SOX Redux: Corporate Governance And the Dodd-Frank Act

Buried in the massive financial reform legislation signed into law in July, the Dodd-Frank Wall Street Reform and Consumer Protection Act, are a number of executive compensation and corporate governance provisions that affect virtually all U.S. publicly traded companies. The Dodd-Frank Act is second only to the Sarbanes-Oxley Act in the potential impact of its provisions in these areas.

This e-Alert summarizes the most important of the executive compensation and corporate governance provisions included in the Act. Most of these provisions are required to be implemented by regulation, with many key decisions left for SEC rule-making. (Many of the provisions exempt certain categories of issuers, such as small issuers or foreign issuers, or authorize the SEC to adopt such exemptions.)

Provisions Relating to Say on Pay

The following provisions are generally effective for the 2011 proxy season.

Say on Pay. The Act requires all companies subject to the proxy rules to hold a shareholder advisory vote on executive compensation. The vote must be on whether to approve the compensation of executives as disclosed in the proxy statement pursuant to Item 402 of Regulation S-K. The statute contemplates a single up or down vote on the compensation program as a whole, as disclosed in the proxy statement. The first vote is required to be held at the first annual meeting occurring after January 21, 2011.

- Although the vote is non-binding, proxy advisory firms such as ISS are likely to recommend votes against directors if the Company loses a Say on Pay vote and does not make significant changes to its executive compensation program.
- Under current SEC rules, including a Say on Pay proposal would require the Company to file a preliminary proxy statement at least 10 calendar days before filing the definitive proxy statement. We expect the SEC to issue guidance waiving this requirement (as it did for the analogous provision under the TARP legislation), but until such guidance is issued companies should allow for this extra step when planning next year's proxy timetable.
- To date, Say on Pay proposals (both those submitted voluntarily and those submitted under the TARP requirement) have overwhelmingly resulted in votes approving the compensation. However, on a going forward basis it may be more difficult to obtain approval as a result of the elimination of broker discretionary voting on this issue (as required under another provision of the Act).

Frequency of Say on Pay Vote. Shareholders must be given a separate vote as to whether subsequent Say on Pay votes will occur every one, two, or three years. The first such vote is required to be held at the 2011 annual meeting. Subsequent votes as to the frequency of Say on Pay votes must be held at least once every six years.

- There are many questions as to how this vote should be conducted, since it contemplates a choice of one of three alternatives rather than a simple Yes or No vote. Although the

Act does not require SEC rulemaking on this provision, we expect the SEC to issue guidance in this area.

Say on Golden Parachutes. The Act requires that any proxy materials for approval of an acquisition, merger, or sale of substantially all assets disclose, and give shareholders an advisory vote on, certain compensation arrangements. The proxy materials must disclose (i) any "agreements or understandings" with the named executive officers concerning any type of compensation "that is based on or otherwise relates to" the transaction and (ii) the aggregate total of all such compensation that may become payable to each named executive officer. The SEC is directed to issue regulations defining the scope of this disclosure. Shareholders voting on the transaction must be given a separate, non-binding vote on whether to approve the agreements, understandings, and compensation so disclosed. However, this separate vote is not required if the agreements or understandings have previously been subject to a general Say on Pay vote.

- Although the language is not clear, the provision seems intended to require target companies to hold an advisory vote on arrangements between their named executive officers and either the target or the acquiring company, and to require acquiring companies that are seeking shareholder approval of the transaction to hold an advisory vote on arrangements between the acquiring company and its own named executive officers.
- While arrangements entered into in contemplation of the transaction after the last Say on Pay vote (presumably including employment agreements with the acquiring company) would be subject to this additional vote, it is not clear whether the vote would also be required to cover, for example, routine equity awards granted since the last Say on Pay vote.
- It remains to be seen whether this provision will have any practical effect if shareholders vote against compensation paid by target companies (whose outside directors will presumably no longer be involved with the company after the transaction). For example, will shareholders "punish" directors of the acquiring company for allowing the target to pay such compensation?

Compensation Committees and Consultants

The Act provides that the following provisions are to be implemented through stock exchange listing standards. The SEC is directed to issue regulations within 360 days of enactment (by July 2011) requiring the stock exchanges to adopt the requisite listing standards. Depending on the timing of the SEC actions, these provisions might be applicable for the 2011 proxy season, but in any case will be applicable no later than the 2012 proxy season.

Independence of Compensation Committee. The mandated listing standards would require all compensation committee members to be independent and would adopt an additional, stricter independence standard for this purpose. The provision is modeled on an analogous provision in the Sarbanes-Oxley Act dealing with audit committee members under which a director is defined as not independent if he or she (i) receives <u>any</u> compensation from the Company or (ii) is affiliated with the Company or any of its subsidiaries or affiliates. The new provision regarding compensation committee members does not require that the director be automatically disqualified for these reasons, but instead requires the stock exchanges to create a definition of independence that considers the source of compensation of the committee member (including any fees paid by the Company), the affiliate status of the member, and other relevant factors.

