 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 the company, a statement from the person making such a solicitation that discloses any agreements or understandings the person has with any named executive officer of the company (or the acquiring company) concerning any type of compensation that is based on or otherwise relates to the transaction and the aggregate total of all such compensation that may be paid or become payable to or on behalf of the executive. The disclosure must be made in a clear and simple form in accordance with regulations to be promulgated by the SEC. Any proxy materials containing such disclosure shall include a separate resolution subject to shareholder vote to approve such agreements or understandings, unless they are already otherwise subject to a vote of the shareholders.

The shareholder votes required by the Act will not be binding on a company's board of directors, and may not be construed as overruling a decision by the company or its board. The votes are not intended create or imply any change to the fiduciary duties of the company or its board and cannot restrict or limit the ability of shareholders to make proposals for inclusion in the company's proxy or consent materials related to executive compensation. The SEC may exempt an issuer or class of issuer from these requirements, taking into account among other considerations, whether the requirements disproportionately burden small issuers.

In addition, every institutional investment manager subject to Section 13(f) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), shall report at least annually how it voted on any of these shareholder votes unless the SEC already requires that the vote be publicly reported.

B. New Executive Compensation Disclosures[2]

The Act adds new disclosure requirements to the executive compensation disclosures required by Item 402 of Regulation S-K.[3] Specifically, companies must now disclose the median annual total compensation of all its employees except the CEO, the annual total compensation of the CEO, and a ratio comparing these two amounts.

The SEC must also establish rules requiring companies to disclose in any proxy materials for an annual meeting of shareholders a clear description of the compensation disclosures for the executives required by Item 402 of Regulation S-K. Such disclosure must include information that shows the relationship between

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2 *See* the Act § 953 (adding new Exchange Act Section 14(i)).

3 Regulation S-K, Item 402 requires disclosure of the compensation of a company's principal executive officer, principal financial officer, three most highly compensated executive officers other than the principal executive or financial officers, and up to two additional individuals for whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer.

executive compensation actually paid and the issuer's financial performance, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions.

C. *Recovery of Erroneously Awarded Compensation*[4]

The Act requires the SEC to direct, by rule, the national securities exchanges and associations to prohibit the listing of any security of an issuer that does not comply with rules promulgated by the SEC requiring public companies to develop and implement policies

- for disclosure of company policy regarding incentive-based compensation (including stock options) based on financial information that must be reported under the securities laws; and
- for recovery of incentive-based compensation from any current or former executive during the three years preceding the date of any accounting restatement due to material noncompliance with financial reporting requirements under the securities laws, in excess of what the executive would have been paid under the accounting restatement.

D. *New Compensation Rules for Covered Financial Institutions*[5]

Not later than April 20, 2011, certain federal regulators[6] must prescribe regulations or guidelines to require covered financial institutions[7] to disclose to the appropriate federal regulator the structures of all incentive-based compensation arrangements to determine whether the structures provide an executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits, or could lead to material financial loss to the institution. The federal regulators must also jointly prescribe regulations or guidelines by April 20, 2011 that prohibit incentive-based payment arrangements that they determine encourage inappropriate risks by covered financial institutions by providing an executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits or that could lead to material financial loss to the covered financial institution.

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4 *See* the Act § 954 (adding new Exchange Act Section 10D).

5 *See id.* § 956.

6 Defined as the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Board of Directors of the Federal Deposit Insurance Corporation, the Director of the Office of Thrift Supervision, the National Credit Union Administration Board, the SEC, and the Federal Housing Finance Agency.

7 Defined as: a depository institution or depository institution holding company, a broker dealer registered under Section 15 of the Exchange Act, credit unions, investment advisors as defined in the Investment Advisors Act of 1940, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and any other financial institution that the appropriate federal regulators determine jointly by rule should be treated as a covered financial institution. Covered financial institutions with assets of less than one billion dollars are excluded from the requirements of this section.

II. COMPENSATION COMMITTEE INDEPENDENCE[8]

The Act requires the SEC to direct, by rule, the national securities exchanges and associations to prohibit listing an equity security of an issuer (subject to certain exceptions[9]) that does not have a compensation committee meeting the independence requirements to be set forth in rules of the national securities exchanges and associations. The Act specifies that the exchanges must take into account "relevant factors" when determining whether compensation committees and their advisers are "independent," including

- the source of compensation of a member of the board of directors of an issuer, including any consulting, advisory or other compensatory fee paid by the issuer to the member; and

- whether a member of the board of directors is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.

