Cooley

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On July 15, 2010, the Senate approved the **Dodd-Frank Wall Street Reform and Consumer Protection Act**, following House approval on June 30, 2010. President Obama is expected to sign the Act into law the week of July 19th. The Act broadly targets many of the perceived root causes of the near collapse of the financial system that began in 2007 through a combination of financial regulatory reform, consumer and investor protection measures and regulation of the derivatives markets. The corporate governance and executive compensation-related provisions of the Act were adopted against the same backdrop of financial crisis, largely in reaction to the public's railing against the levels of compensation paid to some corporate executives despite poor performance by their firms, especially where those firms were viewed as contributors to the crisis itself. Although these provisions received relatively little media focus and public attention in the debate surrounding adoption of the Act, they address a number of highly controversial issues, such as say on pay and proxy access, that have been the center of battles among business interests, shareholder activists, legislators and regulators for almost a decade. Much like the Sarbanes-Oxley Act of 2002, many of these provisions promise to have a significant impact on public companies in all industries.

This *Alert* addresses the Act's executive compensation and corporate governance provisions. For the most part, the Act is not prescriptive with regard to these requirements, leaving much of the heavy lifting to subsequent rulemaking by the Securities and Exchange Commission and the national securities exchanges and associations. As a result, we will have to wait until implementing rules and regulations are adopted to gain a full understanding of the scope and complexity of the requirements. It is important to recognize that the SEC and the exchanges could implement these rules and regulations substantially sooner than required by the Act and, as a matter of good corporate practice, it may make sense for companies to comply with some provisions of the Act in advance of their effectiveness.

This *Alert* summarizes the key executive compensation and corporate governance provisions of the Act as follows:

- Proxy access
- Say on pay
- Say on golden parachutes
- Discretionary voting by brokers
- Compensation committee independence
- Compensation committee consultants and advisers
- Disclosure regarding pay for performance
- Disclosure regarding internal pay equity
- Recovery of erroneously awarded compensation policy (clawback policy)
- Exemption from SOX 404(b) for non-accelerated filers
- Disclosure regarding employee and director hedging
- Disclosure regarding board leadership structure

This *Alert* also provides commentary and recommendations for actions companies may want to take in response to or in preparation for the new requirements.

Proxy access (Section 971)

The most controversial corporate governance provision to survive in the Act probably is the section addressing so-called "proxy access," that is, the requirement for a company to include director nominees submitted by its shareholders in its proxy solicitation materials. Activist shareholders and others have long complained that procedures to nominate directors currently available to shareholders, such as waging a costly proxy contest, do not afford a practical mechanism for shareholders to hold directors accountable or to participate effectively in the nomination process. Proxy access has been advocated by these shareholders as a way to remove impediments under the federal proxy rules to their abilities to exercise their fundamental rights under state corporate law to nominate and elect directors. The business community has opposed proxy access since the concept first emerged, maintaining that proxy access would allow directors representing only a single interest group with a narrow agenda to win seats on boards, focusing primarily on achieving these groups' narrow goals rather than representing the interests of the entire shareholder base. Business interests have also contended that proxy access could deter other qualified candidates who prefer to avoid contested elections and that the presence of a shareholder-nominated director could disrupt the functioning of the board and even lead the company to take steps, such as a quick sale of the company, that would not otherwise be taken and may not reflect the long-term interests of shareholders overall.

The Act amends Section 14 of the Securities Exchange Act of 1934 to authorize the SEC to require proxy access. Notably, the legislation retrenches slightly on the provision included in the initial version of the Senate bill by *authorizing* the SEC to issue proxy-access regulations but not *mandating* it. A proposal had been floated in conference providing that the only shareholders entitled to submit nominees would be those meeting a minimum 5% share ownership threshold with a two-year minimum holding period requirement. Ultimately, however, the Act leaves open the issues of share ownership thresholds and minimum holding periods, giving the SEC wide latitude to structure the rule's framework. The Act also expressly allows the SEC to exempt issuers or classes of issuers, taking into account, among other considerations, whether the requirements of proxy access would be disproportionately burdensome on small issuers.

