CORPORATE GOVERNANCE/EXECUTIVE COMPENSATION UPDATE

Dodd-Frank Wall Street Reform and Consumer Protection Act - General Application to Public Companies

On June 30, 2010, the U.S. House of Representatives approved the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), and it is expected that Senate action will follow in early July. President Obama is expected to sign the measure into law shortly after final approval by the Senate. For information about the Act generally, see our comprehensive Client Update, which is available at http://www.sidley.com/sidleyupdates/Detail.aspx?news=4479.

The Act is focused in large part on the regulation of the financial services industry. It does, however, include a number of corporate governance, executive compensation, disclosure and other provisions that apply to public companies more broadly. This memorandum describes these more broadly applicable provisions, which include:

- shareholder use of the proxy materials to nominate directors;
- shareholder "say on pay" voting;
- independence of compensation committees and their advisers;
- clawback requirements for incentive compensation paid to executives based on misstated financial statements;
- increased compensation disclosure in proxy statements;
- increased oversight of compensation arrangements at large financial institutions;
- restrictions on the voting of shares by brokers;
- increased disclosure requirements of companies that use certain minerals sourced from the Democratic Republic of Congo or its adjoining countries, companies engaged in coal or other mining operations and companies engaged in the development of oil, natural gas or other minerals;
- exemption of non-accelerated filers from the Sarbanes-Oxley Act's external audit of internal control requirement; and
- whistleblower protections and incentives.

Proxy Access

- The Act gives the Securities and Exchange Commission (the "SEC") the authority, but not a mandate, to issue rules that allow shareholders to nominate directors by using the company's proxy solicitation materials. Under

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pre-existing law, there is some uncertainty as to whether the SEC has authority to adopt such rules. The Act gives the SEC the authority to exempt an issuer or a class of issuers from this requirement and directs the SEC to consider whether the requirement disproportionately burdens small issuers.

Say on Pay

- The Act requires that, at least once every three years, each company that is subject to the SEC's compensation disclosure requirements must include a separate non-binding "say on pay" vote in its proxy statement by which shareholders may approve the compensation of named executive officers as disclosed in the proxy statement. The vote will be purely advisory, and apply to the overall compensation disclosure, rather than the compensation of each executive or each program. In a separate nonbinding vote held at least once every six years the shareholders will determine whether the say on pay vote is to occur every one, two or three years.
- The Act also provides that whenever an issuer seeks shareholder approval of an acquisition, merger, consolidation or sale of all or substantially all of the issuer's assets, the issuer must disclose in its proxy statement all compensation arrangements, which the statute refers to as "golden parachute compensation," with named executive officers that relate to the transaction and the amount of compensation that may be paid to them. The shareholders are then entitled to exercise a nonbinding vote to approve the disclosed compensation arrangements, unless such arrangements previously were subject to a say on pay vote.
- Institutional shareholders who are subject to Section 13(f) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") are required to report annually how they voted in any say on pay vote.
- The say on pay requirements take effect at the first shareholder meeting that occurs more than six months after the date of enactment. For the first shareholder meeting, shareholders will vote on two items: (1) whether to approve the current compensation of named executive officers, as disclosed in the proxy and (2) whether future say on pay votes will be held every one, two or three years.
- The SEC is authorized to exempt issuers or classes of issuers, such as small issuers, from the say on pay requirement.

Compensation Committee Independence

- The Act requires the SEC to adopt rules to direct the national stock exchanges and national securities associations to prohibit the listing of an issuer's equity securities if the issuer does not have an independent compensation committee.
- For purposes of determining independence, the SEC's rules will take into account:
  - consulting, advisory or other compensatory fees paid by the issuer to the member of the committee and
  - whether the committee member is an affiliate of the company.
- The following entities are exempt from the independence requirement: (1) "controlled companies" that hold board of director elections in which more than 50% of the voting power is held by an individual, a group or another issuer, (2) limited partnerships, (3) companies in bankruptcy, (4) open-ended registered management investment companies and (5) foreign private issuers that disclose to shareholders annually why they do not have an independent compensation committee.

