

Dodd-Frank Act: Executive Compensation and Corporate Governance Provisions

July 19, 2010

On June 29, 2010, a U.S. House of Representatives and Senate conference committee finalized the text of the financial reform legislation that is now titled the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).¹ On June 30, 2010, the House approved the Dodd-Frank Act by a vote of 237-192, followed on July 15, 2010 by the Senate’s approval by a vote of 60-39. The President is expected to sign the Dodd-Frank Act this week.

The Dodd-Frank Act will impose, directly or through regulatory action, new executive compensation and corporate governance requirements on public companies, including:

- non-binding shareholder votes on executive compensation and “golden parachute” arrangements
- enhanced independence requirements for compensation committee members and consideration of independence factors in selecting compensation and other consultants
- disclosure about pay vs. performance and internal pay equity
- mandatory “clawback” policies applicable to all current and former executive officers
- disclosure about employee and director hedging
- financial institution risk committees, compensation structure disclosure and prohibitions on inappropriate risk taking
- authority for the Securities and Exchange Commission (the “SEC”) to adopt “proxy access” rules and

¹ The text of the Dodd-Frank Act is available [here](#). Our Client Alert, dated July 2, 2010, entitled “House Approves Conference Report on Dodd-Frank Wall Street Reform and Consumer Protection Act; Senate to Consider Bill after Independence Day Recess,” is available [here](#).

- prohibition on discretionary broker voting with respect to the election of directors, executive compensation and other “significant” matters.

Executive Compensation Provisions

Non-Binding Shareholder Vote on Executive Compensation

Say-on-pay. Section 951 of the Dodd-Frank Act adds a new Section 14A to the Securities Exchange Act of 1934, as amended (the “Exchange Act”), which requires a non-binding shareholder vote on the compensation of the executive officers, as disclosed in the proxy statement pursuant to Regulation S-K, Item 402, at least once every three years. Shareholders are to determine at least once every six years, in a separate non-binding vote, whether the say-on-pay vote should be held every one, two or three years.

Golden parachute arrangements. New Section 14A also provides that any proxy statement for a meeting at which shareholders are asked to approve an acquisition, merger, consolidation or disposition of all or substantially all of a company’s assets must:

- disclose any agreement or understanding with any named executive officer of the company or the acquiring company concerning any type of compensation (so-called “golden parachutes”) that is based on, or otherwise relates to, the transaction, as well as the aggregate amount of all such compensation that may become payable. The disclosure must be in “clear and simple form” in accordance with rules to be promulgated by the SEC and
- include a separate non-binding shareholder vote to approve the golden parachute arrangements and amount of compensation, unless the golden parachute arrangement was previously subject to a say-on-pay vote.

Companies affected. Section 14A affects companies that are required to file proxy materials with the SEC. The SEC is specifically authorized to exempt companies from the new requirements taking into account, among other things, burdens on smaller companies.

Institutional investment manager reporting. Institutional investment managers subject to Exchange Act Section 13(f) are required to report annually how they voted on say-on-pay and golden parachute resolutions.

Implementation and effectiveness. The requirements of Section 14A will be effective for shareholder meetings occurring six months after enactment of the Dodd-Frank Act. No SEC rulemaking is necessary for the requirements to become operational; however, the SEC is required to adopt rules clarifying the required disclosure on golden parachute arrangements. There is no deadline in the Dodd-Frank Act for the adoption of these rules.

Observations.

- Unless the SEC amends Exchange Act Rule 14a-6(a), a preliminary proxy statement will be required to be filed with the SEC in connection with say-on-pay votes. The SEC previously has exempted from the preliminary proxy statement filing requirements say-on-pay votes under Section 111(e)(1) of the Emergency Economic Stabilization Act of 2008.
- New Section 14A(a)(2) requires a separate shareholder vote on “whether votes on the [say-on-pay] resolutions . . . will occur every 1, 2, or 3 years.” The mechanics of implementation of this vote are unclear. If Section 14A(a)(2) requires that shareholders be presented with all three choices, no choice, or more than one choice, may receive the required vote under applicable state corporate laws.² In addition, the SEC may need to amend Exchange Act Rule 14a-4(b) to create an exception to the requirement that proxy cards include boxes for shareholders to specify approval, disapproval or abstention with respect to a matter.
- Companies also should keep in mind that Section 957 of the Dodd-Frank Act requires the exchanges to prohibit discretionary voting by brokers on executive compensation matters. Companies will need to think about how to improve communications with their retail