Recommendations and commentary

- Contested elections conducted using proxy access can be expected to feature many of the same techniques as are employed in today's election contests, with the attendant fight letters, roadshows and other campaign tactics. As a result, proxy access campaigns could absorb as much management time and involve as much or more company resources to defend incumbent directors as do election contests under current rules. However, one difference from a traditional election contest is that both slates will appear on a single proxy card (and be described in a single proxy statement), which will make it easier for shareholders to split their votes to include dissident shareholder nominees than in a traditional election contest in which shareholders choose between two proxy cards with completely different slates. Accordingly, it may be even easier for shareholders to make changes to the composition of the board. Anticipating these issues, companies will want to look for opportunities to enhance their efforts to foster good shareholder relations and make sure they are carried out on a year-round basis, not just during proxy season. It will also behoove companies to make sure they understand the voting profiles of their large and institutional shareholders. In addition, while current SEC proxy rules require a fairly extensive discussion of the qualifications of nominees, companies that want to retain the current composition of their boards will want to frame these disclosures in a manner designed to persuade vacillating shareholders that the incumbent directors are the most qualified and best suited to continue on their boards. We also expect that companies will be vying with even greater intensity for the approval of proxy advisory firms, the influence of which is sure to be enhanced.
- The SEC debated whether to institute proxy access in 2003 and 2007, but no rules were adopted. Fueled by concerns stemming from the economic crisis, in 2009, the SEC again introduced proxy access to make, in the words of SEC Chair Mary Schapiro, "boards more accountable for the risks undertaken by the companies they manage." Interestingly, the earlier versions of proxy access proposed by the SEC could be viewed as more favorable to the business community than the one the SEC put on the table in 2009 (requiring, for example, higher ownership thresholds or the occurrence of specific triggering events). However, Ms. Schapiro has indicated that the SEC wants "to ensure that any procedural requirements for access are rational, and not a means

to thwart effective investor participation."

- The SEC's 2009 proposal would require a shareholder desiring to nominate a director using the company's proxy to meet tiered beneficial ownership thresholds based on the company's market capitalization, from 1% for the largest companies to 5% for the smallest. In addition, the shareholder would be required to have beneficially owned the securities used to satisfy the ownership threshold continuously for at least one year and represent that it intends to continue to own those securities through the date of the meeting. The SEC's 2009 proposal also spells out complex procedural requirements to be followed by companies and nominating shareholders, including limitations on the maximum number of shareholder-nominees. Where more than one shareholder or group would be eligible to have its nominees included in the company's proxy statement, the nominees would be included on a first-in basis, a feature of the proposal that has drawn fire because of its potential to create a rush to the ballot box.
- If proxy access is ultimately adopted by the SEC, whether any or all of the provisions in the SEC's 2009 proposal survive in the final rules, or whether the SEC will take the Congressional hint regarding an exemption for smaller issuers, remains to be seen. Nevertheless, companies may want to examine their shareholder bases in light of the terms of the most recent proposal to determine whether there are any shareholders or potential groups of shareholders that may exceed the applicable thresholds and are likely—whether because of previously expressed concerns, portents of an agenda that differs from current management's, a past history of activism at other companies or other indicia—to pursue the new nomination mechanism. We recommend that companies not wait until a nominee has been submitted; identifying these shareholders early may present opportunities to address possible concerns in advance and potentially to deflect the nomination of dissident candidates.

Say on pay (Section 951)

A non-binding shareholder vote to approve executive compensation, commonly referred to as "say on pay," is probably the most anticipated compensation-related provision in the Act. The Act adds a new Section 14A to the Exchange Act requiring that, when a public company solicits any consent, proxy or authorization for an annual or other shareholder meeting that requires compensation disclosure, the company must also submit, at least once every three years, a separate resolution for non-binding shareholder approval of the compensation of its named executive officers disclosed in the proxy materials pursuant to Item 402 of Regulation S-K. (Under Item 402, the "named executive officers" generally include the chief executive officer, the chief financial officer and the three other most highly compensated executives.) Item 402 covers compensation discussion and analysis (subject to certain exceptions for smaller reporting companies), the compensation tables and related narrative disclosure, all of which will be the subject of the say-on-pay resolutions. The Act clarifies that the non-binding nature of the say-on-pay vote means that it may not be construed to overrule a decision by the company or its board of directors or to create or imply any change to the fiduciary duties or any new fiduciary duties of the company or its board of directors.

The less anticipated aspects of the say-on-pay provisions in the Act are the frequency requirements—beginning with meetings occurring after the six-month anniversary of the date the Act is signed by the President, a vote must be held at least once every three years (not necessarily annually), and, at least once every six years, shareholders must be given the right to determine whether the say-on-pay vote will occur every one, two or three years. Both of these votes are required in the first year of say on pay. These requirements came as a surprise because both the House and Senate bills had called for annual say-on-pay votes.

No SEC rulemaking is expressly required pursuant to the Act, but the Act gives the SEC authority to exempt an issuer or class of issuers from this requirement after taking into account, among other considerations, whether the requirement disproportionately burdens small issuers.

