AKIN GUMP
STRAUSS HAUER & FELD LLP

Corporate Alert

What Every Public Company Needs to Know About the Impact of the Financial Reform Legislation on Corporate Governance and Executive Compensation

July 16, 2010

On July 15, 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), which President Obama is expected to sign into law next week. While the legislation is focused primarily on overhauling the U.S. financial regulatory system, the Act contains several provisions that will have a major impact on public companies. The key corporate governance and executive compensation provisions of the Act are summarized in the chart below and then addressed in greater detail in the discussion that follows.

Summary of Key Corporate Governance and Executive Compensation Provisions

Proxy Access	Authorizes, but does not require, the Securities and Exchange Commission (SEC) to issue rules requiring an issuer to include shareholder nominees in its proxy materials. The SEC is expected to adopt rules before the 2011 proxy season.
Discretionary Voting	Requires national securities exchanges to prohibit discretionary voting by brokers with respect to the election of directors, executive compensation and any other significant matter, as determined by the SEC.
Credit Rating Agency Disclosures Subject to Regulation FD	Requires the SEC to amend Regulation FD to remove the exemption for disclosures to credit rating agencies. The SEC must act within 90 days after enactment of the Act.
Say-on-Pay	Gives shareholders a nonbinding vote on executive compensation at least once every three years and a nonbinding vote at least once every six years to determine the frequency of the say-on-pay vote. Both votes must be held at the first shareholder meeting occurring more than six months after enactment of the Act.
Shareholder Vote on Golden Parachutes	Gives shareholders a nonbinding vote on golden parachute arrangements when shareholder approval is sought for a merger or sale of the company, unless such arrangements were previously subject to a say-on-pay vote. Applies to shareholder meetings occurring six months after enactment of the Act.

www.twitter.com/akin_gump

Compensation Committees	***Independence of Committees.*** Requires compensation committee members to be independent. When determining a director's independence, issuers must also look at the sources of compensation of the director, as well as whether the director is affiliated with the issuer. ***Independence of Advisers.*** Prior to selecting a compensation consultant, legal counsel or other adviser, the compensation committee must consider certain factors that affect the independence of such adviser. ***Authority Relating to Advisers.*** Compensation committees must have authority to retain or obtain the advice of an adviser and be directly responsible for the appointment, compensation and oversight of the adviser. The SEC must adopt rules within 360 days after enactment of the Act.
Executive Compensation – Pay Versus Performance Disclosure	Requires proxy statement disclosure regarding the relationship between executive compensation actually paid and the financial performance of the issuer. The Act does not set a deadline for SEC implementation of this provision.
Executive Compensation – Pay Equity Disclosure	Requires proxy statement disclosure on the median annual total compensation of all employees, the annual total compensation of the CEO and the ratio of these two amounts. The Act does not set a deadline for SEC implementation of this provision.
Clawbacks	Effectively requires issuers to develop and disclose clawback policies for the recovery of incentive-based compensation granted to any current or former executive officer based on erroneous data that is corrected in an accounting restatement. The Act does not set a deadline for SEC implementation of this provision.
Disclosure Regarding Employee and Director Hedging	Requires issuers to disclose whether employees or directors are permitted to purchase financial instruments designed to hedge any decrease in market value of the issuer's securities. The Act does not set a deadline for SEC implementation of this provision.
Whistleblower Incentives and Protections	Requires the SEC, in any successful enforcement action resulting in monetary sanctions exceeding $1 million, to pay whistleblowers between 10 and 30 percent of the collected amount. Also prohibits employers from retaliating or discriminating against whistleblowers and provides such individuals with a private cause of action against employers who do so. The SEC must adopt regulations within 270 days after enactment of the Act, but a whistleblower who provides information after enactment of the Act and before the effective date of the regulations may still receive payment.

Discussion

Spurred by the financial crisis that beset U.S. and world financial markets beginning in 2007, the Act creates new standards for banks and Wall Street firms and regulates a wide range of activities in an attempt to prevent or mitigate another crisis. The sweeping financial reform legislation includes provisions relating to, among other things, systemic risk, investment advisers, bank regulation, derivatives, winding-up of non-banks, investor protection, credit rating agencies, corporate governance, executive compensation and consumer financial protection. Although the earlier House and Senate bills contained provisions requiring companies to adopt a majority voting standard in uncontested director elections, such provision was not included in the Act.