² Pursuant to Section 216(2) of the Delaware General Corporation Law, the default standard for shareholders of Delaware corporations to approve a matter at a shareholder meeting is the “affirmative vote of the majority of shares present in person or represented by proxy and entitled to vote on the matter.” Section 7.25(c) of the Model Business Corporation Act requires that “the votes cast . . . favoring the action exceed the votes cast opposing the action.”

shareholders about executive compensation matters to avoid a reduced retail vote on these matters.³

Independence of Compensation Committee and Its Advisers

Compensation committee independence. Section 952 of the Dodd-Frank Act adds a new Section 10C to the Exchange Act requiring the SEC to direct the national securities exchanges and associations to prohibit the listing of any equity security of a company unless all compensation committee members are independent and meet enhanced independence requirements. When defining independence, the national securities exchanges are to consider relevant factors including the source of a director's compensation and whether the director is affiliated with the issuer.

Compensation consultants, independent legal counsel and other advisers. New Section 10C also provides that compensation committees will have sole discretion to retain, and be directly responsible for the appointment, compensation and oversight of, compensation consultants, independent legal counsel and other advisers, with companies responsible for paying their reasonable fees. Compensation committees may select compensation consultants, legal counsel and other advisers only after considering independence factors to be determined by the SEC, including:

- the provision of other services to the issuer by the person that employs the adviser
- the amount of fees received from the issuer by the person that employs the adviser as a percentage of that person's total revenue
- the policies and procedures of the person that employs the adviser that are designed to prevent conflicts of interest
- any business or personal relationship of the adviser with a compensation committee member and
- any stock of the issuer owned by the adviser.

³ On July 14, 2010, the SEC issued a concept release soliciting comments with respect to the proxy system, including shareholder voting, communications with beneficial owners and the alignment of voting power and economic interest. See SEC Release No. 34-62495 (Concept Release on the U.S. Proxy System) (July 14, 2010), available [here](#).

The independence factors to be determined by the SEC are required to be competitively neutral among categories of compensation consultants, legal counsel and other advisers.

Compensation consultant disclosure. Companies will have to disclose in their proxy statements whether their compensation committees retained a compensation consultant, whether the consultant's work raised any conflicts of interest and, if so, the nature of the conflict and how it was addressed.

Companies affected. The compensation committee independence requirements in Section 10C will affect companies with equity securities listed on a national securities exchange, with the exception of controlled companies, limited partnerships, companies in bankruptcy proceedings, open-ended management investment companies and foreign private issuers that annually disclose to their shareholders why they do not have an independent compensation committee. Controlled companies are automatically exempt from the other Section 10C requirements, and the national securities exchanges may exempt other companies, taking into account, among other things, burdens on smaller companies.

Implementation and effectiveness. Companies are required to include the compensation consultant disclosure required by Section 10C in proxy statements for annual shareholder meetings occurring one year after the date of enactment. The SEC, not later than 360 days after enactment, is required to direct national securities exchanges to prohibit the listing of any security of a company that does not comply with Section 10C.

Observations.

- The new compensation committee member independence requirements to be developed by the exchanges will likely be similar to those imposed on listed company audit committee members by the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act").
- While Section 10C(a) prohibits the listing of "equity securities" of companies that do not comply with the compensation committee independence requirements, Section 10C(f) prohibits the listing of "any security" of a company that fails to comply with any provision of Section 10C. In addition to imposing new requirements on companies with only non-equity securities listed on an

exchange, the inconsistency between Sections 10C(a) and 10C(f) raises the question as to whether non-equity securities may be listed on a national securities exchange if any member of a company's compensation committee is not independent.

