

August 12, 2010

## Dodd-Frank Act: Executive Compensation and Corporate Governance Provisions

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Act is the culmination of Congressional negotiations and debate that focused principally on the overhaul of the U.S. financial regulatory framework to avert future financial crises. In addition to wide-ranging financial reforms, the Act includes provisions that impose new executive compensation and corporate governance requirements on U.S. public companies. This Client Alert summarizes the executive compensation and corporate governance provisions of the Act. For Client Alerts that summarize certain of the other provisions of the Act, see the links at the end of this Client Alert.

### Executive Compensation

*Say on Pay.* The Act requires public companies to include a non-binding shareholder vote on the compensation of their named executive officers disclosed in their proxy statements at least once every three years. Companies are also required to hold a non-binding shareholder vote, at least once every six years, to determine whether say on pay votes should be held every one, two or three years. Both votes — say on pay and the frequency of future say on pay votes — are required to be included in a company's proxy statement for its first annual or other meeting of shareholders occurring on or after January 22, 2011.

*Say on Golden Parachutes.* The Act also mandates that any proxy solicitation that seeks shareholder approval of a merger or other business combination transaction must disclose "in a clear and simple form" any compensation arrangements with named executive officers that relate to the transaction and the aggregate total of all such compensation that may be paid. The Act requires that the proxy materials include a non-binding shareholder vote on the compensation arrangements relating to the transaction unless the compensation arrangements have already been the subject of a say on pay vote at a prior shareholder meeting.

The Act clarifies that these shareholder votes are not binding on a company's board of directors and a negative vote cannot overrule any company or board decision, change or create any fiduciary duties for the company or board members or limit shareholders' ability to submit executive compensation proposals for inclusion in the company's proxy materials. These say on pay rules, however, provide public company shareholders with a means for opposing or supporting their company's pay practices, and it is expected that public company boards and their compensation committees will be inclined to consider and respond to the shareholder vote on their executive compensation package. We expect that the recommendations of organizations such as RiskMetrics and other advisory groups will become more relevant in the context of the say on pay rules.

Under the Act, the SEC has the authority to exempt companies from the say on pay and say on golden parachute requirements after taking into account, among other considerations, whether they would disproportionately burden smaller companies.

*Compensation Committee Independence.* The Act requires the SEC to implement rules that prohibit national securities exchanges from listing the securities of any company that does not have a compensation committee comprised solely of independent members of its board.<sup>1</sup> The SEC is required to promulgate rules to implement these provisions by no later than July 16, 2011, and is also required to establish appropriate procedures permitting a company to have a reasonable opportunity to cure any defects in the composition of its compensation committee that would result in delisting. Under these rules, which are expected to be comparable to existing SEC rules on independent audit committees, a director's independence will be based on the exchange's consideration of relevant factors, which must include the source of the director's compensation (including any consulting, advisory or other compensatory fees), as well as the director's affiliation with the company or its affiliates.

While the rules of the New York Stock Exchange and Nasdaq already require fully independent compensation committees (subject to limited exceptions), the implementation of this provision of the Act is expected to impose additional factors to be considered in determining the independence of a director to serve on the compensation committee.

*Compensation Committee Consultants, Legal Counsel and Other Advisors.* The Act empowers a compensation committee, in its sole discretion, to retain or obtain the advice of a compensation consultant, legal counsel or other advisor. The Act also provides that the compensation committee is directly responsible for the compensation and oversight of those advisors. Companies are required under the Act to provide appropriate funding to permit their compensation committee to pay reasonable compensation to compensation consultants, legal counsel and other advisors.

The Act provides that compensation committees will only be permitted to select and retain a compensation consultant, legal counsel or other advisor after taking into consideration factors that are to be formulated by the SEC, and which must include:

- the provision of other services to the company by the consultant or other advisor;
- the amount of fees paid by the company as a percentage of the total revenue of the consultant or other advisor;
- the policies and procedures of the consultant or other advisor that are designed to prevent conflicts of interest;
- any business or personal relationship of the consultant or other advisor with a member of the compensation committee; and
- any stock of the company owned by the consultant or other adviser.

