August 5, 2010

President Obama Signs the Dodd-Frank Act: Corporate Governance and Disclosure Provisions and Smaller Public Company Relief from SOX § 404(b)

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The Act was intended primarily to overhaul the financial regulatory framework following the global financial crisis, and financial institutions are most affected by its provisions. However, all public companies may be substantially affected by certain provisions of the Act relating to corporate governance and disclosure.

Summary of Key Corporate Governance and Disclosure Provisions of the Act

To assist our clients in preparing for the new regulatory changes, a summary of the Act's key corporate governance and disclosure provisions follows:

"Say on Pay." The Act requires public companies to include a non-binding resolution to approve the compensation of their named executive officers in any proxy statement containing executive compensation disclosure at least every third year, effectively giving shareholders an advisory vote on executive compensation. At least every six years, such proxy statements must include a separate resolution subject to shareholder vote to determine whether the advisory vote on executive compensation will occur every one, two, or three years. Both resolutions must be included in the proxy statement for the first meeting of shareholders occurring after January 21, 2011. The "say on pay" provision in the Act is a scaled-back version of the provision in the Senate's version of the Act, which would have mandated a shareholder vote annually.

"Golden Parachute" Compensation. The proxy or consent solicitation materials for any meeting at which shareholders of a public company are asked to approve an acquisition, merger, consolidation, or proposed sale of all or substantially all the assets of the company, must disclose any compensation arrangements

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involving named executive officers that are related to the transaction. The proxy or consent solicitation materials must also contain a separate non-binding resolution for shareholders to approve such compensation. Any proxy statement for a merger or acquisition transaction on which shareholders will vote after January 21, 2011 must include the new disclosure and advisory resolution.

Proxy Access. The Act authorizes the Securities and Exchange Commission (the "SEC") to adopt rules permitting shareholders to include their own director nominations in a public company's proxy solicitation materials. Companies continue to have the ability to exclude other types of shareholder proposals from their proxy solicitation materials under certain circumstances. While the SEC has previously proposed such proxy access rules several times, the proposals have been controversial because, among other things, questions were raised as to whether the SEC had sufficient authority to adopt the rules. The express authority granted by the Act resolves those questions, and the SEC is expected to adopt proxy access rules that will be applicable for the 2011 proxy season.

Clawback. The Act requires securities exchanges to implement listing standards requiring exchange-listed companies to adopt and disclose policies under which "excess" incentive-based compensation (including stock options) must be recovered by the company from current and former executive officers in the event the company is required to restate its financial statements due to material non-compliance with financial reporting requirements. "Excess" incentive-based compensation is the amount by which the incentive-based compensation paid based on erroneous data during the three years preceding the restatement exceeds the incentive-based compensation that would have been paid based on the restated financial statements. Unlike the clawback provision in the Sarbanes-Oxley Act of 2002 ("SOX"), this provision does not require misconduct.

Compensation Committee Independence (and Independence of Advisers). The Act imposes heightened independence requirements on the directors who serve on an exchange-listed company's compensation committee similar to those currently imposed on audit committee members. The Act requires the national securities exchanges to consider relevant factors in determining the appropriate definition of "independence" for compensation committee members, including the source of compensation to the director (such as consulting, advisory, or other compensatory fees paid by the company to the director) and whether the director is affiliated with the company or its subsidiaries. The Act also gives compensation committees authority to retain and supervise their own compensation consultants, counsel, and other advisers. Compensation committees are not required to engage only independent advisers, but they must consider specific independence factors to be identified by the SEC before selecting such consultants, counsel, and advisers.

Broker Discretionary Voting. The Act prohibits broker discretionary voting on director elections, executive compensation, or any other significant matter as determined by the SEC. Beginning in 2010, brokers are already prohibited from voting on director elections without instructions from beneficial owners of securities, but the Act also prohibits broker discretionary voting on a "say on pay" or "golden parachute" proposal and authorizes the SEC to designate further "significant matters" for which broker discretionary voting would be prohibited.

Additional Disclosure Provisions. The Act directs the SEC to adopt rules requiring all public companies to disclose the relationship between executive compensation and the company's financial performance, information about internal pay equity, whether any employee or director is permitted to engage in hedging activities, and the reasons why the CEO and chairman of the board roles are or are not combined. With respect to internal pay equity, companies must disclose (1) the median of the annual total compensation for all employees except the CEO, (2) the annual total compensation of the CEO, and (3) the ratio between these amounts. The SEC's rules are expected to clarify the required calculation methods for the internal pay equity disclosure.

SOX § 404 Auditor Attestation. The Act permanently exempts non-accelerated filers (companies with a public float of less than $75 million) from the requirements of SOX § 404(b), which requires a public company's outside auditors to attest to the company's internal control over financial reporting. Over the last few years, the SEC has postponed this requirement for non-accelerated filers several times, but it was to have finally taken effect with respect to fiscal years ending on or after June 15, 2010. The Act effectively negates the SEC's requirement, providing welcome relief for smaller public companies.

Practical Impact of New Provisions

The corporate governance and disclosure provisions of the Act, several of which will become effective as early as the 2011 proxy season, may substantially increase shareholders' influence over a public company's affairs and may result in increased pressure on director elections. Shareholders will have more information than ever before regarding executive compensation and the power to vote on it. While the "say on pay" vote would be non-binding, shareholder disapproval of a company's executive compensation program will signal an expectation that the company will change its compensation practices. If the company does not respond to shareholder concerns, shareholders would have the power to nominate their own director candidates in the company's proxy statement, which may result in a contested election. It remains to be seen how the "say on pay" advisory vote will impact director elections (and how the "golden parachute" advisory vote will impact changes of control) and what approach companies will take with respect to the frequency of "say on pay" votes. We will monitor the trends and keep our clients informed as best practices develop in these areas. Importantly, however, the Act does not include any provision for mandatory majority voting for director elections, which was included in the Senate's version. As a result, companies that have not already adopted majority voting for directors will not be required to do so by the Act.

In preparation for the upcoming proxy season, public companies should closely review their executive compensation practices, including any "golden parachute" provisions in executive officer employment agreements, to determine whether they might present any "hot button" issues with the company's shareholders and develop an investor relations management strategy. Exchange-listed companies also will need to prepare clawback policies or revise existing policies to meet the new, more stringent requirements. Exchange-listed companies should also consider reviewing their corporate governance policies related to the independence of the compensation committee and its supervision authority with respect to advisers, as well as the independence of compensation committee consultants, in anticipation of forthcoming regulatory changes.

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While every effort has been made to ensure the accuracy of this memorandum, it is not intended to provide legal advice as individual situations will differ and should be discussed with an expert and/or lawyer. For specific technical or legal advice on the information provided and related topics, please contact Gerald Roach (919.821.6668), Amy Batten (919.821.6677), or Margaret Rosenfeld (919.821.6714).

Special thanks to Amy Wallace, Francisco Benzoni and Mikal Shaikh, contributing writers.

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