

ADVISORY

SULLIVAN & WORCESTER LLP CORPORATE ADVISORY

The Dodd-Frank Act – What Public Companies Should Be Doing Now

On July 21, 2010, President Obama signed into law what is being called the most sweeping set of financial reforms since the Great Depression. The Dodd-Frank Wall Street Reform and Consumer Protection Act promises to keep market observers and participants on the edge of their seats for months and perhaps years to come as federal agencies enact regulations according to the Act's mandates.

The Act is composed of sixteen distinct titles, touching upon nearly every facet of the financial system. Unwrapping the totality of its contents would require numerous volumes; this advisory focuses solely on the corporate governance and securities regulation components of the legislation as they relate to U.S. public companies, including in most cases foreign private issuers. Specifically, we cover below the following key topics under the Act that will affect public company practices and disclosures:

- "Say on pay" and "say-on-golden parachutes";
- Clawback policy requirements for listed companies;
- Enhanced compensation disclosures;
- Proxy access;
- Internal control audit exemption for smaller companies;
- Compensation committee independence;
- Board leadership disclosures;
- Disclosures regarding employee and director hedging;
- Amendments to Regulation D offerings and the definition of "accredited investor"; and
- Reforms relating to public companies' use of credit ratings and communications with credit rating agencies.

While some of the Act's provisions are self-executing and take effect immediately, most will be phased in. A public company navigating this regulatory maze will need to determine not only which rules apply, but also when such rules will apply.

Say-on-Pay and Say-on-Golden Parachutes

Perhaps the most talked about of the Act's governance reforms is the so-called "Say-on-Pay" initiative. The legislation will require public companies to provide for a nonbinding shareholder vote on

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the executive compensation disclosures that appear in proxy statements. The say-on-pay vote will occur every one, two or three years, depending on a separate vote of the shareholders to take place at least every six years.

Although public companies will have to conduct the say-on-pay vote, it is merely advisory. Critics have pointed out that it will be unclear what a “no” vote would be opposing—the specific disclosures, the lack of greater transparency about executive compensation generally, or the actual levels of compensation, among other things. Proponents argue that the rule will encourage boards to consider shareholder opinions as they make decisions relating to executive compensation.

Similar rules will also apply to so-called “golden parachute” payments in connection with mergers and acquisitions. Certain disclosures and a separate nonbinding shareholder vote will be required in M&A-related proxy statements with respect to any agreements or understandings between a company and any “named executive officer” concerning any type of compensation (whether present, deferred or contingent) that is based on or otherwise relates to the M&A transaction and the total of all such compensation that may (and the conditions upon which it may) be paid or become payable to such officer. “Named executive officers” are generally a company’s CEO, CFO and the other three most highly compensated executives.

The Act specifically instructs the SEC to consider exemptions for small companies that might be burdened by the say-on-pay and say-on-golden parachutes votes. Companies should accordingly watch for rulemaking developments. Management of smaller reporting companies, for example, may want to discuss the likelihood of exemption with legal counsel before they begin to draft potentially unnecessary proxy language.

Under the Act brokers will not be able to vote on executive compensation matters without instructions from beneficial holders (similar to their inability to exercise discretion in voting in director elections or with respect to equity compensation plans).

What Public Companies Should be Doing

The say-on-pay and say-on-golden parachutes rules are self-executing, meaning SEC action is not

necessary for the rule to take effect. Both votes are required to be included in public companies’ proxy statements for annual or other shareholder meetings, as applicable, occurring after the six-month anniversary of the legislation’s enactment.

As noted above, a separate additional vote will be required the first year of compliance and at least every six years thereafter asking shareholders how often they want to exercise their say-on-pay. Companies will need to decide if they want to recommend to shareholders that they vote every one, two or three years, balancing shareholder relations with cost and efficiency issues as well as short-term versus long-term considerations regarding pay programs.