Recommendations and commentary

- Shareholder advocates have indicated that say on pay is intended to encourage better communication between companies and their shareholders and to hold compensation committees accountable for their decisions. We recommend proactively soliciting

feedback from shareholders *before* the say-on-pay vote in time to address any concerns expressed that might help avoid a negative result and *after* the say-on-pay vote if majority support is not obtained. We also recommend that compensation committees be mindful of common shareholder concerns when structuring and setting executive compensation.

- Companies have employed a variety of strategies for engaging significant shareholders in dialogue (historically, both in connection with and in lieu of say-on-pay votes), including meetings with significant shareholders, surveys soliciting shareholders' views on executive compensation matters, shareholder feedback forums or shareholder working groups formed to advise the compensation committee on executive compensation decisions. Companies that are considering adopting any of these strategies should implement policies and procedures intended to avoid Regulation FD violations in this context, such as pre-clearing limitations on discussion topics with the shareholder, having company counsel participate in the meeting or requiring the shareholder to expressly agree to maintain the disclosed information in confidence.
- Support for say-on-pay proposals submitted by companies participating in the Troubled Asset Relief Program (which were required to submit say-on-pay proposals to their shareholders) as well as for those voluntarily submitted by companies not subject to the TARP requirement has been overwhelmingly high. It has been reported that during 2009 and the first part of 2010, support for say-on-pay proposals has averaged approximately 90%. However, earlier this year, Motorola, Inc. became the first U.S. company to fail to obtain majority support for a say-on-pay proposal, followed by company losses at Occidental Petroleum Corp. and KeyCorp. That said, many commentators believe that say on pay is an evolutionary process and that shareholders will eventually develop procedures to meaningfully evaluate these proposals and vote accordingly. Whether the first three failed proposals indicate the beginning of a trend is still an open question.
- Despite the non-binding nature of say-on-pay proposals, companies wanting to maintain good relationships with their shareholders will likely take these votes seriously. A negative vote on a say-on-pay proposal indicates only general dissatisfaction with a company's executive compensation practices, but does not identify the shareholders' specific objections. Companies may want to follow up with significant shareholders if majority approval is not obtained to understand and respond appropriately to the objections. The three companies whose say-on-pay proposals have so far failed to obtain majority support may create precedent this year regarding the actions they decide to take (and not take) in response to the signals sent by their shareholders. To the extent that shareholders are not satisfied with a company's response to a negative vote, they may next decide to withhold their votes for members of the compensation committee in subsequent years.
- As further described below, the new prohibition on broker discretionary voting for these proposals will probably magnify the influence of proxy advisory firms. Most proxy advisory firms already have policies regarding say-on-pay vote recommendations. Historically, when analyzing say-on-pay proposals to make vote recommendations, Institutional Shareholder Services, or ISS, has taken a variety of factors into account, such as pay for performance, problematic pay practices and board communication and responsiveness. ISS and Glass Lewis typically express dissatisfaction with a company's executive compensation practices by first recommending a vote against a say-on-pay proposal that may be on the ballot, followed by recommendations in a subsequent year to withhold votes from compensation committee members (or potentially the entire board) if the compensation committee fails to respond to concerns regarding unsatisfactory executive compensation practices.
- Although the frequency of the say-on-pay vote will, in the end, be determined by each company's shareholders, companies may want to advocate triennial votes to discourage short-term thinking and to allow shareholders adequate time to thoughtfully evaluate the effects of executive compensation programs on long-term corporate performance. If shareholders ultimately adopt a biennial or triennial vote requirement, companies may have the opportunity to strategize regarding the timing of the submission to shareholders of other compensation-related proposals (for example, equity plan proposals) vis-à-vis say-on-pay proposals. Alternatively, if shareholders adopt an annual vote requirement, companies may want to consider submitting the frequency proposal to shareholders again in less than six years; while the Act requires that the issue of frequency be submitted to shareholders at least once every six years, it does not prohibit more frequent submission.
- Even though the SEC is not required to do so, it may well decide to issue regulations regarding the nature and extent of additional disclosure, if any, required in say-on-pay proposals. Any such regulations will need to be issued fairly quickly in light of the upcoming deadline for companies to submit say-on-pay proposals to their shareholders. If the requirements imposed by the SEC for TARP participants are any indication, we can expect that the SEC will not prescribe any specific form of resolution and that proxy statements containing say-on-pay proposals will not be required to be filed with the SEC in preliminary form. Notably, no small TARP participants were exempt from say on pay; the SEC instead simply clarified that the say-on-pay vote would be limited to compensation as disclosed under the scaled disclosure requirements of Regulation S-K. In this instance (unlike in the TARP legislation), Congress has expressly authorized the SEC to take into account the potential burden on small issuers, and

the SEC may well determine that the burdens here are too great.

