

Corporate Finance and Securities and Employee Benefits Client Service Groups

To: Our Clients and Friends

July 22, 2010

President Signs Sweeping Financial Reform Bill: What Our Non-Bank Public Companies Need to Know Now

Yesterday, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) (for a copy of the Act, click [here](#)), passed by Congress late last week. Included in this reform legislation - aimed primarily at the reform of *financial institutions* - are provisions that will apply to all publicly traded companies, including provisions relating to "say on pay" shareholder votes, proxy access, executive compensation disclosure and compensation committees. Some of these provisions are effective immediately. Most will become effective only upon rule-making by the Securities and Exchange Commission (SEC or the Commission). These provisions are summarized below.

"Say on Pay" and Golden Parachutes (Section 951)

The Act requires that shareholders be given the opportunity - at least once every three years - to approve the compensation paid to the CEO, the CFO and the other named executive officers as disclosed pursuant to Item 402. In addition, shareholders must be given the opportunity - at least once every six years - to vote on whether this "say-on-pay" vote will occur every one year, two years or three years.

Public companies must include shareholder resolutions on both of these matters in the proxy statement for the first shareholder meeting held after January 21, 2011 - the six-month anniversary of the enactment of the Act. This means that these provisions will be effective for the 2011 proxy season.

The Act provides that the shareholder votes relating to the say-on-pay matters must be set out in separate proposals and will be non-binding. A "rule of construction" set out in the Act provides that the votes will not be construed as overruling a board decision or creating or implying any change or addition to directors' fiduciary duties.

In addition, in any proxy or consent solicitation in connection with a shareholder vote on an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all of the

assets of a company, the Act requires the soliciting public company to provide disclosure of compensation payments triggered by the transaction, referred to as golden parachute payments, which may be made to its named executive officers. Then, in a separate resolution in that proxy statement, the issuer must provide shareholders with the opportunity to approve those golden parachute payments, unless the golden parachute payments were previously approved by the shareholders. Like the say-on-pay provisions, the golden parachute payment disclosure and approval provisions are applicable to shareholder meetings occurring after January 21, 2011.

Compensation Committee Independence (Section 952)

New “Independence” Standard for Compensation Committee Members. The Act directs the SEC to adopt rules to ensure the independence of the compensation committees of all public companies. Most public companies already comply with the independence standards put in place by the exchanges, so members of those compensation committees are independent. The current exchange rules, however, do not require compensation committee members to meet any specific independence standards such as are imposed on members of audit committees. The Dodd-Frank Act will require exchanges to prohibit the listing of any security of any issuer that does not have an independent compensation committee as determined under the standards set out in the Act.

Specifically, the new SEC rules must require that exchanges consider as relevant for determining compensation committee independence the following factors:

- The source of compensation of the director, including any consulting, advisory or other “compensatory fee” paid by the company to the director, and
- Whether the director is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.

The SEC must adopt these rules within 360 days of enactment (by July 16, 2011).

Compensation Committee Consultants and Advisors. The Act requires compensation committees to select consultants, counsel or other advisors only after taking into account independence factors to be established by the SEC. The Act goes on to provide that the SEC shall identify factors that affect such independence, including:

- whether the proposed consultant, counsel or advisor provides other services to the company;
- the amount of fees received by the proposed consultant, counsel or advisor as a percentage of the total revenue of that person;
- the policies and procedures of the proposed consultant, counsel or advisor designed to prevent conflicts of interest;
- any business or personal relationship of the proposed consultant, counsel or advisor with any member of the compensation committee; and
- any stock of the company owned by the proposed consultant, counsel or advisor.

The Act further provides that compensation committees may, in their sole discretion, retain or obtain the advice of a compensation consultant, independent legal counsel or other advisors and shall be directly responsible for the hiring, compensation and oversight of such persons. For all shareholder meetings occurring after July 21, 2011, proxy materials must disclose whether the compensation committee retained or obtained the advice of a compensation consultant, whether the work of that consultant raised any conflict of interest and, if so, the nature of the conflict and how it was addressed. Companies will be required to provide appropriate funding, as determined by the committee, to provide reasonable compensation to the consultants, independent legal counsel or other advisors selected by the compensation committee.

The SEC must adopt these rules within 360 days of enactment (by July 16, 2011).

Executive Compensation Disclosures (Section 953)

The Dodd-Frank Act imposes two new executive compensation disclosures:

Pay vs. Performance Disclosure. First, Section 953 requires that the SEC expand Item 402 of Regulation S-K to include information showing the relationship between executive compensation paid and the “financial performance of the issuer,” which must take into account changes in the company’s stock price and any dividends or distributions. It is unclear whether this is simply a return to inclusion of the stock performance graph in the proxy statement or whether more disclosure is intended.