Independent Compensation Consultants and Counsel

- The Act also requires the SEC to adopt rules that would permit an issuer's compensation committee to engage compensation consultants, counsel and other advisers only after considering their independence. The Act directs the SEC to identify factors to be considered in assessing the independence of these advisers, including other services performed for the company, the fees paid to the adviser as a percentage of total revenue, procedures for selection, business or personal relationships and any stock of the issuer owned by the adviser. These factors must be "competitively neutral" among categories of consultants, counsel and other advisers.
- The issuer's compensation committee must have the authority to retain and oversee the work of any independent compensation consultant or legal counsel, and the company must fund the engagement.
- Any proxy statement for an annual meeting of shareholders occurring on or after the one-year anniversary of enactment must disclose whether the committee retained a compensation consultant, whether there are any conflicts of interest and how they are being addressed.
- The rules relating to the use of independent advisers do not apply to "controlled companies" that hold board of director elections in which more than 50% of the voting power is held by an individual, a group or another issuer.
- The Act directs the SEC to adopt these rules relating to Compensation Committee and advisor independence within 360 days of enactment.

Expanded Clawback Requirements

- The Act requires the SEC to adopt rules to direct the national stock exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the compensation clawback requirements included in the Act. The SEC rules will require that:
    - Exchange-traded companies adopt a clawback policy covering incentive compensation paid to all executive officers.
    - The required clawback applies in the event of an accounting restatement due to material noncompliance with financial reporting requirements. If triggered, the policy would require recovery from current and former executive officers of any incentive compensation received (including options) during the three-year period preceding restatement, in excess of what otherwise would have been paid to the officer.
- In contrast, the clawback requirement found in the Sarbanes-Oxley Act of 2002 covers only a company's CEO and CFO and applies only if noncompliance results from misconduct.

Hedging Disclosure

- The Act requires the SEC to adopt rules requiring disclosure in a company's proxy statement as to whether any director or employee of a company is permitted to hedge his or her position in any equity security of the company, whether granted to the employee or director as compensation or held, directly or indirectly, by the employee or director.

Increased Compensation Disclosure

- The Act requires the SEC to adopt rules requiring additional disclosure of:
    - information that shows the relationship between executive compensation actually paid and the financial performance of the company, taking into account any change in the stock value and dividends paid. This disclosure may include a graphic representation of the information required to be disclosed; and

- information on internal pay disparity, including:
  - the median annual total compensation of all employees, excluding the CEO,
  - the annual total compensation of the CEO, and
  - the ratio of the median non-CEO employee total compensation to that of the CEO.

Disclosures Regarding Chairman and CEO Structures

- The Act requires the SEC to adopt rules that would require an issuer to disclose in its annual proxy materials why the issuer has chosen the same person to serve as chairman of the board of directors and CEO or different individuals to serve in those positions. The SEC already requires similar disclosure pursuant to existing Item 407(h) of Regulation S-K.

Excessive Compensation of Covered Financial Institutions

- The Act requires the various regulators of covered financial institutions to jointly establish regulations, within nine months after enactment, that:
  - require financial institutions with assets of at least $1 billion to disclose to the regulators the structures of their incentive-based compensation arrangements (but not actual individual compensation levels), and
  - prohibit any such incentive-based compensation arrangements that the regulators determine encourage inappropriate risks (1) by providing executive officers, employees, directors or principal shareholders with excessive compensation, fees or benefits or (2) that could lead to a material financial loss to the institution.
- This requirement applies to (1) depositary institutions or holding companies, (2) broker-dealers registered under section 15 of the Exchange Act, (3) credit unions, (4) investment advisers, (5) Fannie Mae, (6) Freddie Mac and (7) any other institution designated by the regulators.

Broker Discretionary Voting

- The Act further restricts the ability of brokers to vote shares in the absence of a direction from shareholders by requiring the rules of the national securities exchanges to prohibit broker discretionary voting "with respect to the election of a member of the board of directors of an issuer, executive compensation, or any other significant matter, as determined by the [SEC]." The Act expressly exempts from this requirement votes with respect to the uncontested election of a member of the board of any registered investment company. The Act's treatment of broker discretionary voting follows the amendment, in January 2010, of NYSE rules governing brokers, which prohibited broker voting in all director elections. The Act would appear to prohibit, contrary to current practice, broker discretionary voting on management say on pay proposals.

