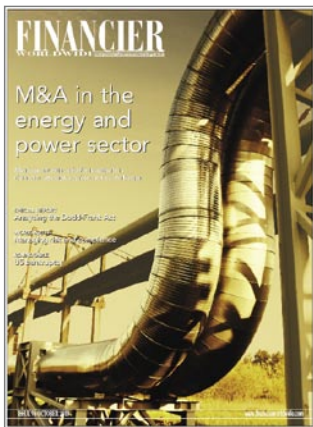




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SPECIAL REPORT

THE DODD-FRANK ACT: CORPORATE GOVERNANCE AND EXECUTIVE COMPENSATION



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Analysing the Dodd-Frank Act



The Dodd-Frank Act: corporate governance and executive compensation

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The Dodd-Frank Act includes a number of changes affecting the corporate governance and executive compensation practices at public companies, as discussed below in more detail.

Say-on-pay

The Act requires a non-binding shareholder vote on executive compensation as disclosed in a proxy statement for an annual shareholders meeting. The vote is required at least once every three years, with shareholders having a right once every six years to decide whether the vote will occur annually, biennially or triennially. The requirement becomes effective for the first shareholders meeting held on or after 21 January 2011.

The Act also requires a non-binding shareholder vote, at any meeting at which shareholders are asked to approve a merger, sale or acquisition, of any compensation for a named executive officer that is based on or related to the transaction ('golden parachute' payments), including the aggregate amount that may be paid or become payable, unless previously approved under a routine say-on-pay vote. This requirement is effective for meetings held on or after 21 January 2011.

Brokers and other nominees will not have authority to vote on these proposals without receiving direction from the beneficial owners. The Act makes clear that the shareholder votes on these matters do not overrule the board's decisions or create or change the fiduciary duties of the directors. In addition, the Act clarifies that the mandatory say-on-pay votes do not limit shareholder rights to submit shareholder proposals on executive compensation matters. The SEC has authority to exempt a class of issuers from the say-on-pay requirements and, in particular, the SEC must consider the burdens of say-on-pay on small issuers. Finally, institutional investment managers will be required to report annually how they voted on both periodic say-on-pay proposals and 'golden parachute' proposals.

Proxy access

The Act clarified the power of the SEC to adopt rules requiring inclusion of shareholder nominees for election to the board of directors in a company's proxy statement, which is often referred to as 'proxy access'. On 25 August 2010, the SEC exercised this authority by adopting rules that will facilitate shareholders' nominations of director candidates to a company's board of directors. New Rule 14a-11 al-

lows shareholders satisfying certain conditions to include director nominees in a company's proxy statement and on the company's proxy card – which will list all nominees by the board and by qualifying shareholders. Among other requirements for shareholders to use the rule, the shareholder or group of shareholders must hold investment and voting power of at least 3 percent of the company's securities entitled to vote on the election of directors at the meeting and the securities must have been continuously held for at least three years as of the date of submitting an intent to use Rule 14a-11. In addition, the shares must be held through the date of the meeting, and the shareholder must disclose its intention with respect to holding the shares after the meeting. Other requirements include no intent to change control of the company or agreements with the company, meeting the notice deadlines and submitting a Schedule 14N. The rules also amend Rule 14a-8 to require that shareholder proposals to add certain procedures relating to director nominees to a company's governing documents be included in a company's proxy statement.

The maximum number of directors that may be elected under Rule 14a-11 is 25 percent of the board or at least one director. If multiple eligible nominees in excess of the 25 percent maximum are nominated by shareholders, the nominating shareholder or group with the highest percentage of the company's voting power will be entitled to have its nominee(s) included.

Despite new Rule 14a-11, a shareholder can still choose to file and mail a separate proxy statement by complying with the company's general advance notice bylaw requirements, which are less restrictive in terms of the stock ownership requirements, advance notice period and number of nominees.

Proxy access will become effective 15 November 2010 and thus will apply to companies that mailed their 2010 proxy statements on or after 15 March 2010. For smaller reporting companies, there is a three-year delay before Rule 14a-11 becomes effective.

Separation of chairman and chief executive

The Act requires the SEC to issue rules by 21 January 2011 that require an issuer to disclose in its annual proxy statement the reasons why the issuer has chosen either the same person to serve as chairman and chief executive or two different individuals to hold these offices. Because the SEC adopted rules in late 2009 mandating very similar disclosure, it is unclear

whether the Act requires the SEC to take any additional rule-making action in this area.