Comparison of CEO Compensation to Employee “Median” Compensation. The Act also requires the SEC to amend Item 402 to require disclosure of the “median of the annual total compensation of all employees of the issuer” (except the CEO) and the ratio of the amount of such median compensation to the CEO’s total compensation. The Act specifies that total compensation of an employee is to be determined in the same manner used to calculate total compensation for the summary compensation table. This requirement may require substantial effort on the part of companies.

The Act does not set a deadline for the SEC to adopt these rule changes.

Compensation “Clawbacks” (Section 954)

The Act requires the SEC to adopt rules requiring public companies to develop and implement policies on disclosure of incentive-based compensation tied to financial information and, in the event of a restatement due to material financial reporting noncompliance, for recovery from any current or former executive officer who received incentive-based compensation in excess of what he or she should have received based on the corrected financial information. The statute provides for a three-year lookback of incentive compensation from the date on which the issuer is required to prepare the restatement.

A similar clawback provision already exists by virtue of the Sarbanes-Oxley Act of 2002. The Sarbanes clawback, however, applies only to CEOs and CFOs who were engaged in the misconduct relating to the erroneous financial reporting and has a lookback of only one year.

Proxy Access (Section 971)

The Act gives the SEC authority to prescribe rules to require an issuer to include in its proxy solicitation materials shareholder nominees for election to the issuer's board. This should put to rest the recent rancorous debate over whether the Commission has the authority to adopt its proposed "proxy access" rules. Thus, any such rules would not be subject to judicial attack on that basis. The Act provides that the SEC may impose such terms and conditions that it deems to be in the interests of shareholders and for the protection of investors. The SEC also may exempt an issuer or class of issuers from any proxy access requirements.

Limitation of Broker Discretionary Voting (Section 957)

The Act, through rules to be adopted by the national securities exchanges, will prohibit discretionary voting by brokers with respect to the election of directors (already the case under current NYSE rules), executive compensation and "any other significant matter as determined by the Commission, by rule." As a practical matter, it does not appear as though this statutory prohibition will limit discretionary voting beyond current rules, but it does make clear that the non-binding say-on-pay votes will not be eligible for discretionary broker voting.

Other Required Proxy Disclosures

Director and Employee Hedging (Section 955). The Act requires the SEC to adopt rules requiring issuers to disclose in their annual meeting proxy statements whether any employee or director (or any designee of any employee or director) is permitted under company policy to engage in hedging transactions relating to equity securities granted to the employee or director as part of his or her compensation or otherwise held by the employee or director (presumably, regardless of how the employee or director came to hold the securities).

The Act does not set a deadline for the SEC to adopt these rule changes.

Chairman and CEO Offices (Section 972). The Act requires the SEC to issue rules within 180 days of the effective date requiring disclosure in annual proxy statements the reasons the issuer has chosen to combine or separate the positions of chairman of the board and chief executive officer. The SEC had already amended its rules to require this disclosure prior to the Act's enactment. In fact, existing SEC rules also require issuers to disclose whether they have a lead independent director if they have combined the offices of chairman and CEO.

Revisions to Regulation D

New "Bad Boy" Disqualification (Section 926). The Act directs the SEC to adopt regulations within one year of the effective date that would disqualify certain offers and sales of securities from eligibility to utilize Regulation 506, the exemption under Regulation D available for private placements in any amount. The disqualifications would cover any offer or sale "by any person" who --

(1) is subject to a final order by state securities commissions or certain financial regulatory authorities that

- bar the person from (i) association with certain regulated entities, (ii) engaging in the business of securities, insurance or banking, or (iii) engaging in savings association or credit union activities, or
- constitutes a final order relating to certain anti-fraud prohibitions within the past ten years, or

(2) has been convicted of a felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the SEC.

Changes to Accredited Investor Standard (Section 413). The SEC has been directed to adjust the net worth standard for “accredited investor” status, so that the individual net worth of any natural person, or joint net worth with his or her spouse, exceeds \$1 million *excluding* the value of the accredited investor’s primary residence. The SEC has been directed to review the standard to determine whether adjustments are needed for the protection of investors, in the public interest and in light of the economy, within four years after enactment, and not less frequently than every four years thereafter. This provision of the Act appears to be effective immediately, so issuers should review their subscription and disclosure documents to ensure compliance with this provision.