Disclosure Regarding Use of Certain Minerals

- The Act contains provisions that relate to the use of certain minerals (the "conflict minerals") that are sourced from the Democratic Republic of Congo and its adjoining countries. The conflict minerals are "columbite-tantalite (coltan), cassiterite, gold, wolframite, or their derivatives" and other minerals specified by the Secretary of State.
- Specifically, the Act directs the SEC, within 270 days of enactment, to promulgate regulations that would require additional reporting by companies for which the use of conflict minerals is "necessary to the functionality or production of a product manufactured by such" company. Companies for which the use of conflict minerals is

necessary as described above would have to disclose annually whether the conflict minerals it uses originated in the Democratic Republic of Congo or an adjoining country. In cases in which the minerals did originate in any such country, the company would be required to submit to the SEC a report that includes a description of the measures taken by the company to "exercise due diligence on the source and chain of custody of such materials," which measures will be required to include an independent private sector audit. The report to be submitted to the SEC would also be required to include a description of a number of other items relating to the use of the conflict minerals, including a description of any such products that are "not DRC conflict free." The term "DRC conflict free" is defined to mean that the products "do not contain minerals that directly or indirectly finance or benefit armed groups in the Democratic Republic of Congo or an adjoining country."

- These disclosure requirements will terminate on the date, not earlier than five years from the date of enactment, on which the President determines and certifies that "no armed groups continue to be directly involved and benefitting from commercial activity involving conflict minerals."
- The Act contains several other provisions imposing obligations on the Secretary of State and the Comptroller General and the Secretary of Commerce that relate to the conflict in the Congo and the effectiveness of the new disclosure requirements.

Disclosure Applicable to Mine Operators

- The Act contains provisions that will require additional disclosure for issuers that operate, or have subsidiaries that operate, "coal or other mines." Specifically, such companies will be required to include in each periodic report a number of items relating to the company's mine-safety history.
- In addition, such companies will be required to file a Form 8-K upon the receipt of certain specified safety-related notices from regulators.
- This section of the Act, which is apparently self-effectuating, will take effect 30 days after enactment.

Disclosure Applicable to Entities Engaged in Resource Extraction

- The Act directs the SEC, within 270 days of enactment, to issue rules that require "resource extraction" issuer[s]" to include in "an annual report" of the issuer information relating to "any payment made by the resource extraction issuer, a subsidiary . . . or an entity under control of the resource extraction issuer to a foreign government or the Federal Government for the purpose of the commercial development of oil, natural gas, or minerals." The term "resource extraction issuer" is defined to mean an issuer that is required to file reports with the SEC and "engages in the commercial development of oil, natural gas, or minerals.

SOX External Audit of Internal Controls

- The Act exempts issuers that are neither "large accelerated filers" nor "accelerated filers" from the Sarbanes-Oxley Act's external audit of internal control requirement. The SEC is to conduct a study to determine how it could reduce the burden of complying with Section 404(b) of the Sarbanes-Oxley Act for companies whose market capitalization is between $75 million and $250 million. The Comptroller General further is to conduct a study on whether issuers that are exempt from Section 404(b) requirements have fewer or more restatements of published accounting statements.

Whistleblower Protection

- The Act amends the Exchange Act to require the SEC, in any judicial or administrative action brought by the SEC under the securities laws that results in monetary sanctions exceeding $1 million, to pay awards to whistleblowers who voluntarily provide original information that leads to a successful enforcement of an action. The amount of payment would be not less than 10 percent, and not more than 30 percent, in total, that has been collected. Employers would be prohibited from firing or discriminating against a whistleblower because of any lawful act done by the whistleblower. The statute of limitations for a whistleblower to bring an action against his or her employer for unlawful retaliation is six years from the date of the violative conduct or three years from the date when facts material to the right of action are known or reasonably should have been known by the employee, but in no case may an action be brought more than 10 years after the date of the violation. The SEC Inspector General must conduct a study of the whistleblower protections established by this amendment, including whether the SEC is prompt in responding to information provided by whistleblowers. The Inspector General must submit a report on his findings to Congress, and must make the report publicly available on the SEC's website, not later than 30 months after enactment of the Act.

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