Pay vs. Performance and Internal Pay Equity Disclosure

Pay vs. performance. Section 953 of the Dodd-Frank Act adds a new subsection (i) to Exchange Act Section 14 directing the SEC to adopt rules requiring companies to include in proxy statements for annual meetings a clear description of compensation required to be disclosed under Regulation S-K, Item 402. This disclosure would include the relationship between executive compensation actually paid and the company's financial performance.

Internal pay equity. Section 953 directs the SEC to amend Regulation S-K, Item 402 to require companies to disclose in any filings under the Securities Act of 1933, as amended (the "Securities Act"), and the Exchange Act, to the extent Item 402 disclosure is required, (a) the median annual total compensation of all company employees, excluding the chief executive officer, (b) the annual total compensation of the chief executive officer and (c) the ratio of the amounts in (a) and (b). Section 953 defines "total compensation" as the amount calculated in accordance with the method used to determine total compensation as shown in the Summary Compensation Table of the proxy statement.

Companies affected. Section 14(i) affects companies that are required to file proxy statements with the SEC. The new internal pay equity disclosure will be made in any Securities Act and Exchange Act filings requiring Regulation S-K, Item 402 disclosure, not just proxy statements.

Implementation and effectiveness. Section 953 of the Dodd-Frank Act directs the SEC to adopt pay vs. performance and internal pay equity disclosure rules, but does not establish a time frame for their adoption.

Observations.

- It is unclear as to whether "a clear description of any compensation required to be disclosed by the issuer" under Regulation S-K, Item 402 suggests that the SEC adopt additional disclosure requirements beyond what is already required by Item 402.

- For the internal pay equity disclosure, companies will be required to gather Summary Compensation Table data for each employee. This process for many companies will be complicated and time-consuming.

Clawbacks

Clawback policies. Section 954 of the Dodd-Frank Act adds a new Section 10D to the Exchange Act requiring the SEC to direct national securities exchanges and associations to prohibit the listing of any security of a company unless it has a policy for recovery of excess incentive-based compensation paid to current or former executive officers during the three years prior to the date on which the company is required to prepare an accounting restatement as a result of the company's material noncompliance with financial reporting requirements.

Companies affected. Section 10D will affect companies with any security listed on a national securities exchange.

Implementation and effectiveness. Section 954 of the Dodd-Frank Act requires the SEC to direct the national securities exchanges to prohibit the listing of any security of a company that does not comply with Section 10D, but does not provide a time frame for such rulemaking.

Observations.

- This provision is far more expansive than the existing clawback provisions in Section 304 of the Sarbanes-Oxley Act in that this new provision applies to all current and former executive officers, not just the CEO and CFO. It also covers a longer time frame – three years vs. one year – and applies to any restatement due to the company's material noncompliance with financial reporting requirements, not just a restatement due to misconduct.⁴
- Section 10D imposes the clawback policy requirement on companies with any debt or equity securities, not just common stock, listed on a national securities exchange.

⁴ See *Securities and Exchange Commission v. Maynard L. Jenkins*, No. CV-09-1510-PHX-GMS, 2010 U.S. Dist. LEXIS 57023 (D. Ariz., June 9, 2010) in which a U.S. district court denied defendant's motion to dismiss an action under Section 304 of the Sarbanes-Oxley Act to recover incentive-based compensation, despite the SEC's failure to allege that Mr. Jenkins was responsible for the "misconduct" that led to the accounting restatement.

- Section 10D does not contain language exempting, or authorizing the SEC to exempt, any company, including foreign private issuers, from its requirements.

Hedging

Hedging by employees, directors and designees. Section 955 of the Dodd-Frank Act adds a new subsection (j) to Exchange Act Section 14 requiring the SEC to adopt rules requiring companies to disclose in proxy statements for annual meetings whether any employee, director or designee may hedge ownership of the company's equity securities.

Companies affected. Section 14(j) affects companies that are required to file proxy statements with the SEC.

Implementation and effectiveness. Section 955 requires the SEC to adopt rules, but does not establish a time frame for their adoption.

Observations.

- Although some companies disclose that their executive officers or directors are subject to anti-hedging policies, Section 955 goes further by requiring such disclosure also with respect to employees and designees.
- Section 955 does not require companies to disclose actual hedging transactions.

