Corporate Executive Briefing: Dodd-Frank Act and SEC Disclosures - What to Expect for 2011

January 2011
Overview of Presentation

- Regulatory updates and impacts of the Dodd-Frank Act and SEC rule-making on your 2011 annual disclosure documents and proxy statement process
  - "Say on Pay" votes by shareholders and other compensation-related matters
  - Proxy Access and other provisions of the Dodd-Frank Act
Dodd-Frank Act
"Say on Pay" Rule
Dodd-Frank Act: "Say on Pay"

Background of "Say on Pay" Rule

• The number of shareholder proposals requesting advisory votes on compensation has been increasing each year since 2006

• 65 companies have voluntarily given their shareholders an advisory vote on compensation. Aflac was the first U.S. company to do so in 2008

• In 2009, advisory votes on pay were mandated for the first time at hundreds of companies that received funds from the government's Troubled Assets Relief Program
Dodd-Frank Act: "Say on Pay"
Status of SEC's "Say on Pay" Rule

- Section 951 of the Dodd-Frank Act authorizes the SEC to issue rules to allow shareholders to have a non-binding vote to approve executive compensation and golden parachutes.

- The SEC's proposed rule was issued on October 18, 2010.

- Public comments on the proposed rule were accepted until November 18, 2010.

- SEC likely to approve rule as proposed. Regardless, the rule will take effect for annual meetings taking place on or after January 21, 2011.
Key Provisions of the "Say on Pay" Rule

- Key provisions of the rule requires a separate "Say on When" vote for every public company:
  - Must allow shareholders to vote, at least once every 6 years, on how often to conduct a separate shareholder advisory vote on executive compensation with the following choices:
    - Every year
    - Once every two years
    - Once every three years
    - Abstaining from this "say on when" vote
Dodd-Frank Act: "Say on Pay"

How the "Say on Pay" Vote Works

- In the proxy statement, a separate advisory (non-binding) proposal would be included asking shareholders to vote to approve the executive compensation described in the proxy statement.

- Non-binding, similar to the advisory vote whether or not to retain the independent auditors selected by the Audit Committee.

- However, a "no" vote by shareholders would force the Compensation Committee to review the compensation programs and policies. ISS and institutional investors would be expected to vote against the re-election of directors serving on the Compensation Committee if no changes to compensation programs were made in response to a "no" vote.
Dodd-Frank Act: "Say on Pay"
Separate "Say on Pay" Vote on Golden Parachutes

- If the company is soliciting votes to approve a merger or acquisition transaction, including a going-private transaction or third party tender offer:
  - The company would disclose all elements of any "golden parachute" arrangements (severance pay, accelerated vesting on stock and option awards, payments in cancellation of stock and option awards, pension and non-qualified deferred compensation benefit enhancements, perquisites, tax gross-ups, etc.) with its executives in a table similar to the summary compensation table, and allow shareholders a separate advisory vote on the "golden parachutes"

- If the "golden parachutes" were included in a prior "say on pay" vote, then this separate proposal is not required
Dodd-Frank Act: "Say on Pay"
Action Items for 2011

- "Say on When" vote:
  - Consider whether to recommend annual, bi-annual or tri-annual vote on executive compensation in your 2011 shareholder meeting. Seek input of compensation consultant, investor relations, proxy solicitor and legal counsel. Some factors to consider: year-over-year consistency in type and amount of compensation and duration of performance periods. Early trends show institutional investors favoring annual votes and companies favoring tri-annual votes
  - know your shareholder base and consider discussions with major shareholders prior to meeting
  - In the first 10-K or 10-Q following the "Say on When" vote, disclose decision regarding how frequently "Say on Pay" votes will be sought
Dodd-Frank Act: "Say on Pay"

Action Items for 2011

- "Say on Pay" vote:
  - Reassess compensation plans and arrangements. Seek input from compensation consultant and legal counsel as to best practices
  - Review policies and voting guidelines of ISS and others regarding compensation practices
  - Examine compensation disclosure- does it meaningfully explain compensation decisions and the reasons why the Compensation Committee felt those decisions were appropriate
  - Revisit approval standard for "Say on When" and "Say on Pay" votes under charter documents and state law. Brokers cannot vote uninstructed shares for "Say on When" and "Say on Pay" votes
  - Know your shareholder base and consider discussions with major shareholders prior to meeting
Dodd-Frank Act: "Say on Pay"
Action Items for 2011