Say on golden parachutes (Section 951)

Newly added Section 14A of the Exchange Act also requires that, in any proxy or consent solicitation material in which a proposal for an acquisition, merger, consolidation or sale or other disposition of all or substantially all the assets of a company is submitted to shareholders, the person making the solicitation must include in the materials additional disclosure regarding executive compensation agreements or understandings related to the proposed change-in-control transaction. In addition, the soliciting person must submit for non-binding shareholder approval a resolution approving those agreements or understandings and the compensation as disclosed. These non-binding votes are referred to as "say-on-parachute" proposals. The disclosure and say-on-parachute proposals will be required to be included in proxy or consent solicitation materials for meetings of shareholders held after the six-month anniversary of the date the Act is signed by the President.

More specifically, the Act requires disclosure of any agreements or understandings that the soliciting person—typically, the target company or the acquiring company—has with named executive officers concerning any type of compensation (whether present, deferred or contingent) that is "based on or otherwise relates to" the change-in-control transaction and the aggregate amount of all such compensation that may (and the conditions upon which it may) be paid or become payable to or on behalf of each named executive officer. The Act specifies that the disclosure should be in a clear and simple form in accordance with rules to be adopted by the SEC. No deadline is imposed for the SEC's adoption of the new disclosure rules, but we expect the SEC will act quickly in light of the upcoming deadline for companies to comply with the new rules.

Under the Act, a say-on-parachute resolution is not required to be submitted to a shareholder vote if the parachute agreements or understandings have already been subject to a say-on-pay vote. As with say-on-pay votes, the say-on-parachute votes are non-binding and may not be construed to overrule a decision by the company or its board of directors or create or imply any change or addition to the fiduciary duties of the company or its board. Likewise, the Act gives the SEC authority to exempt an issuer or class of issuers from these requirements.

Recommendations and commentary

- The rationale for parachute compensation is typically to align the interests of management with those of shareholders so that, for example, executives considering takeover proposals are not distracted by personal concerns over job retention and instead are able to focus on achieving results that are in the best interests of shareholders. However, many shareholders and shareholder advocates feel that the *size* of parachute compensation has escalated to unacceptable levels, recently resulting in the submission by shareholders of a number of proposals seeking to require companies to submit say-on-parachute resolutions to shareholder votes. Reportedly, although far fewer say-on-parachute proposals have been submitted by shareholders compared to say-on-pay proposals, say-on-parachute proposals have recently received greater shareholder support.
- The question remains whether shareholder votes on parachutes will have any impact on change-in-control transactions or on the approval of those transactions. In most cases, executives will already be entitled to the compensation submitted to shareholders for approval and, unlike with say on pay, companies will not easily be able to address shareholder discontent by making changes in future years or by modifying existing contractual commitments unilaterally: presumably, few executives would be willing to forfeit compensation to which they are entitled because of the results of a non-binding say-on-parachute vote. The incentives of each party to make or resist making the parachute payments in the face of a potential negative shareholder vote is a dynamic that may well affect whether or how parachute payments are discussed during transaction negotiations.
- The precise application of the exception for agreements or understandings that have already been subject to a shareholder vote will require further interpretation. For example, it is unclear whether the exception will be available if the *type* of compensation was described in a prior say-on-pay vote, but the *amount* subject to the prior vote differed from the amount that will actually be paid as a result of the specific transaction.

- The nature and extent of the compensation that must be submitted to shareholders for approval is similarly vague. The language in the Act requiring disclosure of and a vote on any "agreements or understandings" seems to suggest that any potential payments are covered, including payments under agreements that have not yet been finalized.

Discretionary voting by brokers (Section 957)

The Act imposes, through the exchanges, a prohibition on voting by brokers of proxies in the absence of instruction by the beneficial owners as to how to vote on specified matters. So-called "discretionary voting" will now be proscribed in connection with the election of board members and proposals related to executive compensation. In addition, the Act gives authority to the SEC to identify any other "significant" matter with regard to which discretionary voting should be precluded. This bar on discretionary voting will apply only to those classes of securities registered under Section 12 of the Exchange Act.