Covered Financial Institution Risk Committees and Compensation Arrangements

Risk Committees. Section 165(h) of the Dodd-Frank Act requires the Federal Reserve Board to issue regulations requiring certain public nonbank financial companies and bank holding companies to establish a risk committee. Risk committees are required to:

- be responsible for oversight of the company's enterprise-wide risk management practices
- include such number of independent directors as the Federal Reserve Board may deem appropriate based on the company's nature of operations, size of assets and other appropriate criteria and

- include at least one risk management expert with experience identifying, assessing and managing risk exposures of large, complex firms.

Compensation arrangements. Section 956 of the Dodd-Frank Act directs federal regulators jointly to require enhanced disclosure of incentive-based compensation offered by covered financial institutions and to prohibit incentive-based compensation that encourages inappropriate risks by providing compensation to employees, directors or principal shareholders that is excessive or could lead to material financial loss.

Companies affected. The risk committee requirements in Section 165 apply to public companies that are either nonbank financial companies supervised by the Federal Reserve Board or bank holding companies with assets of not less than \$10 billion. Section 165(h) permits the Federal Reserve Board to determine whether publicly traded bank holding companies with assets of less than \$10 billion should be required to establish risk committees.

“Covered financial institution,” for purposes of Section 956, is broadly defined and may be expanded by the federal regulators. Covered financial institutions with assets of less than \$1 billion are exempt from the requirements of Section 956.

Implementation and effectiveness. Section 165(h) requires the Federal Reserve Board to issue final rules implementing the risk committee requirements not later than one year after the date that certain bank regulatory functions are transferred under Section 311 of the Dodd-Frank Act, to become effective not later than 15 months after such transfer date. Public nonbank financial companies supervised by the Federal Reserve Board have one year from receipt of a notice of final determination under Section 113(e)(3) of the Dodd-Frank Act to establish a risk committee.

Federal regulators must prescribe regulations implementing the enhanced disclosure requirements and the prohibition on incentive compensation described in Section 956 of the Dodd-Frank Act not later than nine months after enactment.

Broker Non-Votes

Broker non-votes. Section 957 of the Dodd-Frank Act adds paragraph (10)(A) to Exchange Act Section 6(b), which establishes conditions that securities exchanges must meet to be registered as a

“national securities exchange” with the SEC. Section 6(b)(10)(A) prohibits discretionary voting by brokers:

- in the election of directors⁵
- on executive compensation and
- on any other significant matters determined by the SEC.

Implementation and effectiveness. Section 957 would prohibit a securities exchange from being registered as a “national securities exchange” with the SEC if the exchange does not adopt a rule prohibiting discretionary voting by brokers on the matters described in Exchange Act Section 6(b)(10)(A). Section 957 does not establish a time frame for the rulemaking required to comply with Section 6(b)(10)(A).

Observation.

- It is unclear whether the prohibition relating to voting on executive compensation is limited to the non-binding shareholder votes described under Section 951 of the Dodd-Frank Act.

Corporate Governance Provisions

Proxy Access

Proxy Access. Section 971 of the Dodd-Frank Act adds new paragraph (2) to Exchange Act Section 14(a), which authorizes, but does not require, the SEC to adopt proxy access rules, including rules for implementation and eligibility. Proxy access refers to the ability of shareholders to include their director candidates in the company’s proxy materials.

Companies affected. The SEC is specifically authorized to exempt companies from any proxy access rules taking into account, among other things, burdens on smaller companies.

⁵ On July 1, 2009, the SEC approved an amendment to New York Stock Exchange Rule 452, which became effective January 1, 2010, that prohibits discretionary broker voting in the election of directors. SEC Release No. 34-60215 (Self-Regulatory Organizations; New York Stock Exchange LLC; Order Approving Proposed Rule Change, as Modified by Amendment No. 4, To Amend NYSE Rule 452 and Corresponding Listed Company Manual Section 402.08 To Eliminate Broker Discretionary Voting for the Election of Directors, Except for Companies Registered Under the Investment Company Act of 1940, and To Codify Two Previously Published Interpretations That Do Not Permit Broker Discretionary Voting for Material Amendments to Investment Advisory Contracts With an Investment Company) is available [here](#).

