Observations on Key Corporate Governance Impacts of Dodd-Frank

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On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, the most sweeping financial regulatory reform legislation in decades. Reaching well beyond the financial services industry, the Act contains significant executive compensation and corporate governance provisions applicable to all public companies. Dodd-Frank continues a shift to federalization of standards for the governance of public companies and toward a shareholder-centric, rather than board-centric, environment.

Say on Pay and Golden Parachutes

Dodd-Frank mandates two new non-binding advisory votes for public company shareholders.

First, the Act requires that public companies hold a non-binding shareholder vote on executive compensation ("say on pay") every one, two, or three years. Companies also are required to provide for a separate vote no less than every six years to determine the frequency of say-on-pay votes.

Second, the Act provides that, in connection with a merger or other business combination transaction, companies must hold a non-binding shareholder vote on executive compensation tied to the transaction ("golden-parachute compensation"), unless the compensation already has been subject to a vote by shareholders.

While neither say-on-pay nor golden-parachute votes will overrule any decision of the company or the board of directors, negative votes will put pressure on directors to adhere to the compensation views of activist shareholder groups and proxy advisory firms.

In light of the golden-parachute provision, companies and executives should establish change-in-control compensation arrangements more definitively in advance, so that they can be subject to approval under a periodic say-on-pay vote rather than being separately voted on when a merger or sale occurs. And investor groups should clearly state which compensation practices they find unacceptable.

Spotlight on Compensation Committees and Their Advisors

Dodd-Frank will reshape compensation committee membership and procedures at listed companies.

Like the heightened independence requirements imposed on audit committees and their advisors under the Sarbanes-Oxley Act in 2002, Dodd-Frank mandates that compensation committee members be independent under a yet-to-be-written definition, and the Act directs compensation committees to assess and report on the independence of their consultants and other advisors.

Companies must disclose in their proxy statements when their compensation committee has retained a compensation consultant, whether the consultant's work raised conflicts of interest, and how conflicts are addressed. This disclosure requirement will create added pressure on companies to utilize only independent consultants to avoid adverse comparison with their peers and criticism from investor groups.

The disclosure requirements cover not only fees paid to compensation consultants for their work, but also other factors (including, for example, family relationships of corporate officers with the consultant) that could affect consultant independence.

Fairness in Executive Compensation

Dodd-Frank contains a number of disclosure and other provisions intended to promote transparency and notions of "fairness" in executive compensation.

The Act requires that public companies disclose in their annual proxy statements the relationship between executive compensation actually paid and the company's financial performance, and whether their employees or directors are permitted to hedge their ownership positions in company securities to reduce market risk.

Bowing to populist sentiment, Dodd-Frank requires disclosure in SEC filings of the ratio between the median annual total compensation of all employees other than the CEO and the annual total compensation of the CEO, a calculation that will prove expensive and time-consuming for issuers given the complexity of calculating total compensation for a large and varied employment force.

The Act significantly sharpens the "claw" in clawback. It requires that listed companies implement a policy to recoup from current or former executives any financial performance-based incentive compensation paid during a three-year look-back period, after a company restates financial results due to a material error.

Notably, this clawback policy will apply even if no one at the company engaged in misconduct. Covering all current and former senior executives and omitting a fault requirement, Dodd-Frank's clawback provision goes far beyond both the clawback obligations created in Sarbanes-Oxley and the policies currently in effect at many companies.

Although the Act does not specify when the SEC must adopt rules implementing the clawback and executive compensation disclosure provisions, compensation committees will need to consider them now as they develop compensation plans. One likely impact of these federal changes is that sought-after, key employees will demand that most of their pay be in fixed salary and guaranteed raises and less in the form of performance incentives, a change investors may rue.

Shareholder Empowerment

In addition to shining a spotlight on compensation, Dodd-Frank continues to tilt the balance of power in public companies toward shareholders.

The Act prohibits uninstructed broker voting in diretor elections, say-on-pay votes, and votes on other "significant" matters as determined by SEC rule. This greatly expands the scope of an NYSE rule change approved last July by the SEC that eliminated uninstructed broker voting in uncontested elections. Retail investors who hold stock in street name will not be able to rely on their brokers to vote for them without specific instruction, with the inevitable result that their participation level in corporate affairs will be lower.

The Act also authorizes the SEC to adopt proxy access rules permitting shareholders to use company proxy solicitation materials to nominate directors, addressing a decade-long debate as to whether the SEC had the authority to adopt such a mandate. Reassured by Dodd-Frank, the SEC adopted proxy access on August 25, giving shareholders or groups who hold 3% of a company's voting power for at least three years the right to contest 25% of a company's board seats using the company proxy.

The Act also requires companies to explain their board leadership structures to shareholders, echoing new SEC disclosure requirements adopted last December.

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Companies and investors should brace for an extremely active period of SEC rulemaking over the next 24 months, including both the Dodd-Frank mandates and new rules relating to the SEC's recently launched project of addressing the cost and effectiveness of the proxy system.

Dodd-Frank is another step along, but far from the end of, the bumpy road toward federal standards of governance for publicly traded companies. ⌘

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