Recommendations and commentary

- The Report by the Senate Committee on Banking, Housing and Urban Affairs on the Senate bill indicates that the provision was intended to ensure that the final vote tallies reflect the wishes of the beneficial owners of shares and are not affected by the wishes of the brokers that hold the shares.
- It remains to be seen whether the SEC will eliminate discretionary voting for any other matters under the Act's new authorization to include any other "significant" matter. In 2006, an NYSE Proxy Working Group recommended that the NYSE evaluate in the future whether there was any need to allow broker discretionary voting at all, keeping in mind the critical role of broker voting in helping issuers to achieve quorums for shareholders' meetings. The SEC may well take up that cudgel, although it has given no indication that it intends to do so.
- This expansion of the prohibition on discretionary voting by brokers will probably have its greatest impact in connection with the new say-on-pay and say-on-parachute votes, discussed above. Discretionary voting by brokers in connection with proposals regarding approval of equity compensation plans has been prohibited since 2003 and, after several years of controversy, discretionary voting in the election of directors was finally prohibited for shareholders' meetings beginning in 2010.
- All of these changes eliminating broker discretionary voting will be a boon to proxy solicitors and a growing expense to companies that find they need to engage them more regularly. Although say-on-pay and say-on-parachute votes will be non-binding, failure to win a favorable vote may well have a persuasive effect on boards of directors and their compensation committees, as discussed above.
- With the experience of the elimination of discretionary voting in the election of directors for this year's proxy season, companies will be better positioned to evaluate the potential impact of the elimination of discretionary voting in other contexts. Some commentators have noted that, despite concerns regarding potential negative consequences, the actual impact of elimination of discretionary voting in the election of directors this year was not as great as anticipated. Nevertheless, companies may still want to consider taking additional steps to encourage favorable votes, such as sending one or more reminder notices and engaging a proxy solicitor to make calls to NOBOs (non-objecting beneficial owners) or registered shareholders to encourage them to vote or to have them submit their votes through "televoting." (In televoting, the proxy solicitor will confirm that the shareholder has received and reviewed the proxy materials and, if so, wants to vote. The solicitor can then record the vote over the phone, send the record to the transfer agent, Broadridge or other vote processing service provider, and send a written confirmation of the vote to the shareholder with instructions as to how the shareholder can contact the solicitor prior to the meeting date to change the vote or to correct an error in how the vote was recorded.)

Compensation committee independence (Section 952)

The Act adds a new Section 10C to the Exchange Act aimed at promoting the independence of compensation committees and

requires the SEC to establish rules directing the exchanges to prohibit the listing of any securities of a company unless each member of the company's compensation committee is an "independent" member of the company's board of directors. The Act does not expressly define independence, but instead requires that, in developing a definition, the exchanges *consider* relevant factors including (i) the source of compensation of a board member, including any consulting, advisory or other compensatory fees paid by the company to such director and (ii) whether the board member is affiliated with the company, its subsidiaries or affiliates of its subsidiaries.

The SEC is required to establish the rules governing the provisions of this section no later than 360 days after the Act is signed by the President. The Act requires that companies have a reasonable opportunity to cure any defects that would be the basis for the prohibition of the listing of their securities before such securities are delisted. The Act also expressly exempts certain companies, such as controlled companies, and authorizes the exchanges to exempt particular relationships and categories of issuers from these requirements, as they determine to be appropriate, taking into account the potential impact of these requirements on smaller reporting issuers and other relevant factors. The Act does not contain a deadline for action by the exchanges, although it is anticipated that the SEC's rules will likely impose such a deadline.

Recommendations and commentary

- The requirement that all members of the compensation committee be independent could have a significant impact on the composition of compensation committees, depending on how "independence" is ultimately defined. The factors required to be considered by the exchanges in defining "independence" are similar to those imposed on audit committee members by Section 10A(m)(3) of the Exchange Act and related Rule 10A-3—audit committee members cannot accept *any* consulting, advisory or other compensatory fees from the company nor can an audit committee member be an affiliate of the company or any of its subsidiaries. However, for audit committee members, the Sarbanes-Oxley Act of 2002, commonly referred to as "SOX," mandated the elements of the definition, but for compensation committee members, the Act simply requires the exchanges to consider these factors in defining "independence." If the SEC or the exchanges ultimately adopt the same standards for compensation committee members as currently apply to audit committee members, companies may need to reevaluate the composition of their committees.
- Each of the Internal Revenue Code, the securities laws and the exchange rules has established its own standard for director independence: Internal Revenue Code Section 162(m) has a definition of outside director, Section 16 of the Exchange Act has a definition of non-employee director and NASDAQ and NYSE have differing definitions of independent director. In addition, most proxy advisory firms have their own definitions of independence and related vote recommendation policies. The multiplicity of independence standards may make it difficult for companies to evaluate the composition of their compensation committees in light of potentially conflicting definitions.

Compensation committee consultants and advisers (Section 952)

The new Section 10C of the Exchange Act also addresses the independence of compensation consultants, legal counsel and other advisers to the compensation committee, as well as the authority of the compensation committee to engage them. The Act requires the SEC to establish rules, no later than 360 days after the date the Act is signed by the President, directing the exchanges to prohibit the listing of any security of an issuer that is not in compliance with the provisions of this new section. As with compensation committee independence, the SEC's rules must permit the exchanges to exempt categories of issuers from these requirements, as they determine to be appropriate, taking into account the potential impact of these requirements on smaller reporting issuers and other relevant factors. Again, no deadline for action by the exchanges is imposed by the Act and thus it is anticipated that the SEC's rules will likely impose a deadline on the exchanges.