• "Say on Pay" vote on Golden Parachutes:
  – Consider whether to include a "Say on Pay" vote on golden parachute payments at the same time as the regular "Say on Pay" vote on executive compensation or only upon a triggering transaction
    - Earlier vote allows a company to link approval of golden parachute arrangements with the rest of the executives' compensation packages. Earlier vote saves the company an additional layer of complication relating to the disclosure and approval process of a major transaction
    - Later vote at the time of a triggering transaction permits the company to seek approval of golden parachute arrangements in the context of a transaction and not in the abstract. Waiting for a later vote may obviate the need for a vote on the issue at all if no triggering transaction occurs
Dodd-Frank Act
Compensation Clawback Rule
Dodd-Frank Act: Incentive Compensation Clawback Rule

Status of the Rule

• Section 954 of the Dodd-Frank Act requires the SEC to issue rules barring the listing of any equity security on an exchange if the company does not have a policy that provides for the recovery of incentive-based compensation erroneously paid to executive officers in the event of an accounting restatement

  – While the specific mechanism for recovery of the compensation is not mandated, many have assumed that the required policy should take the form of a traditional "clawback"

• SEC final rule expected to be issued sometime between April and July 2011
Dodd-Frank Act: Incentive Compensation Clawback Rule

Elements of a policy to recover erroneous incentive compensation

- When any restatement is required, the company needs to determine if any executive incentive compensation in the prior three years was paid or awarded based on achievement of a performance target that is affected by the restatement.

- The clawback requirement is mandatory and is not predicated on misconduct by the company or the executive. Mere error triggers the recovery.

- The company must have the right to recover or "clawback" any excess compensation (including stock options) which was based on erroneous data and paid during the 3-year period preceding the accounting restatement.

- The policy is required for the named executive officers, but could have broader coverage.
Dodd-Frank Act: Incentive Compensation Clawback Rule

- Key differences between Sarbanes-Oxley and Dodd-Frank: Executive Compensation Clawbacks
  - Compensation clawbacks under SOX only for CEO and CFO, but clawbacks under Dodd-Frank are for all five "named executive officers" listed in the proxy statement (and includes retired officers)"
  - Clawback under SOX is limited to past 12 months, but clawback under Dodd-Frank goes back three years
  - Clawback under SOX is based on fraud or misconduct (a "knowingly" standard), but clawback under Dodd-Frank is based merely on error
Dodd-Frank Act: Incentive Compensation Clawback Rule
Action Items for 2011

- Board will have to adopt a policy to recover incentive compensation that was paid in error if a policy is not already in place

- Determine if the policy should take the form of a traditional "clawback". Consider with legal counsel if a contractual obligation with the named executive officers is sufficient to enforce the payment of erroneous incentive compensation payments
  - As an alternative to "clawback", you could consider if a deferred compensation plan, where incentive compensation is deferred for three years, is appropriate

- Failure to adopt a policy could result in being delisted from a stock exchange
Dodd-Frank Act
Executive Compensation Disclosures
Dodd-Frank Act: Executive Compensation Disclosures

Status of Executive Compensation Disclosures

- Sections 953 and 955 of the Dodd-Frank Act requires the SEC to adopt or amend rules regarding executive compensation disclosure in proxy statements

- Will not be in effect until adoption by the SEC of final rules. SEC final rules expected to be issued sometime between April and July 2011
Dodd-Frank Act: Executive Compensation Disclosures

Key Provisions of Revised Executive Compensation Disclosures

- Disclose: (A) the median of the annual total compensation of all employees of the company, except the CEO; (B) the annual total compensation of the CEO; and the ratio of (A) to (B)

- Disclose the relationship between executive compensation actually paid to CEOs and financial performance taking into account any changes in the value of the company's shares and dividends and distributions. Graphical presentation is suggested but awaiting details in SEC final rulemaking