Boards should analyze the compensation packages of executive officers and revisit the overall compensation disclosures contained in their company’s most recent proxy statement, anticipating components that could potentially be controversial to their shareholder bases. Management or compensation committees may also want to communicate with key shareholders in advance of shareholders meetings to help identify and address any compensation concerns.

Companies looking toward potential M&A transactions may want to review employment, severance and other compensation arrangements of named executive officers that could be triggered by the transaction, to determine whether any potential “golden parachute” payments might cause discord among their shareholder bases.

Clawback Policy Requirements For Listed Companies

Under the Act, the SEC is required to instruct national securities exchanges such as NYSE and Nasdaq to delist companies that have not implemented and disclosed a “clawback” policy. The requisite clawback policy would require that, in the event that a company is required to prepare an accounting restatement due to the material noncompliance of the company with any financial reporting requirement, companies will recover (or “claw back”) from their current and former executive officers the portion of incentive-based compensation (including stock options awarded) received based on the erroneous data in excess of what would have been paid to such executive officer under the accounting restatement. The

mandated policy would not require any direct misconduct or fraud by the officer from whom compensation is recovered. The policy is required to apply to the three-year period preceding the date on which the company becomes required to restate its financial statements.

What Public Companies Should be Doing

Although the Act does not set forth a time during which the SEC and stock exchanges must establish clawback rules, companies should be on the watch for proposed clawback rules issued by the SEC and stock exchanges and prepare to move quickly. Many large public companies already have some form of clawback policies, but even those will need to be reviewed for compliance with the more precise requirements under the Act and ensuing stock exchange rules. Public companies without established clawback policies should begin the process of drafting and putting into practice a compliant policy.

Management may also consider engaging in a more general discussion of whether the company's clawback policy should be narrowly tailored to regulatory requirements, or whether to draft a more extensive policy, which may be looked upon favorably by governance ratings agencies and some investors.

Enhanced Compensation Disclosures

The Act requires the SEC to issue rules requiring additional executive compensation disclosures. Such disclosures will include information illustrating the relationship between actual executive compensation and a company's financial performance. The disclosures will be required to take into account stock price and dividends paid, though the Act does not provide a more specific definition of financial performance. Companies will likely need to include a graph to help illustrate the disclosures and numerical relationships. The forthcoming rules will also require "pay disparity" disclosures covering (1) the median annual total compensation of all employees, excluding the CEO, (2) the annual total compensation of the CEO, and (3) the ratio of the former to the latter. Total compensation will be calculated under the same method as currently provided in proxy statements for "named executive officers."

What Public Companies Should be Doing

The Act is silent on the time period during which the SEC must act, but it is possible these

disclosure rules will be in effect for the 2011 proxy season. Companies with large or disparate employee populations may want to begin formulating a process for how they will gather the voluminous employee compensation data necessary to run the newly required calculations.

Whether in effect for 2011 proxy season or beyond, public companies will eventually be required to disclose CEO pay disparity, which has been a controversial benchmark. These disclosures may impact how shareholders vote on say-on-pay discussed above and raise numerous issues affecting compensation policies. Whether the additional disclosures will prompt policy changes will be a complex issue for companies to consider.

Proxy Access

The Act's passage marks the end of a protracted debate over the SEC's authority to mandate shareholder rights of proxy access, which could provide shareholders with cost-savings and procedural advantages by having their nominees included in company proxy statements. However, the sunset on one debate marks the dawn of another—namely, whether the SEC should adopt such rules and the reach of shareholder access. The SEC now has express discretionary authority to adopt rules relating to the inclusion of certain shareholders' nominees in a company's proxy solicitation materials.

Based on past statements by SEC Chair Schapiro, many observers expect the SEC to respond swiftly in order to effect shareholder access for the 2011 proxy season. However, the SEC has proposed shareholder proxy access rules several times over the past decade but has struggled to find a balance between shareholder interests and board of directors' authority. Among the details to be addressed are how much stock must be held, and for how long, by shareholders making nominations and what additional information they must provide and by when. Also to be determined are what exceptions may be provided to the proxy access rules.