The new listing standards must also provide that the compensation committee has sole discretion to retain, and is directly responsible for the appointment, compensation, and oversight of, a compensation consultant, independent legal counsel, and other advisers, and that the Company is required to provide appropriate funding for any such consultants and advisers retained by the committee. The Act expressly provides that the compensation committee is not required to follow the advice or recommendations of any such adviser, but is free to exercise its own judgment in making compensation determinations.

Independence of Compensation Consultants, Legal Counsel and Advisers. The SEC is required to identify factors that affect the independence of compensation consultants, legal counsel and other advisers to a compensation committee, and the committee is required to take these factors into account before selecting any of such advisers. The factors are required to be competitively neutral among categories of consultants (*i.e.*, so as not to favor either boutique or full-service firms). The SEC is required to include at least the following factors:

(1) other services provided to the Company by the entity that employs the compensation consultant, legal counsel or advisor;
(2) the percentage of the consulting entity's total revenue received from the Company;
(3) the policies and procedures of the consulting entity that are intended to prevent conflicts of interest;
(4) any business or personal relationship of the compensation consultant, legal counsel or other adviser with any member of the compensation committee; and
(5) any Company stock owned by the compensation consultant, legal counsel or other adviser.

- The first three of these factors appear to relate to the consulting entity, while the last two of the factors appear to relate to the individual directly providing the consulting services, but the SEC may well extend the scope of one or more of these factors to include both the entity and the individual.
- While the Act requires the compensation committee to take the "independence" factors into consideration when choosing a consultant or adviser, it does not limit the committee's choice to only those consultants that qualify as independent. We expect the SEC to require a compensation committee to confirm that it took the required factors into consideration and, if applicable, explain its reasons for selecting a consultant or adviser that does not satisfy all of the independence factors.

Additional Disclosure. Any proxy material for an annual meeting occurring on or after July 21, 2011 is required to disclose, in accordance with regulations to be adopted by the SEC, whether the compensation committee obtained advice from a compensation consultant, whether the work of the consultant raised any conflict of interest, and if so, the nature of the conflict and how it is being addressed.

New Executive Compensation Disclosures

The Act directs the SEC to adopt rules requiring the following additional disclosures. No deadline for this rulemaking is specified. Thus the effective date for these disclosures will be determined by the SEC.

Pay for Performance. The SEC is directed to adopt rules requiring proxy statements for annual meetings to disclose the relationship between executive compensation "actually paid" and the financial performance of the Company. The Act specifies that financial performance is to be determined taking into account any change in the value of the Company's shares and any dividends and distributions. The required disclosure "may include" a graph.

- Unlike the current performance graph, which compares the Company's performance to that of specified other companies, the new requirement appears to envision a comparison of the Company's performance to amounts of compensation paid to its executives.
- It remains to be seen whether the compensation element of this comparison will be required to be shown as a single total for the group of named executive officers or on a person-by-person basis.
- The SEC rules will need to interpret the requirement that the disclosure relate to

compensation "actually paid." For example, should stock options be taken into account at the time of grant, vesting, or exercise? How should deferred compensation or pension accruals be treated?

- The Act is silent regarding the time period over which the pay and performance are to be compared.

Pay Ratio Disclosure. The SEC is directed to amend Item 402 of Regulation S-K to require all proxy statements and most other Securities Act or Exchange Act filings to include disclosure of (i) the median annual total compensation of all employees other than the CEO; (ii) the annual total compensation of the CEO; and (iii) the ratio of these two amounts. For purposes of this disclosure "total compensation" is defined as total compensation shown in the Summary Compensation Table as in effect immediately before passage of the Act.

- SEC rules will need to define the employee group for which the median compensation is determined. For example, will it include part-time employees? Non-U.S. employees? Employees of less than 100%-owned subsidiaries?
- Determining the median "total compensation" is likely to be extremely burdensome for companies with multiple payroll systems, and will be particularly difficult if foreign employees need to be included.

Hedging Policy. The SEC is directed to adopt rules requiring proxy statement disclosure of whether the Company permits employees and directors to purchase financial instruments designed to hedge against declines in the price of Company stock. The Act expressly includes certain common hedging instruments within the scope of this provision, namely prepaid variable forward contracts, equity swaps, collars, and exchange funds, but this is not intended to be an exhaustive list. The disclosure is required to address hedging of both shares acquired as equity compensation and shares otherwise held by the employee or director.

- The provision does not require the Company to adopt such a policy, but merely to disclose whether or not it has one.

Clawbacks

The Act provides that the following provisions are to be implemented through stock exchange listing standards. The SEC is directed to issue rules requiring the stock exchanges to adopt the requisite listing standards, but the Act sets no deadline for these rules.

Adoption of Clawback Policy. Listed companies will be required to adopt and implement a clawback policy. The policy must apply in the event the Company is required to prepare an accounting restatement due to "material noncompliance" with any financial reporting requirement. It must provide for recovery by the Company from any current or former executive officer of any "incentive-based compensation" received by the officer during the three-year period preceding the date on which a restatement is required, to the extent that the amount received exceeds the amount that would have been payable under the financial statements as restated.