The Act provides that a listed company's compensation committee may, in its sole discretion, obtain the advice of compensation consultants, independent legal counsel and other advisers and that it is directly responsible for the advisers' appointment,

compensation and oversight. Additionally, the Act makes clear that a compensation committee must exercise its own judgment in fulfillment of its duties and is not required to implement or act consistently with the advice or recommendations of a compensation consultant, legal or other adviser. The Act also provides that each listed company must provide appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to a compensation consultant, independent legal counsel or any other adviser to the compensation committee.

Under the Act, in selecting compensation consultants, independent legal counsel or other advisers, compensation committees of listed companies must take into consideration factors to be identified by the SEC that affect the independence of consultants, counsel and other advisers, including the following, among any others:

- other services provided to the company by the consulting, law or other advisory firm;
- the amount of fees paid by the company with respect to these services as a percentage of total revenue of the consulting, law or other advisory firm;
- policies and procedures implemented by the consulting, law or other advisory firm designed to prevent conflicts of interest;
- business or personal relationships of the consultant, counsel or other adviser with any member of the compensation committee; and
- any company stock owned by the consultant, counsel or other adviser.

The Act requires that the factors identified by the SEC be competitively neutral among categories of consultants, legal counsel or other advisers and preserve the ability of compensation committees to retain the services of members of any such category. While the Act requires compensation committees to consider these factors when engaging advisers, it does not mandate disqualification of an adviser in the event any of these criteria are not satisfied.

Under the Act, each listed company will be required to disclose, in any proxy or consent solicitation materials for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting) occurring on or after one year after the Act is signed by the President, in accordance with regulations to be adopted by the SEC, whether the company's compensation committee retained or obtained the advice of a compensation consultant and whether the work of the compensation consultant raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed. The Act does not require companies to disclose this information with regard to the compensation committee's independent legal counsel or other advisers.

Recommendations and commentary

- Note that existing SEC disclosure requirements already require companies, in certain circumstances, to disclose fees paid to compensation consultants. For example, if the board or compensation committee engaged a compensation consultant to provide services related to the determination of the amount or form of executive or director compensation and that consultant also provided "additional services" to the company involving fees paid to the consultant in excess of $120,000 during the company's last completed fiscal year, the company must disclose all fees paid to the consultant.
- Boards and their compensation committees should review (and in some cases create) their committee charters and procedures for retaining and engaging advisers in light of these new rules. When engaging advisers, compensation committees will need to solicit the information from advisers or potential advisers that they are required to consider before engaging (or potentially re-engaging) these advisers. Likewise, compensation consultants and other advisers will need to be prepared to provide this information. As compensation consultants and other advisers often provide additional services to companies that are more lucrative than services provided to compensation committees, it is possible that the prospect of potential conflicts of interest could, under these new requirements, lead to disengagements of existing compensation consultants or other advisers in some circumstances.

Disclosure regarding pay for performance (Section 953)

A new Section 14(i) of the Exchange Act requires the SEC to establish rules requiring each company to disclose in its proxy statement or consent solicitation material for its annual meeting of shareholders a "clear description" of any compensation required to be disclosed by the company under Item 402 of Regulation S-K, including information that shows the relationship between executive compensation "actually paid" and the "financial performance" of the company. The disclosure must take into account any change in the value of stock and dividends of the company or other distributions. The disclosure may include a graphic representation of the information required to be disclosed.

Recommendations and commentary

- The Act does not define "financial performance" and, as a result, the SEC will need to determine its meaning for this purpose—that is, whether performance will be based on stock price, earnings, total stockholder return or some other measure of financial performance. Similarly, the SEC will need to promulgate rules to clarify the meaning of the term "actually paid," particularly in the context of equity awards.
- As suggested in the Report by the Senate Committee on Banking, Housing and Urban Affairs on the Senate bill, companies may want to consider a graph with a horizontal axis of a number of years and a vertical axis with two scales, one for executive compensation and a second for financial performance of the company for each year.

Disclosure regarding internal pay equity (Section 953)

The Act also requires the SEC to amend Item 402 of Regulation S-K to require each company to disclose in a wide range of its SEC filings, including registration statements, annual reports and proxy statements:

- the median of the annual total compensation of all employees of the company, except the CEO (or equivalent position);
- the annual total compensation of the CEO (or equivalent position); and
- the ratio of the two amounts above.

