

Public Company Impact of Dodd-Frank Bill

Columbus

52 East Gay Street
P.O. Box 1008
Columbus, Ohio 43216
tel 614.464.6400
fax 614.464.6350

Washington

1909 K Street NW
Suite 900
Washington, DC 20006-1152
tel 202.467.8800
fax 202.467.8900

Cleveland

1375 East Ninth Street
2100 One Cleveland Center
Cleveland, Ohio 44114
tel 216.479.6100
fax 216.479.6060

Cincinnati

221 East Fourth Street
Suite 2000, Atrium Two
P.O. Box 0236
Cincinnati, Ohio 45201
tel 513.723.4000
fax 513.723.4056

Alexandria

277 South Washington Street
Suite 310
Alexandria, VA 22314
tel 703.837.6999
fax 703.549.4492

Akron

106 South Main Street
Suite 1100
Akron, Ohio 44308
tel 330.208.1000
fax 330.208.1001

Houston

700 Louisiana Street
Suite 4100
Houston, Texas 77002
tel 713.588.7000
fax 713.588.7050

On June 25, 2010, the United States Senate and the United States House of Representatives completed the reconciliation process for the Restoring American Financial Stability Act of 2010, sponsored by Senator Christopher Dodd (the "Senate Bill") and the Wall Street Reform and Consumer Protection Act of 2009 (the "House Bill"). The final legislation is known as the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank"), and represents one of the most comprehensive and broad-sweeping pieces of financial reform legislation since the Great Depression.

While much of Dodd-Frank focuses exclusively on the financial sector, there are significant measures which impact publicly traded companies overall and those whose shares are listed on national securities exchanges. Dodd-Frank does not contain all of the provisions of the Senate Bill or the House Bill and allows the Securities and Exchange Commission (the "SEC") to issue exemptions from certain requirements. Dodd-Frank still must be approved by both the House and the Senate before being signed into law, and some commentators have noted the possibility of a Republican filibuster in the Senate. Many new requirements affect the areas of corporate governance and executive compensation, with companies facing additional proxy disclosure obligations and restrictions on shareholder voting.

Enhanced Disclosure

Dodd-Frank is another example of the ongoing trend toward requiring increased disclosure by publicly traded companies in their annual proxy statements and other SEC filings.

- *Executive Compensation Disclosure.* Dodd-Frank focuses on executive compensation levels in the context of

the company as a whole, instead of the specifics of each executive officer's compensation package. Under Dodd-Frank, the SEC would create rules requiring a company to disclose in any proxy solicitation materials for an annual meeting of shareholders a "clear description" of compensation paid to executive officers and the relationship between the executive compensation actually paid and the financial performance of the company, taking into account dividends and distributions and any change in the price of the company's shares. The text of Dodd-Frank suggests that this "pay for performance" disclosure may be accomplished using a "graphic representation."

In addition, the SEC would amend the current executive compensation disclosure rules to require that in every filing described in Item 10(a) of SEC Regulation S-K, each company disclose the median of the annual total compensation paid to all employees (other than the chief executive officer), along with the ratio of the chief executive officer's annual total compensation to that median figure.

The SEC would also adopt rules requiring companies to disclose in any proxy solicitation materials for an annual meeting of shareholders whether employees or directors are permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities granted as part of their respective compensation or held, directly or indirectly, by them.

- *Board Leadership Structure.* The SEC would adopt rules requiring

public companies to disclose in the annual proxy solicitation materials sent to shareholders whether they have separate chief executive officer and chairman of the board of directors positions along with their reasons for having their particular leadership structure. The SEC already requires each public company to disclose its board leadership structure along with justifications for the selected structure under Item 407(h) of SEC Regulation S-K, as part of the enhanced executive compensation disclosure requirements adopted in December 2009. There has been no indication of how the requirement in Dodd-Frank might differ from or supplement the current SEC disclosure requirements.

Shareholder Voting

Dodd-Frank's greatest influence on public companies may come in the form of additional requirements related to shareholder voting at annual meetings.

- *Greater Shareholder Influence.* Dodd-Frank would require companies that provide compensation disclosure in their proxy statements to give shareholders a non-binding vote on executive compensation, or "say on pay."¹ The "say on pay" proposal must be presented for shareholder approval at least once every three years. At least once every six years, shareholders must be given the opportunity to require more frequent "say on pay" votes. Also, in connection with the approval of a merger or acquisition of the company or substantially all of its assets, shareholders must be given the chance to record a separate non-binding vote on any "golden parachute" payments to named executive officers relating to the proposed transaction. The "say on pay" and "golden parachute" shareholder votes would be strengthened by new

SEC rules that would prevent broker discretionary voting in elections for directors, executive compensation proposals or any other matters that the SEC would deem significant.²

Dodd-Frank does not contain the controversial "majority voting" requirement that was included in the Senate Bill. That provision would have required directors to submit their resignations if they failed to receive a majority of the votes cast in uncontested elections.

- *Proxy Access.* The issue of "proxy access" for shareholders is also addressed in Dodd-Frank, but will ultimately be left to the discretion of the SEC. Dodd-Frank provides the SEC with the authority to issue rules which would allow certain shareholders to include their director nominees as candidates in the company's proxy solicitation materials; however, the SEC would not be required to adopt such rules. The SEC would also have the authority to exempt certain issuers or classes of issuers from compliance, likely based on the size of the issuer. Even though this provision would only create authority instead of mandating new rules, it would represent a significant measure, as the right of shareholders to nominate directors has traditionally been left to state law.

Executive Compensation

Dodd-Frank also includes requirements addressing the maintenance of independent compensation committees and evaluation of the independence of compensation consultants, the "clawback" of erroneously paid incentive compensation and the oversight of incentive-based compensation levels at financial institutions.