- It is not clear how broadly "incentive-based compensation" will be defined. The Act specifies that it includes "stock options awarded as compensation" but it is not clear whether this is intended to pick up all stock options or only those issued or vesting upon achievement of performance goals. Similarly, how will the clawback rules apply to discretionary bonuses? In addition, it is not clear what must be returned if a stock option has already been exercised and the shares sold.
- It is also not clear when a restatement is "required." There would seem to be an element of discretion on the part of the Company, at least with respect to the timing of such a determination.
- This provision is significantly broader than the clawback provision in the Sarbanes-

Oxley Act in that it applies whether or not the restatement is due to misconduct. In addition, the Company is made directly responsible for enforcing the clawback policy, whereas the SOX provision has been interpreted as being enforceable only by the SEC.

- The Act does not repeal the SOX clawback provision, under which the amount to be clawed back from the CEO and CFO is any bonus or incentive-based or equity-based compensation received, and any profits from the sale of Company securities realized, during the 12 months after public issuance of the erroneous financial statements. Thus it is possible that in egregious situations both clawback provisions could be applied.

Disclosure of Incentive Pay Policy. The listing standards are to require each listed company to disclose its policy regarding incentive-based compensation based on financial information required to be reported under the securities laws. No details are provided in the Act.

- It is not clear whether this provision is merely intended to require disclosure of the Company's clawback policy or whether something more is contemplated.

Discretionary Voting by Brokers

The Act requires all U.S. stock exchanges to prohibit voting of shares held in street name without instructions from the beneficial owner in any vote with respect to election of directors or executive compensation, and authorizes the SEC or an individual stock exchange to extend the scope of this prohibition to other matters. The provision has no stated effective date. Even if effective immediately upon enactment, presumably the SEC will issue transition guidance for implementation.

- The substance of this provision already applies to election of directors and approval of equity plans as a result of NYSE rules. The Act extends this policy to the various Say on Pay matters required by the Act.

- Since this provision is directed at conduct by brokers who are members of a stock exchange, it will affect all companies that have some of their shares held in street name, regardless of whether the Company is itself listed on an exchange.

Special Incentive Compensation Provisions for Financial Institutions

The Act requires the SEC and various financial institution regulators to jointly adopt regulations or guidance imposing additional restrictions on incentive compensation of specified financial institutions with assets of at least $1 billion. The financial institutions subject to these requirements include depository institutions and depository institution holding companies, broker-dealers, credit unions, investment advisers, and any other financial institution determined appropriate by the regulators. The deadline for adoption of these regulations or guidance is April 2011.

Disclosure. The regulations or guidance will require each covered financial institution to disclose to its federal regulator sufficient information about the structure of its incentive compensation arrangements for executive officers, employees, directors, and principal shareholders to enable the regulator to determine whether the compensation structure (i) provides "excessive compensation, fees, or benefits" or (ii) "could lead to material financial loss" to the institution. Reporting of actual amounts of compensation of particular individuals is not required under this provision.

Prohibition. The joint regulations or guidance are also required to prohibit any types of incentive-based payment arrangements or features of such arrangements that the regulators determine encourage inappropriate risks (i) by providing excessive compensation, fees, or benefits, or (ii) that could lead to material financial loss to the institution.

Standards established under these provisions are required to be comparable to, and take into consideration, the standards for compensation established under the Federal Deposit Insurance Act.

Other Provisions

Proxy Access. The Act expressly authorizes the SEC to issue rules governing proxy access (*i.e.*, making the Company's proxy solicitation materials available for shareholder nominations for director) and gives the SEC wide latitude in prescribing applicable procedures. SEC Chairman Mary Shapiro has stated that she expects the Commission will issue proxy access rules in time for the 2011 proxy season.

Disclosure Regarding Board Structure. The Act requires the SEC to issue rules (by January 17, 2011) that require annual meeting proxy statements to disclose whether the same person or different individuals serve as chairman of the board and chief executive officer, and the reason for the structure chosen. This provision seems to merely make permanent the disclosure requirement already adopted by the SEC.

For more information about the executive compensation and corporate governance provisions of the Dodd-Frank Act or Hughes Hubbard's executive compensation and corporate governance practices, please contact any of the following attorneys:

Gloria W. Nusbacher
(212) 837-6719
nusbache@hugheshubbard.com

Ellen S. Friedenberg
(212) 837-6465
frieden@hugheshubbard.com

Gary J. Simon
(212) 837-6770
simon@hugheshubbard.com

Spencer L. Harrison
(212) 837-6858
harrison@hugheshubbard.com

Bruce N. Goldberger
(212) 837-6781
goldberger@hugheshubbard.com

John K. Hoyns
(212) 837-6762
hoyns@hugheshubbard.com

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Corporate Governance Practice
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Hughes
Critical matters. Critical thinking.®
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Hughes Hubbard & Reed LLP
One Battery Park Plaza | New York, New York 10004-1482 | 212-837-6000