- Disclose whether any employees (not only executive officers) or directors are permitted to hedge against decreases in the value of company stock granted as compensation or held directly or indirectly by any employees or directors
Dodd-Frank Act: Executive Compensation Disclosures
Action Items for 2011

- Assess personnel and resources necessary for your company to calculate the median annual total compensation of all employees

- Assess where companies may need to implement further controls or processes to gather the necessary information to calculate the median annual total compensation of all employees. The final rules will need to clarify several items including, if a company would be required to include U.S. and non-U.S. employees, full-time and part-time employees, and issues relating to the conversion of foreign currency amounts

- Consider how to put this information in context and address potential misimpressions and negative reactions that could impact "Say on Pay" votes
Dodd-Frank Act
Proxy Access Rule
Dodd-Frank Act: Proxy Access

Status of SEC's Proxy Access Rule

- Section 971 of the Dodd-Frank Act authorizes the SEC to issue rules to allow shareholders to have direct access to a public company's Proxy Statement for its Annual Meeting to be able to nominate individuals to the Board of Directors.

- The SEC's final rule was adopted in August 2010, applicable to 2011 annual meetings. The final rule provides a 3-year moratorium for smaller reporting companies.

- US Chamber of Commerce and Business Roundtable filed suit; SEC agreed to delay implementation pending Court decision.

- Court likely to approve rule. If so, rule will likely take effect in late 2011 and be applicable for 2012 proxy season.
Dodd-Frank Act: Proxy Access
SEC Final Rule Adopted August 2010

- A public company must include a qualifying shareholder's nominee(s), together with the Board's nominees, in its Proxy Statement. A shareholder qualifies to nominate one or more individuals to serve as directors if it:
  - Owns 3% or more of the voting and dispositive power of outstanding shares, for at least 3 years preceding the meeting
  - Commits to hold its shares at least through the annual meeting date, and discloses its intention with respect to continued ownership following the meeting
  - Confirms that it is not seeking to change control of the company or gain more than the maximum number of board seats permitted

- Shareholders can form groups to meet the 3% minimum ownership level
The number of shareholder nominees may be up to a maximum 25% of the entire Board (or one director, whichever is greater)

- For a Board with staggered terms with only 1/3 of the directors up for election at a given meeting, a shareholder nominee elected for a 3-year term will count against the 25% cap for the following two annual meetings

- If the number of shareholder nominees exceeds the maximum, then priority is given to the nominees of the largest nominating shareholder(s)
Dodd-Frank Act: Proxy Access
Qualifications of the Shareholder Nominee

• The nominee must meet the objective independence standards of the stock exchange on which the company's securities are listed

• The nominee is not required to meet director qualification standards included in the company's governing documents

• The nominee may not have a direct or indirect agreement with the company regarding his or her nomination

• There is no restriction on relationships between the nominating shareholder or shareholder group and the nominee, but any such relationships need to be disclosed. For example, a union trying to organize at a company could nominate its executive to the Board
Dodd-Frank Act: Proxy Access
Nominating Process for a Shareholder

- A nominating shareholder must file a Schedule 14N with the SEC no earlier than 150 and no later than 120 days prior to the anniversary of the mailing date of the prior year's Proxy Statement.

- Schedule 14N would disclose information about the nominating shareholder, its qualifications to nominate (3% ownership for 3 years), its nominee (independence, background, and relationship with the nominating shareholder), and other matters.
Dodd-Frank Act: Proxy Access
Company Response to a Nominating Shareholder

• A company cannot opt out of the Proxy Access Rule

• A company can use the no-action process to exclude nominees if it believes a nominee or nominating shareholder does not satisfy the requirements

• Schedule 14N would disclose information about the nominating shareholder, its qualifications to nominate (3% ownership for 3 years), its nominee (independence, background, and relationship with the nominating shareholder), and other matters
Dodd-Frank Act: Proxy Access
Impact on Section 13, Section 16, and Affiliate Status