¹Dodd-Frank would not require the companies to take any action in response to the vote. Financial institutions that received money under the Troubled Asset Relief Program ("TARP") have already included similar proposals among their annual meeting agenda items as a condition of the receipt of TARP funds.

²The national securities exchanges currently have rules that restrict broker discretionary voting on certain matters, including uncontested director elections. Under the new rules, the exchanges would still be able to allow brokers to vote on routine matters such as the ratification of auditors.

- Compensation Committees and Consultants.* Under Dodd-Frank, national securities exchanges would be required by the SEC to ban from listing any company³ that does not maintain a compensation committee composed entirely of independent directors.⁴ Compensation committees would have sole discretion in selecting, compensating and overseeing compensation consultants, independent legal counsel and other advisors but must take into consideration factors identified by the SEC as affecting the independence of a compensation consultant, legal counsel or other advisor. The company would have to disclose the retention of any compensation consultant in its annual proxy solicitation materials, as well as whether the work undertaken by such compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how it is being addressed. Companies are required to provide appropriate funding for payment of reasonable compensation to compensation consultants, independent legal counsel and other advisors retained by the compensation committee.
- Clawback Provisions.* Listed companies would also be required to have “clawback” policies. The “clawback” would allow a company to recover incentive-based compensation (including stock options awarded as compensation) received by current or former executive officers based on financial information that was erroneous and required the company to prepare an accounting restatement due to material non-compliance with any financial reporting requirements under the securities laws, as long as the non-compliance was discovered within a three year look-back window. The company would also be required to disclose the details of its “clawback” policies. Importantly, clawbacks are not limited to incentive-based compensation paid to the executive officers who were involved with the preparation of the incorrect financial statements.⁵
- Enhanced Compensation Oversight for Financial Industry.* Within nine months after the enactment of Dodd-Frank, the “appropriate Federal regulators”⁶ would be required to jointly prescribe regulations or guidelines to require each covered financial institution⁷ to disclose to its appropriate Federal regulator the structures of all incentive-based compensation arrangements sufficient to determine whether those structures provide an executive officer, employee, director or principal shareholder with excessive compensation, fees

³This requirement would not apply to controlled companies, limited partnerships, companies involved in bankruptcy proceedings, open-ended management investment companies or foreign private issuers which already disclose their reasons for not maintaining independent compensation committees.

⁴The SEC or the exchanges may heighten existing requirements to be considered an independent director, focusing primarily on whether a director receives consulting, advisory or other compensatory fees from the company outside of his or her role as director or is affiliated with the company or one of its subsidiaries other than as a director. Any such heightened requirements would likely closely track the independence requirements for audit committees under the SEC and securities exchange listing rules.

⁵This provision is much broader than the clawback contained in Section 304 of the Sarbanes-Oxley Act, which requires “misconduct” and limits the recovery to compensation received in the 12 month period after the release of financial information that is later restated; however, it shares a similar weakness with Sarbanes-Oxley in that the clawback lacks a culpability standard (i.e., fraud, gross misconduct, negligence, etc.).

⁶The “appropriate Federal regulators” include the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Board of Directors of the Federal Deposit Insurance Corporation, the Director of the Office of Thrift Supervision, the National Credit Union Administration Board, the SEC and the Federal Housing Finance Agency.

⁷Dodd-Frank defines a “covered financial institution” as a depository institution or depository institution holding company, a broker-dealer registered with the SEC, a credit union, an investment advisor, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation or any other financial institution which the Federal regulators determine should be treated as such. Covered financial institutions with less than \$1 billion in assets would be exempt from these requirements.

**For more information,
please contact your
regular Vorys attorney
or one of the following:**

Aaron S. Berke

asberke@vorys.com
330.208.1017

Adam K. Brandt

akbrandt@vorys.com
614.464.6426

Michael A. Cline

macline@vorys.com
614.464.5416

Elizabeth

(Betsy) T. Farrar

etfarrar@vorys.com
614.464.5607

James H. Gross

jhgross@vorys.com
614.464.6231

Jason L. Hodges

jlhodges@vorys.com
513.723.8590

Roger E. Lautzenhiser

relautzenhis@vorys.com
513.723.4091

John M. Saganich

jmsaganich@vorys.com
216.479.6120

J. Bret Treier

jbtreier@vorys.com
330.208.1015

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and other published
materials are available
on our website,
www.vorys.com*

or benefits, or could lead to material financial loss to the covered financial institution. In addition, within that same timeframe, the appropriate Federal regulators would be required to jointly prescribe regulations or guidelines that prohibit any types of incentive-based payment arrangements, or features thereof, that the regulators determine encourage inappropriate risks by covered financial institutions by providing an executive officer, employee, director or principal shareholder with excessive compensation, fees or benefits, or that could lead to a material financial loss to the covered financial institution.⁸

Although Dodd-Frank represents the reconciliation of the House Bill and the Senate Bill, the details regarding the actual implementation of the Bill's provisions and its true scope will not be known

⁸The recent guidance regarding incentive compensation and risk management jointly issued by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation may serve as a basis for this requirement.

until its passage by the House and the Senate and subsequent rulemaking by the SEC and national securities exchanges. Once Dodd-Frank is signed into law, the rulemaking process will require additional time to complete, with certain provisions containing specified deadlines within which rules must be enacted. Several of the provisions, including those addressing the required "say on pay" votes, would go into effect six months after enactment of Dodd-Frank, impacting proxy statements and annual shareholder meetings in 2011.

Despite significant protest and debate, new financial reform will soon become law, likely in the form described above. The impact on the executive compensation and corporate governance practices of publicly traded companies will be significant.

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