What Public Companies Should be Doing

Companies should monitor their shareholder bases and strive to maintain a healthy dialogue with major holders. Although it may be difficult to determine the likelihood of any particular holders availing themselves of potential proxy access rules, healthy investor relations could go a long way in

allaying concerns of adverse shareholder activism. Even if the SEC does not act quickly, the threat of proxy access may loom indefinitely. Management of large companies unlikely to be exempt from proxy access rules should discuss approaches for dealing with proxy access issues, and should communicate regularly with legal advisors to stay on top of SEC rulemaking developments.

Internal Control Audit Exemption for Smaller Companies

Since the passage of the Sarbanes-Oxley Act in 2002, smaller public companies have been gearing up for compliance with Section 404(b) of that act, which requires an external audit of internal control over financial reporting. While larger companies have had to comply with this requirement for several years, the deadline for smaller companies has been extended numerous times (most recently to fiscal years ending after June 15, 2010). The Act includes a provision that makes the exemption permanent for "non-accelerated filers" and "smaller reporting companies" (though they must still annually provide management's assessment of internal controls). "Non-accelerated filers" and "smaller reporting companies" are those with a public float (common equity held by non-insiders) of less than \$75 million, measured at certain prescribed times, and meet certain other conditions.

What Public Companies Should be Doing

The exemption is self-executing and immediately effective. This development was somewhat of a surprise to many, as it results in more relaxed disclosures for certain companies, in contrast with the bulk of the Act's governance procedures. Nevertheless, these smaller companies must still maintain adequate internal control over financial reporting. The lack of an audit requirement does not lessen the stringent nature with which management must assess internal controls. It merely reduces costs and resource allocation associated with the separate audit.

The Act also tasks the SEC with conducting a study to determine methods of reducing the burden of Section 404(b) compliance for companies whose market capitalization is between \$75 and \$250 million. Accordingly, there could potentially be additional relief down the road for larger companies not subject to the Act's current Sarbanes-Oxley exemption.

Compensation Committee Independence

Similar to the clawback reforms, the Act requires the SEC to direct national stock exchanges to prohibit the listing of non-exempt companies whose compensation committees do not meet certain heightened independence requirements. The independence rules to be developed will take into account consulting, advisory and other compensatory fees paid to compensation committee members and whether members are affiliates of the company.

The new rules will further mandate that compensation committees be authorized to retain and manage compensation consultants, legal counsel and other advisers. However, such advisers may only be retained after the compensation committee deems such advisers independent after considering an array of "competitively neutral" factors to be determined by the SEC, such as:

- other services performed for the company;
- fees received from the company as a percentage of total revenue of the adviser;
- the company's policies and procedures designed to prevent conflicts of interest;
- business or personal relationships of the adviser with a compensation committee member; and
- stock of the company owned by the adviser.

The rules also will require a listed company to disclose whether its compensation committee retained a compensation consultant and whether that retention raised any conflicts of interest and how such conflicts are being addressed. These requirements add to disclosures about conflicts of interest of compensation consultants already addressed by the SEC's 2009 proxy enhancements. For more information on the earlier proxy enhancements, please see our January 2010 advisory, "[SEC Mandates Increased Disclosures Regarding Executive Compensation, Risk, Director Qualifications and Corporate Governance.](#)"

What Public Companies Should be Doing

Disclosures relating to this rule will be required to be included in proxy statements issued after the Act's one-year anniversary. Accordingly, most

companies will not become subject to the disclosure requirements until the 2012 proxy season. However, changing practices or committee members can require lengthy lead times, so listed companies should analyze these items in the near-term.

As an initial matter, companies should determine whether they will be subject to the new independence requirements. The Act exempts certain companies, including “controlled companies” in which more than 50% of the voting power is held by a single person or entity, foreign private issuers meeting certain disclosure requirements, and others.