This alert focuses on the corporate governance and executive compensation features of the legislation.[1] Although the scope of the new provisions varies, as a general matter these provisions apply to public companies listed on a national securities exchange in the United States and/or subject to federal proxy rules.

CORPORATE GOVERNANCE

Proxy Access

The legislation provides the SEC with authority to adopt proxy access rules. Specifically, the legislation gives the SEC explicit authority to issue rules permitting shareholders to use the issuer's proxy solicitation materials for the purpose of nominating individuals to the board, under such terms and conditions as the SEC determines are in the interests of shareholders and for the protection of investors. The legislation allows the SEC to exempt an issuer or class of issuers from these requirements, particularly if the SEC determines the requirements disproportionately burden small issuers. This section of the legislation becomes effective one day after enactment of the Act.

The SEC already considered it had authority to adopt proxy access, but some market participants and commentators took the position that adopting proxy access would exceed the authority of the SEC. The legislation removes any doubt in this regard. As far as proxy access is concerned, the legislation shifts the focus back to the SEC, where proposed rules on proxy access (Securities Exchange Act Release Nos. 34-60089 and 34-61161) remain pending. It is highly likely that the SEC will adopt some version of proxy access prior to the 2011 proxy season. The Act did not, however, reflect an earlier version of draft legislation that would have *required* the SEC to adopt proxy access rules.

Discretionary Voting

The legislation, through rules of the national securities exchanges, will prohibit discretionary voting by brokers with respect to the election of directors, executive compensation and any other significant matter, as determined by the SEC. Specifically, any member of a national securities exchange that is not the beneficial owner of a security registered under Section 12 of the Securities Exchange Act of 1934 ("Exchange Act") will be prohibited from granting a proxy to vote such security on the specified matters unless the beneficial owner has instructed the member to vote the proxy in accordance with the voting instructions of the beneficial owner. The legislation does not prohibit a national securities exchange from prohibiting discretionary voting on additional matters (i.e., areas other than those specified above). The new provision extends and builds upon Rule 452 of the New York Stock Exchange (NYSE), which was amended effective January 2010 to eliminate discretionary voting in uncontested director elections by all NYSE member firms.[2] Further, although NYSE Rule 452 also already prohibits broker discretionary voting on equity compensation plans and on shareholder proposals, the Act appears to expand the rules to prohibit broker-discretionary voting on management say-on-pay proposals.

This provision operates through an amendment to the Exchange Act providing that an exchange may not be registered as a national securities exchange unless the SEC determines that the rules of the exchange reflect the provisions described above. This provision becomes effective immediately upon enactment of the Act, although the stock exchanges have not yet amended their rules, and the SEC has not yet identified any matters in addition to the election of directors and executive compensation on which brokers may not vote at their discretion.

---

[1] This client alert summarizes the key corporate governance and executive compensation provisions of the Act that are generally applicable to public companies, but does not discuss additional provisions in the Act that may affect certain public companies. Among other things, the Act contains provisions requiring board committee approval of certain swaps prior to using an exemption for the clearing of swaps and requiring increased disclosure for certain issuers that (a) use certain minerals sourced from the Democratic Republic of Congo and its adjoining countries, (b) operate coal or other mines or (c) are engaged in the commercial development of oil, natural gas or minerals. In addition, the Act contains provisions that may affect certain financial institutions and bank holding companies by (a) prohibiting covered financial institutions from providing incentive-based payment arrangements that could encourage inappropriate risks and (b) requiring certain nonbank financial companies and bank holding companies to establish risk committees.

[2] Please refer to our July 2, 2009 client alert, "SEC Approves Rule Change Eliminating Broker Discretionary Voting for Election of Directors."

Relief for Non-Accelerated Filers from Section 404(b) of Sarbanes-Oxley Act

The legislation amends Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) to exempt smaller issuers from the requirement in Section 404(b) of SOX to provide an auditor's attestation concerning the report by management on internal control over financial reporting required by Section 404(a) of SOX. Section 404(b) will not apply with respect to any audit report prepared for an issuer that is neither a "large accelerated filer" nor an "accelerated filer" as defined in Rule 12b-2 of the Exchange Act.