Implementation and effectiveness. The SEC's authority to adopt proxy access rules will be effective on the date of enactment. Based on statements by SEC Chairman Mary Schapiro, final rules on proxy access are expected to be in effect for the 2011 proxy season.

Disclosures Regarding Chairman and CEO Structures

Chairman/CEO disclosure. Section 972 of the Dodd-Frank Act adds a new Section 14B to the Exchange Act directing the SEC to issue rules requiring companies to disclose in proxy statements for annual meetings the reasons for combining or separating the chairman/CEO positions.

Companies affected. Section 14B affects companies that are required to file proxy statements with the SEC.

Implementation and effectiveness. Section 972 requires the SEC to issue rules requiring chairman/CEO disclosure not later than 180 days after enactment.

Observation.

- It is unclear what additional disclosure Section 14B is intended to elicit, as companies already are required by Regulation S-K, Item 407(h) to discuss the rationale for combining or separating the chairman/CEO positions.

Permanent Exemption for Non-accelerated Filers from Internal Control Auditor Attestation Report Requirements

Section 989G provides that non-accelerated filers will be permanently exempt from the requirement of Sarbanes-Oxley Act Section 404(b) to provide an auditor attestation report on the effectiveness of their internal control over financial reporting.

No Majority Vote Requirement

While the Senate version of the bill contained a majority vote requirement for the election of directors, the Dodd-Frank Act does not contain such a requirement.

Beneficial Ownership Reporting Provisions

Beneficial Ownership. Section 766 of the Dodd-Frank Act amends Exchange Act Section 13(d)(1) and Section 13(g)(1) to provide that a

person may become a beneficial owner through the purchase or sale of a security-based swap that the SEC may define by rule.

Section 766 also adds a new subsection (o) to Exchange Act Section 13 providing that, for purposes of Exchange Act Sections 13 and 16, a person is deemed to beneficially own an equity security as a result of the purchase or sale of a security-based swap to the extent the SEC determines that:

- the purchase or sale of the security-based swap provides incidents of ownership comparable to direct ownership of the equity security and
- it is necessary to deem the purchase or sale of the security-based swap as the acquisition of beneficial ownership of the underlying equity security to fulfill the purposes of the section.

Beneficial ownership reporting. Section 929R of the Dodd-Frank Act amends Exchange Act Section 13(d)(1) by authorizing the SEC to shorten the ten-day period in which greater than five percent beneficial owners must initially report their ownership of a company's equity securities to the SEC and no longer requiring these reports to be sent to the company or the national securities exchange on which the securities are traded.

Section 929R also amends Exchange Act Section 16(a) by authorizing the SEC to shorten the ten-day period in which greater than ten percent beneficial owners, directors and executive officers must file a Form 3 initial statement of beneficial ownership with the SEC and no longer requiring Section 16(a) reports to be submitted to the national securities exchange on which the securities are traded.

Implementation and effectiveness. The SEC's authority to determine which purchases and sales of security-based swaps will constitute acquisitions of beneficial ownership and to shorten the ten-day periods for filing initial ownership reports, as required by Exchange Act Sections 13(d)(1) and 16, will be effective on the date of enactment.

Foreign Private Issuers

Foreign private issuers are currently exempt from complying with the provisions of Exchange Act Sections 14(a), 14(b), 14(c), 14(f) and 16 pursuant to Exchange Act Rule 3a12-3(b). As the SEC adopts rules to implement the new requirements, it will presumably add new Exchange

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

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Act Sections 14(i), 14(j), 14A and 14B to Exchange Act Rule 3a12-3(b), and foreign private issuers will not be required to comply with provisions relating to say-on-pay, proxy access and proxy statement disclosure regarding executive compensation and pay vs. performance, compensation consultant conflicts of interest, hedging and chairman/CEO structures. However, Section 10D does not exempt, and does not authorize the SEC to exempt, foreign private issuers from the clawback policy requirement.

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