Public companies subject to the more stringent independence requirements should assess the current composition of their compensation committees to determine whether their memberships would require modification. Such companies should be familiar with similar independence requirements, which have applied to audit committees for several years. Committees (and management) should also be cognizant of the independence considerations in the Act when renewing relationships with existing advisers or selecting new ones. Compensation committee charters should also be reviewed for possible changes emanating from the new rules. Companies may also want to develop more explicit policies addressing potential conflicts of interest in the selection of outside advisers. Further, companies may need to revise their annual director and officer questionnaires to capture necessary data to analyze committee members’ independence and potential conflicts of interest.

Disclosure of Board Leadership

Under the Act, the SEC must issue rules that will require public companies to discuss in proxy statements the company’s reasons for having separated or combined the positions of Chairman and CEO. Although the Act stops short of requiring companies to have separate chairmen and CEOs, requiring disclosure will cause companies that combine the positions to consider why they believe such a leadership structure is appropriate.

What Public Companies Should be Doing

In an unusual twist, though the Act requires SEC rulemaking within 180 days, current SEC rules

already require the leadership disclosures mandated by the Act. The proxy enhancement reforms that went into effect during the 2010 proxy season required companies to disclose whether they combined or separated the roles of Chairman and CEO and their reasons for doing so. Most public companies should therefore be familiar with, and in many cases have already provided, these disclosures. For more information on the earlier proxy enhancements, please see our January 2010 advisory, “[SEC Mandates Increased Disclosures Regarding Executive Compensation, Risk, Director Qualifications and Corporate Governance.](#)”

Disclosures Regarding Employee and Director Hedging

Companies will be required to disclose in proxy statements whether they permit employees and/or directors to hedge their positions in equity securities of the company. Hedging arrangements include the purchase of prepaid variable forward contracts, equity swaps, collars and exchange funds designed to hedge or offset any decrease in the value of equity securities. The rule will apply to securities granted by the company, as well as to any securities of the company held either directly or indirectly by employees or directors.

What Public Companies Should be Doing

The Act does not give the SEC a deadline for adopting the hedging policy disclosure rules. Many observers do not expect the new rules to apply until the 2012 proxy season. Nonetheless, companies should begin to assess current practices and policies with respect to employee hedging. Although the Act does not direct the SEC to prohibit hedging by public company directors and employees, companies that allow hedging should analyze whether any limits in policy are appropriate in light of the new disclosure rules. Companies without an established policy addressing employee and director hedging should consider contacting their legal advisers about drafting a written policy.

Amendments to Regulation D Offerings and Accredited Investor Definition

Companies issuing securities pursuant to private placements frequently seek to rely on an exemption from registration under Regulation D

under the Securities Act of 1933. Regulation D provides a “safe harbor” for private placements if certain conditions are met. This safe harbor relaxes certain disclosure and other requirements in a private placement made to “accredited investors.” One of the tests to determine if someone is an accredited investor requires an individual’s net-worth, or joint net-worth with the individual’s spouse, to exceed \$1,000,000 at the time of purchase (several other tests under the definition have not changed—an investor need only qualify under one of the tests). The Act modified the applicable rules to exclude the value of a person’s primary residence from an individual’s net-worth under this test. According to interpretative guidance issued by the SEC, indebtedness secured by a person’s primary residence may also be excluded from the net-worth calculation, up to the home’s fair market value; mortgage indebtedness in excess of the home value should be considered a liability and deducted from the investor’s net worth.

Additionally, the Act requires the SEC to issue rules disqualifying offers and sales made under Rule 506 under Regulation D by persons who:

- have been convicted of a felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false SEC filing;
- have been barred from association with certain regulated entities or from engaging in the business of securities, insurance or the activities of certain financial institutions on account of deceptive practices; or
- have been found within the last ten years by certain regulatory authorities to be in violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct.

The new rules will also prohibit Rule 506 offerings by companies that meet, or have officers, directors, partners or 10% owners who meet, a variety of additional “bad actor” criteria set forth in existing SEC regulations.