Chairman/CEO Structure

The legislation calls for the SEC to issue rules requiring issuers to disclose in their annual proxy statement the reasons why they have chosen either to combine or separate the positions of CEO and chairman of the board. While the SEC must issue rules implementing this section within 180 days after enactment of the Act, the SEC already requires issuers to make this disclosure in their annual proxy statements.[3]

Credit Rating Agency Disclosures Subject to Regulation FD

The Act requires the SEC to revise Regulation FD to remove from such regulation the exemption for entities whose primary business is the issuance of credit ratings. Currently, disclosures by issuers and other covered persons to nationally recognized statistical rating organizations and to credit rating agencies that make their credit ratings publicly available are exempt from Regulation FD where the disclosures are made solely for the purpose of determining or monitoring a credit rating. The SEC must act within 90 days after enactment of the Act. This provision is part of the Act's comprehensive reform of the credit rating process that will require, among other things, rating agencies to disclose publicly their rating methodology and a description of data about an issuer relied upon in the rating process.

It is not clear how this provision of the Act will be implemented. Regulation FD currently covers disclosures only to certain designated market participants and to security holders. Even if the express exemption for disclosures to credit rating agencies is removed, it remains to be seen whether rating agencies will become one of the designated market participants to whom a disclosure triggers Regulation FD. Also, in view of the Act's new public disclosure requirements for credit rating agencies, it is unclear whether disclosures to a credit rating agency could qualify for the separate exemption from Regulation FD for disclosures to recipients who agree to maintain the information in confidence.

ACCOUNTABILITY AND EXECUTIVE COMPENSATION

Shareholder Approval of Executive Compensation

Say-on-Pay. The legislation requires that, at least every three years, a proxy statement in which compensation disclosure is required under SEC rules—typically the proxy statement for the annual meeting—shall include a resolution allowing for a shareholder vote on executive compensation, or "say-on-pay." Further, at least once every six years, such proxy statement shall include a separate resolution allowing for a shareholder vote to determine whether the say-on-pay votes will occur every one, two or three years. An issuer must include both resolutions in the proxy statement for the first shareholder meeting held more than six months after the date of enactment of the Act. Thus, the provision will be effective for meetings held during the 2011 proxy season.

Golden Parachute Compensation. The legislation also requires that any proxy solicitation material for a shareholder meeting 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 an issuer must disclose any agreements or understandings with any named executive officer of the issuer (or of the acquiring issuer, if such issuer is not the acquiring issuer) 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 (and the conditions upon which it may) be paid or become payable to, or on behalf of, such executive officer. The legislation also requires any proxy relating to the foregoing to include a separate resolution allowing for a shareholder vote to

[3] Item 407(h) of Regulation S-K. Please refer to our December 22, 2009 client alert, "SEC Adopts Changes to Executive Compensation and Corporate Governance Disclosure Rules."

approve such agreements or understandings and compensation as disclosed, unless they have been subject to a say-on-pay vote as discussed above. The provision applies to shareholder meetings occurring more than six months after the Act's enactment.

Disclosure of Voting by Institutional Investors. The legislation requires every institutional investment manager subject to Section 13(f) of the Exchange Act to report at least annually how it voted on any say-on-pay or golden parachute compensation as discussed above.

The shareholder votes discussed above will not bind the issuer or the board and do not override any decision by the issuer or the board. Nor will the shareholder votes be construed to create or imply any change to the fiduciary duties of the issuer or board or create or imply any additional fiduciary duties for the issuer or board. Furthermore, the Act provides that the shareholder votes will not restrict or limit the ability of shareholders to submit proposals for inclusion in proxy materials relating to executive compensation. The SEC is given authority to exempt an issuer or class of issuers from either or both of the shareholder votes discussed above. The Act provides that, in determining whether to grant an exemption, the SEC must consider, among other things, whether the voting provisions disproportionately impact small issuers.

The new shareholder approval requirements on executive compensation represent the culmination of many years of pressure by institutional investors and shareholder activists for a greater role in approving executive compensation. Although the shareholder vote will be nonbinding, it will nonetheless put pressure on issuers that will not want to suffer adverse publicity associated with a negative vote on compensation.

Compensation Committees

The legislation requires the SEC to adopt rules augmenting the independence and power of compensation committees. The SEC's rules, which must be adopted within 360 days after enactment of the Act, must direct the national securities exchanges and national securities associations[4] to prohibit the listing of any equity securities of an issuer (subject to certain exceptions)[5] that does not comply with the subject provisions.

Independence of Compensation Committees. The SEC's rules must require that each member of the compensation committee be an "independent" director. In determining the meaning of "independence," the national securities exchanges and national securities associations must consider certain relevant factors, including: (a) sources of compensation of the director, including any consulting, advisory or other compensatory fee paid by the issuer to the director and (b) whether the director is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer. An exchange may exempt a particular relationship from the independence requirements as it deems appropriate, taking into consideration the issuer's size and other relevant factors.