Compensation committees must also have the authority to retain or obtain in their sole discretion the advice of a compensation consultant, independent legal counsel, and other advisers. If a compensation consultant, legal counsel, or other adviser is retained, the compensation committee must take into account factors that affect the independence of such person, legal counsel or other adviser including

- the provision of other services to the issuer by the person that employs the compensation consultant, legal counsel, or other adviser;

- the amount of fees received from the issuer by the person that employs the compensation consultant, legal counsel, or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel, or other adviser;

- the policies and procedures of the person that employs the compensation consultant, legal counsel, or other adviser that are designed to prevent conflicts of interest;

- any business or personal relationship of the compensation consultant, legal counsel, or other adviser with a member of the compensation committee; and

- any stock of the issuer owned by the compensation consultant, legal counsel, or other adviser.

The compensation committee must be directly responsible for the appointment, compensation, and oversight of such advisers. The committee is not required to implement or act consistently with the advice it receives from such advisers, and the Act specifies that this authority to retain advisers does not affect the ability

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8 *See* the Act § 952 (adding new Exchange Act Section 10C).

9 Excepted are: issuers that are controlled companies, limited partnerships, companies in bankruptcy proceedings, open-ended management investment companies that are registered under the Investment Company Act of 1940, and foreign private issuers that provide annual disclosures to shareholders of the reasons that the foreign private issuers do not have an independent compensation committee.

or obligation of a compensation committee to exercise its own judgment in the fulfillment of its duties. Furthermore, in any proxy materials for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting) occurring on or after July 20, 2011, each issuer must disclose in the proxy materials in accordance with SEC regulations whether the compensation committee retained or obtained the advice of a compensation consultant (but not legal counsel or other advisers) and whether the work of the compensation consultant has raised any conflict of interest, the nature of any such conflict, and how it is being addressed. These provisions of the Act do not apply to "controlled companies" listed on a national securities exchange or association and that hold elections for boards of directors in which more than half of the voting power is held by an individual, group or other issuer.

The SEC must direct national securities exchanges and associations to prohibit the listing of any company that does not comply with these requirements by July 16, 2011. The SEC must also permit a national securities exchange or association to exempt a category of issuers from these requirements as the exchange or association determines is appropriate. In determining what may be appropriate for this exemptive purpose, the exchanges and associations shall take into account the potential impact of the requirements of the Act on smaller reporting issuers.

The Act requires the SEC to conduct a study and review the use and effect of compensation consultants, and to submit the results to Congress no later than July 20, 2012.

III. Disclosure of Employee and Director Hedging[10]

The SEC must also establish rules requiring public companies to disclose in any proxy materials for an annual meeting of shareholders whether any employee or director (or their designee) is permitted to purchase financial instruments designed to hedge or offset any decrease in the market value of the equity securities granted to the employee or director by the issuer as part of their compensation, or otherwise directly or indirectly held by the employee or director.

IV. Voting by Brokers[11]

The Act requires national securities exchanges to prohibit any member that is not a beneficial owner of a registered security from granting a proxy to vote the security in connection with certain shareholder votes unless the beneficial owner has instructed the member to vote the proxy. The shareholder votes in question include the election of directors, executive compensation decisions, and any other significant matter as determined by the SEC. A vote with respect to the uncontested election of a director of an investment company registered under the Investment Company Act of 1940 is specifically excluded from this section of the Act. National securities exchanges are still allowed to prohibit a member that is not a beneficial owner of a registered security from granting a proxy to vote the security in connection with a shareholder vote not described above.

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10 *See* the Act § 955 (adding new Exchange Act Section 14(j)).

11 *See id.* at § 957 (adding new Exchange Act Section 6(b)(10)).

V. DISCLOSURES REGARDING CHAIRMAN AND CEO STRUCTURES[12]

No later than January 17, 2011, the SEC must issue rules that require public companies to disclose in the annual proxy sent to investors the reasons why the company has chosen either the same or different individuals to serve as chairman of the board and CEO (or in equivalent positions).

VI. SHAREHOLDER PROXY ACCESS[13]

The Act gives the SEC authority to issue rules permitting shareholders to nominate individuals to membership on a company's board of directors, under such terms and conditions as the SEC may determine are in the interests of shareholders and for the protection of investors. The SEC may also exempt an issuer or class of issuers from any such requirement taking into account, among other things, whether the requirement disproportionately burdens small issuers. Notably, this is the only significant change to the corporate governance rules affecting directors and boards of directors that the SEC is permitted, and not required, to implement.

12 *See* the Act § 972 (adding new Exchange Act Section 14B).

13 *See id.* § 971 (adding new Exchange Act Section 14(a)(2)).

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Guillaume Buell at 212.701.3012 or gbuell@cahill.com.