What Public Companies Should be Doing

The provision requiring the exclusion of the value of the primary residence became immediately effective. Accordingly, companies in discussion with potential investors about unregistered

offerings will need to confirm that such investors qualify as “accredited” under the new net-worth standards or under one of the other standards, such as the income test, which remain unchanged.

The Act gives the SEC the authority to revisit the accredited investor standards to determine whether the requirements should be adjusted in order to protect investors in light of the economy. Additionally, every four years commencing in 2014 the SEC is required to reconsider the “accredited investor” definition and to increase the \$1,000,000 net-worth threshold as appropriate in light of the economy and the public interest.

The SEC has a year to issue rules regarding the bad actor exclusions from Regulation D offerings, so companies will have some time to assess potential issues that may arise in future offerings with respect to such rules. In the meantime, companies may wish to revisit director and officer questionnaires to make sure they solicit information necessary to determine whether any such officers and directors are at risk of falling within these definitions. Also, it may be prudent for companies to undertake additional diligence regarding prospective investors if there is a reasonable possibility of any such investor becoming a director or 10% owner of the company.

Reforms Relating to Public Companies’ Use of Credit Ratings and Communications with Credit Rating Agencies

The Act repealed a rule that in effect exempted rating agencies from being considered to be an “expert” and being exposed to related potential liability under the Securities Act of 1933 with respect to their ratings of debt or preferred stock appearing in certain prospectuses and registration statements (including documents incorporated therein by reference). As a result, companies will no longer be permitted to include ratings disclosure in such documents for marketing purposes without first obtaining from a consent from the applicable rating agency. Industry participants have reported that the major rating agencies are currently unwilling to provide such a consent.

The SEC has already issued interpretive guidance indicating that disclosure of credit ratings for certain non-marketing purposes, such as

describing financial covenants or risk factors, is permitted without obtaining consents and that the Act's provision does not affect the use of ratings in certain free writing prospectuses, Rule 134-compliant press releases and term sheets. The SEC has also stated its view that the rule change does not affect ratings information contained in registration restatements, prospectuses and incorporated documents filed prior to the provision's July 22 effective date, unless they are subsequently amended. The SEC has reminded companies that the incorporation of an annual report on Form 10-K is deemed to be an amendment.

The Act also requires the SEC to eliminate the exemption under Regulation FD for disclosures of material nonpublic information to rating agencies. Under the mandated rule change, unless another exemption, such as communication of information subject to a confidentiality agreement, is available, any material nonpublic information provided to a rating agency must have been or be simultaneously publicly disclosed.

What Public Companies Should be Doing

The repeal of rating agencies' exemption from being considered experts was effective immediately. Companies planning (or the middle of) securities offerings will be forced to deal with this change and should discuss any ratings disclosures with their legal counsel. Additionally, companies will need to exercise caution when making references to ratings in annual, quarterly or current reports or other filings that will be incorporated by reference into registration statements or prospectuses.

Public companies will need to watch for SEC rulemaking relating to rating agency ratings and disclosures to ratings agencies. The Act requires the change to Regulation FD to occur within 90 days, one of the briefest windows for SEC action required by the Act. Companies will therefore have a relatively narrow window to evaluate and conform practices with respect to information provided to rating agencies to the new rules.

Conclusion

Although it comes at the end of a lengthy legislative process, the Dodd-Frank Act promises to mark the beginning, rather than the end, of an extensive rulemaking process. Public companies

and market participants will be paying attention for some time as new regulations are proposed for comment and implemented.

While scholars and market observers debate whether the Act appropriately responds to the financial crisis that ostensibly triggered the Reforms, public companies are now facing a different regulatory environment and can expect further changes to unfold over the coming months. S&W is continuing to follow these developments closely. In light of the expected speed of implementation of new regulations and interpretations, it is important that public companies communicate regularly with their legal advisers.

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The summary above is meant to describe only the major corporate governance and securities changes included in the Dodd-Frank Act. To discuss these topics in more detail or for information about other provisions of the Act, please contact your lawyer at Sullivan & Worcester LLP or one of the lawyers listed above.

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