Compensation committee independence

The Act requires the SEC to direct stock exchanges to require compensation committee members to be independent under heightened standards and to consider the independence of compensation consultants and advisers. The SEC must adopt the rules by 16 July 2011, and the rules may exempt certain issuers, such as controlled companies and foreign private issuers. The exchanges may also exempt other issuers. The rules must also provide companies with an opportunity to cure any violation before becoming subject to delisting.

Specifically, the rules will require exchange-listed companies to have only independent directors serving on the compensation committee, and the exchanges' independence definition must consider compensation paid to the committee members (including compensation for consulting or advisory work) and whether the members are affiliates of the issuer. The Act also requires the SEC to adopt factors that companies must consider before selecting any consultant, legal counsel or other adviser to the compensation committee.

Companies must also give compensation committees authority and funding to engage and oversee compensation consultants, independent legal counsel and other advisers. Commencing with the first proxy statement for annual meetings held after the one year anniversary of adoption of the Act, companies would be required to disclose whether the compensation committee engaged any compensation consultants and describe any potential conflicts of interest, including the nature of the conflict and how it is being addressed.

In addition, recent SEC rules already require certain information about fees paid to compensation consultants that may raise independence concerns; however, the current SEC rules do not generally cover legal counsel or other advisers. Notably, the Act does not prohibit any particular engagements, but merely requires compensation committees to consider certain factors before engaging consultants, counsel and other advisers. The Act clarifies that the rules are not intended to require compensation committees to follow any advice received from the advisers. The Act also requires the SEC to conduct a study of the use of compensation consultants and the effects of such use, and report the SEC's findings to Congress within two years. ▶▶

Clawbacks of incentive compensation

The Act requires the SEC to direct all stock exchanges to require disclosure of each company's policies on incentive compensation based on financial information and adopt a clawback policy. The clawback policy must apply to all current and former executive officers and require the forfeiture of incentive compensation awarded to any such executive officer during the three years preceding the date on which a restatement resulting from material noncompliance with financial reporting requirements becomes required and requires a recalculation of the incentive compensation that would have been awarded based on the actual results. Stock options awarded as compensation are included as incentive compensation for this purpose, but it is unclear exactly how the clawback policy should apply to stock options – whether it relates to the number of options awarded or any gains recognised. It is also unclear how the clawback policies would relate to incentive compensation arrangements and stock options that have been granted prior to the effective date of the rule.

Whistleblower provisions

The Act encourages whistleblowers to report any violation of 'securities laws' directly to the SEC instead of the company by providing cash incentives for employees who provide 'original' information that leads to successful recovery by the government. Whistleblowers can receive a reward of between 10-30 percent of 'monetary sanctions' that are at least \$1m in the aggregate. The reward is based on how helpful the whistleblower is to the SEC.

The Act also takes measures to protect whistleblowers. First, it extends the statute of limitations for retaliation claims from 90 days to six years. Next, it exempts whistleblower claims from alternative dispute agreements. It also allows whistleblowers to bring claims directly in federal court and clarifies that whistleblower claims can be tried before a jury. The Act also provides for double-back pay in addition to reinstatement and attorneys fees and broadens employees covered by SOX to employees of consolidated subsidiaries of publicly traded companies and expands coverage to almost all financial services companies even if not public.

Other notable provisions

Brokers' discretionary voting. The Act expands on the SEC's 2009 change to NYSE Rule 452 (eliminating brokers' discretionary authority to vote in uncontested director elections) by mandating that all US stock exchanges have rules prohibiting member brokers from voting on the election of directors, executive compensation, or any other 'significant' matter (as the SEC may determine by rule), unless the beneficial owner has instructed the broker on how to vote.

Enhanced compensation disclosure. The Act requires the SEC to adopt a rule requiring clear disclosure of executive compensation, including the relationship between executive compensation actually paid and the company's financial performance and the ratio of CEO compensation to the median compensation of all other employees.

Disclosure of hedging policies. The Act requires the SEC to adopt a rule requiring disclosure in each annual meeting proxy statement of whether any employee or director, or their designees, are permitted to engage in hedging transactions. ■



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