Issuers listed on the NYSE are already required to have a compensation committee composed solely of independent directors make determinations on executive compensation. Similarly, issuers listed on the Nasdaq Stock Market are required to have either a compensation committee composed solely of independent directors or a majority of the independent directors make determinations on executive compensation. The Act will now require issuers, when determining a director's independence, to also look at the source of compensation of the director (in addition to the amount) and whether the director is affiliated with

[4] Currently, FINRA is the only registered national securities association, and it does not list securities. Accordingly, as a practical matter, this provision and analogous provisions in the legislation will be implemented through the exchanges rather than by securities associations.

[5] The following types of issuers are exempt from the Act's requirements regarding compensation committees: controlled companies (defined as an issuer that holds an election for the board of directors in which more than 50 percent of the voting power is held by an individual, a group or another issuer), limited partnerships, companies in bankruptcy, open-ended management investment companies registered under the Investment Company Act of 1940 and foreign private issuers that provide annual disclosures to shareholders of the reasons the foreign private issuer does not have an independent compensation committee.

the issuer. As such, a director could potentially be disqualified from serving on the compensation committee if the director beneficially owns a significant amount of securities of the issuer.[6]

Independence of Compensation Committee Advisers. The compensation committee of an issuer may only select a compensation consultant, legal counsel or other adviser ("Adviser") to the committee after taking into consideration certain factors, to be identified by the SEC, that affect the independence of the Adviser. These factors must be competitively neutral among categories of consultants, legal counsel and other advisers and preserve the ability of compensation committees to retain the services of members of any such category. These factors shall include, without limitation—

- 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 employer's total revenue
- the policies and procedures of the employer of the Adviser that are designed to prevent conflicts of interest
- any business or personal relationship of the Adviser with a member of the compensation committee
- any stock of the issuer owned by the Adviser.

Compensation Committee Authority Relating to Advisers. The compensation committee must have the authority, in its sole discretion, to retain or obtain the advice of an Adviser. The committee will be directly responsible for the appointment, compensation and oversight of the work of such Adviser. The committee is not, however, required to implement or act consistently with the advice or recommendations of the Adviser, and nothing in this provision affects the committee's ability or obligation to exercise its own judgment in fulfillment of its duties. In any proxy solicitation materials for an annual shareholder meeting occurring on or after one year following enactment of the Act, the issuer must disclose, in accordance with SEC regulations, (a) whether the committee retained or obtained the advice of a compensation consultant and (b) whether the work of the consultant raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed. The issuer will be required to provide appropriate funding for payment of reasonable compensation to the Adviser(s) serving the compensation committee.

The SEC has already begun to address the independence of compensation consultants by requiring issuers to disclose in their annual proxy statements certain information regarding compensation consultants, including details on compensation services, as well as any other services, provided to the issuer by such consultants.[7] The Act, however, will likely place more pressure on issuers to avoid engaging compensation consultants whose independence could be questioned.

SEC Rules. The legislation requires the SEC, within 360 days after enactment of the Act, to direct the national securities exchanges and associations to prohibit the listing of any security of an issuer (other than exempt issuers as noted above) that is not in compliance with the requirements relating to compensation committees discussed above. The issuer, however, must have a reasonable opportunity to cure any defects. Also, the national securities exchanges and associations are permitted to exempt categories of issuers from these requirements as they determine appropriate. In this regard, the exchanges must take into account the potential impact of the compensation committee independence rules on smaller reporting issuers.

Executive Compensation Disclosures

Pay Versus Performance Disclosure. The legislation calls for the SEC to require issuers to disclose, in annual meeting proxy solicitation materials, a "clear description" of any compensation that is required to be disclosed by the issuer under Item 402 of Regulation S-K. Compliance with Item 402 is, of course, already required by SEC rules. The legislation, however,

---

[6] The independence requirement under the Act closely tracks the independence standard imposed on audit committee members under the Sarbanes-Oxley Act. In implementing the audit committee standard, the SEC created a safe harbor that provides that a person will not be deemed to be in control of an issuer where the person is not an executive officer and does not own more than 10 percent of any voting securities of the issuer. It remains to be seen whether the SEC and the stock exchanges will adopt the same standards for compensation committee members.