Total compensation must be determined in accordance with Item 402(c)(2)(x) of Regulation S-K (that is, the provision governing the disclosure of "total compensation" in the Summary Compensation Table), as in effect on the day before the Act is signed by the President. Depending on how quickly the SEC acts to amend Item 402, these requirements could potentially affect the 2011 proxy season.

Recommendations and commentary

- The provision regarding internal pay equity may turn out to be the "sleeper" among the compensation and corporate governance provisions of the Act. The components of compensation included in the Summary Compensation Table are complex and include salary, bonus, stock awards, option awards, non-equity incentive plan compensation, change in pension value and nonqualified deferred compensation earnings and all other compensation. Unless the SEC adopts rules simplifying the method of calculation of total compensation of all employees, this information is likely to be extremely burdensome to collect and analyze, perhaps the most difficult new requirement with which to comply, especially for those companies with hundreds of thousands of employees located all over the world. Given that the Act expressly requires that total compensation be determined in accordance with the rules governing the Summary Compensation Table, it may be difficult to simplify the calculations required. Moreover, because the Act mandates changes to Item 402, the requirement will have broad application to a number of company filings under the Exchange Act and the Securities Act of 1933.
- In addition, because the Act specifically requires that the total compensation be calculated according to the rule in effect on the day before the Act is signed by the President, any subsequent amendments adopted for purposes of the Summary

Compensation Table would not be applicable with regard to the internal pay equity disclosure, potentially requiring companies to perform two different calculations of total compensation for the named executive officers.

Recovery of erroneously awarded compensation policy (clawback policy) (Section 954)

A new Section 10D of the Exchange Act requires the SEC to direct the exchanges to require each listed company to develop and implement a policy for recouping executive compensation that was paid on the basis of erroneous financial information. The policy would apply in the event the company is required to prepare an accounting restatement due to the company's material noncompliance with any financial reporting requirement under the securities laws. The policy must provide that the company will recover from any current or former executive officer an amount of incentive-based compensation (including options awarded as compensation) equal to the excess, if any, of the amount that was paid to the executive officer, in the three years preceding the date on which the company was required to prepare the restatement, over the amount that would have been paid to the executive officer based on the accurate financial data. Additionally, the SEC must require each listed company to have a policy providing for disclosure of its policy on incentive-based compensation that is based on financial information required to be reported under the securities laws.

Recommendations and commentary

- These requirements are further reaching than the clawback requirements included in SOX in that they cover any current or former executive (while the SOX requirements cover only the CEO and CFO) and no culpability on the part of the company or the executive is necessary to trigger a clawback (while SOX requires that the company's material noncompliance be the result of its misconduct, although not necessarily misconduct of the executive subject to the forfeiture). However, SOX did not limit the clawback to amounts paid in excess, although it covered only a 12-month period (compared to the three-year period mandated by the Act).
- Additional SEC guidance is needed to define "incentive-based compensation" for this purpose and to determine how to calculate the amount of incentive-based compensation that should be recovered, the type of incentive-based compensation that must be subject to the policy and how to measure the three-year cut-off date. The SEC is also expected to provide guidance regarding the nature of the disclosure required in connection with policies on incentive-based compensation that is based on reported financial information.
- One open question regarding the Act's clawback provision is whether it may be enforced by private plaintiffs or only by the SEC or the company itself. Whether a private right of action to enforce a clawback provision exists was recently litigated with regard to the SOX forfeiture provisions. In a Ninth Circuit case, *In re Digimarc Corporation Derivative Litigation,* the plaintiff filed a shareholder derivative action, asserting among other things, a claim for disgorgement under SOX. The Ninth Circuit, interpreting the statute and underlying legislative intent, found that there was no private right of action to enforce this provision of SOX, and it is unclear whether the same line of reasoning would necessarily prevail with regard to the new requirements in the Act.

Exemption from SOX 404(b) for non-accelerated filers (Section 989G)

The Act amends Section 404 of SOX by exempting smaller issuers from the requirements of SOX 404(b), which requires each issuer to obtain an auditor's attestation report on the company's internal control over financial reporting. More specifically, the exemption will apply to public companies that are neither "large accelerated filers" nor "accelerated filers," as those terms are defined in Rule 12b-2 under the Exchange Act, that is, issuers with aggregate worldwide market value of voting and non-voting common equity held by non-affiliates of less than $75 million, as of the last business day of their most recently completed second fiscal quarter. The Act also mandates that the SEC conduct a study to determine how it could reduce the burden of complying with SOX 404(b) for companies with market capitalizations between $75 million and $250 million, while maintaining investor protections

for those companies. The study must also consider whether reducing the compliance burden or providing a complete exemption for these companies would encourage companies to list on U.S. exchanges. The study is due in nine months.