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<sup>1</sup> Controlled companies, limited partnerships, companies in bankrupt proceedings, registered open-ended 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.

These provisions are comparable to existing law under the Sarbanes-Oxley Act relating to audit committee engagements of independent registered public accounting firms.

Companies will also be required to disclose in their proxy statements for their first meeting of shareholders occurring on or after July 22, 2011:

- whether the company's compensation committee retained or obtained the advice of a compensation consultant; and
- 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.

These disclosures will be in addition to recently adopted SEC rules requiring disclosure of compensation paid to compensation consultants for executive compensation and other services.

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 to Congress no later than July 21, 2012.

*Internal Pay Equity Disclosure.* The Act also requires the SEC to implement rules requiring companies to disclose the:

- median annual "total compensation" of all employees, other than the CEO;
- annual "total compensation" of the CEO (which is already required to be disclosed); and
- ratio of these two amounts.

"Total compensation" is required to be calculated in accordance with the current rules for determining a named executive officer's total compensation in the Summary Compensation Table. While this rule appears to be straightforward, it may be burdensome to compile compensation statistics for all employees across an entire organization, particularly in the first year of implementation if certain amounts are not tracked. Compiling compensation statistics for international employees in multiple jurisdictions and business units may also be burdensome. The Act does not specify an effective date for this disclosure and SEC Chairwoman Mary Schapiro noted on July 20, 2010 in an appearance before the House Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises that it was unlikely that these rules would be in place for the 2011 proxy season.

*Additional Executive Compensation Disclosure.* The Act requires the SEC to issue rules requiring disclosure in annual proxy statements of information that "shows the relationship between executive compensation actually paid and the financial performance of the issuer." The disclosure may include a graphic representation of the information required to be disclosed. It is unclear what additional information companies will be required to disclose. There is no specified deadline for the SEC to issue these rules.

*Disclosure of Hedging.* The Act directs the SEC to impose disclosure requirements as to whether any employee or director is permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds) that are designed to hedge or offset any decrease in the market value of the company's equity securities held by the employee or director or granted to the employee or director by the company as compensation. The Act does not state when the SEC must promulgate these disclosure requirements or when they will be effective. Companies may wish to review

their policies for compliance, or consider implementing a policy against hedging if they do not currently have a policy.

*Compensation Clawbacks.* The Act requires the SEC to direct national securities exchanges to require companies to develop and implement policies providing for the clawback of incentive-based compensation (including stock options) paid to current or former executive officers in the event of an accounting restatement due to the company's material noncompliance with any financial reporting requirement under the securities laws.

Under the required clawback, companies will be required to recover the portion of any incentive-based compensation that was paid based on the erroneous data during the three-year period preceding the date of the restatement that is in excess of what would have been paid to the executive officer under the restatement. The SEC will also issue rules regarding disclosure of a company's clawback policy.

The Act does not specify an effective date for the required clawback or new disclosure requirement.

The Act's clawback requirement is significantly broader than the clawback requirement under the Sarbanes-Oxley Act. For example, the clawback under the Sarbanes-Oxley Act:

- applies only to compensation received by the CEO and CFO (compared to all current and former executive officers under the Dodd-Frank Act);
- applies to compensation received during the 12-month period following the misstatement (compared to the three-year period preceding the date of the restatement under the Dodd-Frank Act); and
- applies if the restatement resulted from misconduct (compared to only material noncompliance with financial reporting requirements under the Dodd-Frank Act).