[7] Item 407(e) of Regulation S-K. Please refer to our December 22, 2009 client alert, "SEC Adopts Changes to Executive Compensation and Corporate Governance Disclosure Rules."

requires the SEC to expand Item 402 disclosure to encompass information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions. A graphic representation of this information may be required.[8]

Pay Equity Disclosure. The legislation further directs the SEC to require disclosure of—

- the median of the annual total compensation of all employees of the issuer, except its chief executive officer (CEO)
- the annual total compensation of the CEO
- the ratio of the median employee compensation (less CEO compensation) to CEO compensation.

This disclosure would be required in filings described in Item 10(a) of Regulation S-K, which includes proxy statements, annual reports, prospectuses and specified other SEC documents. The Act provides that the "total compensation" of employees shall be calculated in the same manner as that for named executive officers under Item 402(c)(2)(x) of Regulation S-K, which may require substantial effort on the part of issuers to determine.

The legislation calls upon the SEC to adopt rules implementing this section, but does not set a deadline for doing so.

Clawbacks

The legislation calls for the SEC to require issuers to develop and implement a policy providing (a) for disclosure of the issuer's policy on incentive-based compensation that is based on financial information required to be reported under the securities laws and (b) that, in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the three-year period preceding the restatement based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement. The SEC must direct the national securities exchanges and associations to prohibit the listing of any security of an issuer that does not comply with this section. The legislation does not set a deadline for these rules.

This provision is broader than the clawback provision in the Sarbanes-Oxley Act (§ 304), which applies only to the CEO and CFO, has only a one-year look-back and requires misconduct.

Disclosure Regarding Employee and Director Hedging

The legislation calls for the SEC to require issuers to disclose in their annual meeting proxy materials whether any employee or board member (or any designee of an 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 equity securities that are either granted to the employee or director as compensation or held, directly or indirectly, by the employee or director. The legislation does not set a deadline for these rules.

Whistleblower Incentives and Protection

The legislation provides monetary incentives to individuals who provide information relating to a violation of the securities laws to the SEC, as well as additional protections for such individuals. Specifically, if a whistleblower voluntarily provides original information[9] to the SEC that leads to a successful enforcement of a judicial or administrative action brought by the SEC or certain other regulatory agencies that results in monetary sanctions exceeding $1 million, the SEC shall pay the

[8] If the SEC does require such a graph, it would differ from the graph specified in Item 201(e) of Regulation S-K, which compares shareholder return to certain other performance indicators.

[9] Pursuant to the Act, "original information" means information that is derived from the independent knowledge or analysis of the whistleblower, is not known to the SEC from any other source, unless the whistleblower is the original source of the information and is not exclusively derived from an allegation made in a judicial or administrative hearing, in a government report, hearing, audit or investigation, or from the news media, unless the whistleblower is a source of the information.

whistleblower an amount between 10 and 30 percent of what has been collected of the monetary sanctions. In determining the actual amount of the award, the SEC must take into consideration, among other things, the significance of the information and the degree of the assistance provided by the whistleblower and any other relevant factors the SEC may establish. The awards will be paid from an Investor Protection Fund to be established in the U.S. Treasury that will be funded with monetary sanctions from SEC cases that are not otherwise distributed. Companies should expect these monetary incentives to motivate an increasing number of individuals to report potential violations to the SEC.

The legislation also provides additional protections for whistleblowers by prohibiting employers from retaliating or otherwise discriminating against a whistleblower in the terms and conditions of employment because of any lawful act done by the whistleblower. Further, the legislation provides for a private cause of action by a person who alleges retaliation or discrimination in violation of the above, allowing for relief that includes reinstatement with the same seniority, two times the amount of back pay owed to the individual and compensation for litigation and expert fees. The statute of limitations for such action is six years after the date on which the violation occurred, or three years from the date when facts material to the action are known or reasonably should have been known by the employee alleging the violation. In no event may an action be brought more than 10 years after the date of the violation.

The legislation requires the SEC to issue final regulations implementing these whistleblower provisions within 270 days after enactment of the Act, but information provided to the SEC after enactment of the Act may still be considered "original information" even if provided prior to the effective date of the regulations.

CONTACT INFORMATION

If you have any questions regarding this alert, please contact —

N. Kathleen Friday
kfriday@akingump.com
214.969.2827
Dallas

Julie M. Kaufer
jkaufer@akingump.com
310.728.3313
Los Angeles

J. Kenneth Menges Jr.
kmenges@akingump.com
214.969.2783
Dallas

Ackneil M. Muldrow III
tmuldrow@akingump.com
212.872.1064
New York

Samuel Wolff
swolff@akingump.com
202.887.4462
Washington, D.C.