Recommendations and commentary

- The SEC has acknowledged that the costs associated with SOX 404(b) were "significantly higher . . . than were projected when the SEC's original rules implementing Sarbanes-Oxley were adopted." In response to the storm of protest over the cost of compliance for smaller issuers, the SEC has regularly extended the compliance date for non-accelerated filers to file SOX 404(b) auditors' attestation reports on internal control over financial reporting. However, when the last extension was approved in October 2009, SEC Chair Mary Schapiro warned that there would be no further extensions by the SEC, and admonished smaller public companies "to act with deliberate speed to move toward full Section 404 compliance." How seriously the SEC intended that warning will remain a mystery, now that Congress has intervened to remove the requirement.
- Non-accelerated filers will continue to be subject to the requirement imposed under SOX 404(a) for an assessment by management of the effectiveness of the company's internal control over financial reporting. In 2007, to help reduce costs and burdens, the SEC issued new guidance for management's assessment under SOX 404(a) intended to illustrate how management could focus its reviews on the internal control issues of most significance to investors.
- It is possible that this action may not spell the end of SOX 404(b) for smaller issuers. Section 989I of the Act requires the Comptroller General of the United States to study the potential impact of this amendment, including whether exempt companies have more restatements, higher cost of capital or lower investor confidence in the integrity of their financial statements. Depending on the results (and the nature of the most recent scandal at the time), the study, which is not due for three years, may spur Congress to walk back the exemption.

Disclosure regarding employee and director hedging (Section 955)

The Act amends Section 14 of the Exchange Act to require the SEC to issue new rules mandating annual proxy (or consent) disclosure of whether any employee or director, or any of his or her designees, is permitted to engage in hedging transactions through the purchase of financial instruments (such as prepaid variable forward contracts, equity swaps, collars and exchange funds) designed to hedge or offset decreases in the market value of equity securities granted as compensation to or held by the employee or director.

Recommendations and commentary

- According to the Report by the Senate Committee on Banking, Housing and Urban Affairs on the Senate bill, this provision was designed to "allow shareholders to know if executives are allowed to purchase financial instruments to effectively avoid compensation restrictions that they hold stock long-term, so that they will receive their compensation even in the case that their firm does not perform."
- While the current executive compensation rules require disclosure of company policies regarding hedging, that discussion is typically limited to the named executive officers; the Act will now expand the disclosure to cover policies applicable to all employees and directors. Many companies already prohibit hedging transactions by officers and directors in company shares. Those companies will need to consider whether to extend the prohibition to include all employees. Companies that do not prohibit hedging will need to decide whether adoption of a policy against hedging makes sense in those cases, taking into account how to address any hedging strategies that may already be in place for some insiders.

Disclosure regarding board leadership structure (Section 972)

The Act adds a new Section 14B to the Exchange Act requiring the SEC, not later than 180 days after the Act is signed by the President, to issue rules that require annual proxy disclosure of the reasons why the issuer has chosen one person to serve in the combined roles of chief executive officer and board chair (or equivalent positions) or two different persons to serve in those roles.

Recommendations and commentary

- Given that the proxy rules already require extensive disclosure regarding a company's board leadership structure, including disclosure regarding why companies have chosen to combine or separate the CEO and board chair positions, Congress must have been concerned that the SEC would rescind these requirements without this legislative imperative. In any event, this deadline will be one that the SEC has little difficulty meeting and this set of rules will be one for which companies have already rehearsed their responses, unless, of course, the SEC decides to expand the nature of the current disclosure required on this topic.
- Inclusion of the disclosure requirement in the Senate bill represented a compromise position: strong views were expressed on the merits of both models—combined CEO and board chair positions and separate CEO and board chair positions—and some consideration was apparently given to precluding public companies from having the same individual serve as chair and as CEO. Ultimately, it was recognized that different companies may have good reasons for following either model and, therefore, the current disclosure provision was included, without endorsing or prohibiting either structure. Similarly, the SEC made clear, in adopting its original amendments, that the requirements were not intended to influence a company's decision regarding its board leadership structure.

On the horizon

One notable omission from the Act is the Senate bill's proposed mandate for majority voting in uncontested elections of directors. A number of commentators have predicted that, in light of the omission, companies may see an increase in the coming year in the number of shareholder proposals advocating the adoption of majority voting. That may be especially true given that shareholders may now devote more energy to majority voting proposals because they have already won the battle for say on pay.

Note that in addition to enacting rules, the Act requires the SEC to complete nearly 20 studies, including the study described above regarding SOX 404(b) and a study regarding the use of compensation consultants that the SEC is required to present to Congress. Any of these studies may lead to further Congressional action. We will keep you up to date on these issues as new developments arise.

If you have any questions about this *Alert*, please contact one of your Cooley team members or one of the attorneys identified above.

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