Rating Agencies (Sections 939B and 939G)

In a subtitle of the Act labeled “Improvements to the Regulation of Credit Rating Agencies,” Congress set out provisions purporting to enhance the regulation and accountability of credit rating organizations. Included in this subtitle are two provisions of immediate relevance to public companies, which Congress stated were intended to reduce reliance on rating agencies and address the way agencies gather information on which their ratings are predicated:

Elimination of Rule 436(g). The Act provides that effective immediately, Rule 436(g) under the Securities Act will have no force or effect. This rule provided that credit ratings assigned by a nationally recognized statistical rating organization were not considered a part of a registration statement prepared or certified by an expert and thus no consent of such rating organizations were required to be included in Securities Act registration statements. Immediate elimination of Rule 436(g) has caused all the major rating agencies to issue statements that issuers may not include their ratings in prospectuses or registration statements because the agencies are unwilling to concede “expert” status, provide consents, and be exposed to “expert” liability under Section 11 of the Securities Act. We expect SEC staff guidance to ameliorate the immediate effect of this provision of the Act such that currently effective registration statements and ongoing offerings will not be adversely affected. The SEC staff has already given guidance that no action is needed for existing registration statements if (i) no ratings are included in any future 10-Qs or 10-Ks (other than disclosure-related information), and (ii) no ratings information is included in any newly filed prospectus or prospectus supplement. Disclosure-related information consists of changes to a credit rating, the liquidity of the registrant, the cost of funds for a registrant or the terms of agreements that refer to credit ratings.

Elimination of Exemption for Rating Agencies under Reg FD. In addition, the Act directs the Commission, within 90 days of enactment of the Act, to revise Regulation FD to remove the exemption for credit rating agencies. This means that public companies risk violating Regulation FD if material nonpublic information is shared with the credit rating agencies in connection with rating activities.

Corporate Social Responsibility Mandate (Section 1502)

The Act imposes a new diligence and disclosure requirement on public companies that manufacture or trade in products using certain “conflict minerals” originating in the Democratic Republic of Congo (DRC). These minerals are typically refined to become gold, tin, tantalum or tungsten and are in components used in a wide variety of consumer and industrial electronics. The stated intent of the provisions was to limit sources of funding available to armed militias operating in and around the DRC.

Within 270 days of enactment of the Act, the SEC must issue rules requiring “covered persons” (presumably the SEC could include all public companies) to annually disclose to the SEC and on their websites:

- whether conflict minerals that were “necessary to the functionality or production of a product manufactured” by the covered person originated in the DRC or an adjoining country; and
- a report that includes, among other things, a description of measures taken to exercise “due diligence on the source and chain of custody” of conflict minerals and a description of any products manufactured or contracted to be manufactured that are “not DRC conflict free”.

The Act does not establish the exact parameters of applicability (i.e., the scope of “covered persons”), nor does it define what is meant by “necessary to functionality or production” of a manufactured product. It is unclear how companies can satisfy themselves that their supply chain diligence is sufficient. We expect the proposed SEC rules will address these and other issues. It would appear that manufacturers of consumer electronic goods, and those companies in the supply chain of such manufacturers, may need to establish internal procedures to address these new requirements.

Permanent Exemption of Non-Accelerated Filers from 404(b) (Section 989G)

The Act codifies the current SEC position with respect to compliance by non-accelerated filers with the auditor attestation requirements of Section 404(b) of the Sarbanes-Oxley Act. Under the Act, 404(b) shall not apply to public companies that are neither “large accelerated filers” nor “accelerated filers”. This means all companies with a public float of \$75 million or less will not be required to provide auditor attestation of management’s report on internal control over financial reporting.

Litigation and Enforcement Implications of the Act

Although beyond the scope of this client alert, the Act contains provisions relating to enforcement and securities litigation. These will be addressed in greater detail in subsequent Bryan Cave alerts. We believe, however, that public companies should be aware of the following which are included in the legislation:

- Enhancements to whistleblower incentives and protections (§ 922), which may encourage employees to report borderline issues to authorities. These whistleblower incentives include payment to the whistleblower of between 10 and 30 percent of monetary sanctions exceeding \$1 million.

- The lowering of the standard for “aiding and abetting” liability from “knowing and substantial” assistance to “knowing or reckless and substantial” assistance (§ 929 O). This may have the effect of encouraging the SEC to pursue marginal actions against companies or individuals who potentially may have assisted a violation. (The Act also mandates a GAO study of the benefits and detriments of enabling private rights of action for aiding and abetting violations. Such a study could be a basis for legislative attempts, within the next few years, to overturn the long-standing prohibition of such actions established by *Central Bank of Denver* and other cases.)
- Empowerment of the SEC to seek and obtain monetary penalties in administrative proceedings against entities and individuals who are not registered with the Commission, e.g. public companies that are not registered as broker-dealers or investment advisors (§ 929 P). There is a perception that administrative proceedings - unlike actions in federal district court - provide the SEC with a “home-court advantage.” Previously, the Commission would have had to file an action in district court in order to seek monetary penalties against a public company.
- The mandating of more rigorous deadlines for the completion of enforcement actions, which may cause the SEC Staff to be less flexible than it is currently in accommodating scheduling requests (§ 929 U).
- Enhancements to federal sentencing guidelines in matters involving financial fraud and the extension of the federal statute of limitations for securities actions (including actions by the SEC seeking monetary penalties) from 5 to 6 years (§ 1079 A).

As is true of other aspects of the Act, the broad parameters of the enforcement and litigation provisions will be clarified by subsequent agency rulemaking.

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