## Corporate Governance

*Proxy Access.* The Act authorizes, but does not require, the SEC to implement rules permitting the use by a shareholder of management's proxy materials for the purpose of nominating directors under terms and conditions that the SEC determines are in the interests of shareholders and for the protection of investors. The SEC proposed implementing so-called "proxy access" rules in 2003, 2007 and 2009, but refrained from adopting the rules. Some commentators stated that the SEC did not adopt its proxy access rules because of concerns about its statutory authority to do so. It now has that statutory authority under the Act.

Members of the Senate attempted to require that any proxy access rules implemented by the SEC include a five percent ownership requirement and a two-year holding period, ostensibly to ameliorate some of the business community's concerns about short-term investors using the proxy access rules for a narrow agenda, but these requirements were ultimately not included in the final version of the Act. Consequently, the SEC will have wide latitude to craft the proxy access rules, which are expected to be promulgated in time for the 2011 proxy season. The Wall Street Journal recently reported that the California Public Employees' Retirement System, the California State Teachers' Retirement System and the Council of Institutional Investors have begun to identify potential nominees to take advantage of the anticipated proxy access rules.

*Broker Discretionary Voting.* The Act requires national securities exchanges to prohibit broker discretionary voting in connection with director elections, executive compensation or any other significant matter, as determined by the SEC. In 2009, the New York Stock Exchange eliminated broker discretionary voting in uncontested director elections, so the principal effect of this provision of the Act is to prohibit brokers from voting uninstructed shares on matters related to executive compensation, including the newly required say on pay and say on golden parachute proposals, and other significant matters to be determined by the SEC.

*Disclosures Regarding Chairman/CEO Positions.* The Act requires the SEC, by January 17, 2011, to issue rules requiring companies to disclose in their annual proxy statements whether and why they have chosen to combine or separate the chief executive officer and board chair positions. The SEC has already addressed this requirement with the enhanced executive compensation and corporate governance proxy disclosures that were approved in December 2009 (Item 407(h) of Regulation S-K).

*Majority Voting.* The Senate version of the financial reform bill would have required public companies to implement a majority vote standard in the election of directors, a provision that was not contained in the House version of the bill. The final version of the Act is consistent with the House bill in that it does not require companies to implement a majority vote standard. Majority voting in director elections has been adopted voluntarily by many larger companies, but all companies will retain the freedom to determine the vote required to elect directors (subject to state law requirements) as a result of the exclusion of this proposed requirement from the Act.

*Auditor Attestation Requirements for Smaller Companies.* The Act permanently exempts companies that are not “accelerated filers” (generally, an issuer with a market capitalization between \$75 million and \$700 million) or “large accelerated filers” (generally, an issuer with a market capitalization of \$700 million or more) from compliance with the internal control auditor attestation requirements of Section 404(b) of the Sarbanes-Oxley Act. The exemption is intended to reduce the disproportionate burden on smaller companies of the costs associated with being a public company. The SEC is also required under the Act to conduct a study to determine how the SEC could reduce the burden of complying with Section 404(b) for companies whose market capitalization is between \$75 million and \$250 million for the relevant reporting period while maintaining investor protections for those companies. The study is also required to consider whether any identified methods of reducing the compliance burden or a complete exemption for those companies from compliance with Section 404(b) would encourage companies to list on exchanges in the U.S.

*Whistleblower Protections.* The Act prohibits employers from firing or discriminating against a whistleblower because of any act done by a whistleblower.

The Act also provides that in any judicial or administrative proceeding brought by the SEC under the securities laws that results in monetary sanctions exceeding \$1 million, the SEC is required to pay awards, ranging from 10% to 30% of the amount collected, to whistleblowers who voluntarily provide original information that leads to a successful enforcement of an action.

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The following recent Client Alerts summarize other provisions of the Dodd-Frank Act:

- [Summary and Analysis of the Volcker Rule in the Dodd-Frank Act - Prohibiting Bank Proprietary Trading and Investing in Hedge Funds, Private Equity Funds and Other Private Funds - It Affects More Than Just Funds](#)
- [Financial Reform Bill Bolsters Anti-Corruption Prosecution](#)

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