• A nominating shareholder does not lose Schedule 13G status as a passive institutional investor by filing a Schedule 14N
  – SEC provided no guidance or safe harbor from "affiliate" status for a nominating shareholder. As a result, if a Section 13G shareholder's nominee is an affiliate of the shareholder and is elected to the Board, the nominating shareholder might become an affiliate of the company. If so, it then would have to convert to Section 13D status

• Shareholders forming a group for purposes of a Schedule 14N nomination would have to consider their "group" status under Section 13D under the existing Section 13 regulations
Dodd-Frank Act: Proxy Access
Action Items for 2011

• Monitor and analyze shareholder base for any 3% shareholders
  – Attempt to track any Schedule 14N filings by institutional shareholders at other companies they are invested in

• Review relationships and, if necessary, enhance engagement with major stockholders
  – Does management have contact with them? Does the Board/Investor Relations know if they have any concerns?

• Consider the current composition of the Board for potential issues that may be raised by institutional shareholders
  – Review how the Board and company have been rated by ISS and other institutional shareholder organizations
Dodd-Frank Act: Proxy Access
Action Items for 2011

• Review advance notice bylaws to confirm that they are not inconsistent with proxy access rules

• Confirm that the company has no vacancies on the Board that could be filled through shareholder nomination

• Review and revise, if necessary, corporate governance guidelines, board committee charters, bylaws and proxy statement disclosure to clarify that the criteria for director selection relate to the selection of nominees by the company's governance/nominating committees

• Assess whether appropriate internal controls and procedures are in place to promptly review and respond to any nomination notices
Dodd-Frank Act
Independence of Compensation Committee Members
Dodd-Frank Act: Independence of Compensation Committee Members

- Status of Independence of Compensation Committee rulemaking:
  - Section 952 of the Dodd-Frank Act authorizes the SEC to adopt rules directing the national securities exchanges from prohibiting the listing of any equity security of an issuer whose compensation committee is not composed exclusively of independent directors
  - SEC must issue rules by July 16, 2011

- Factors to be considered in the definition of independence:
  - Source of compensation of the director, including any consulting, advisory, or other fees paid by the company
  - Whether the member is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of the issuer

- Action items:
  - Review current compensation committee membership and address any potential problem areas
Dodd-Frank Act
Compensation Consultants
Dodd-Frank Act: Independence of Compensation Consultants

- Status of Independence of Compensation Consultant rulemaking:
  - Section 952 of the Dodd-Frank Act requires that the compensation committee may only select a compensation consultant, legal counsel or other adviser after taking into account independence factors identified by the SEC.

- Factors to be considered:
  - Provision of other services to the company by the adviser's employer.
  - Amount of fees paid to the adviser's employer, considered as a percentage of the employer's total revenues.
  - Policies and procedures of the adviser's employer that are designed to prevent conflicts of interest.
  - Business or personal relationships between the adviser and members of the compensation committee.
  - The adviser's ownership of the company's stock.
Dodd-Frank Act: Independence of Compensation Consultants

• Disclosure and Funding:
  – Companies must disclose in their annual proxy statement whether:
    - The compensation committee retained or obtained the advice of a compensation consultant
    - The compensation consultant's work raised any conflict of interest, the nature of the conflict and how the conflict is being addressed
  – Disclosure requirement applicable to compensation consultants but not to independent legal or other advisers
  – Disclosure requirement applicable for shareholder meetings occurring on or after July 20, 2011
Dodd-Frank Act
Whistleblower Bounty Program
Dodd-Frank Act: Whistleblower Bounty Program

Status of the Whistleblower Bounty Program

- Section 922 of the Dodd-Frank Act provides that any eligible whistleblower who voluntarily provides the SEC with information that leads to SEC enforcement action with a recovery of $1 million or more of sanctions is awarded between 10% and 30% of the total sanctions.

- The SEC issued proposed rules on November 3, 2010 (181 pages). The SEC accepted public comments on the proposed rule until December 17, 2010.

- SEC must issue regulations no later than April 17, 2011.
Dodd-Frank Act: Whistleblower Bounty Program

Goals of the Whistleblower Bounty Program

- Increase the volume of high-quality tips that the SEC receives
- Dissuade employees from bypassing internal corporate compliance programs
- Prevent wrongdoers from profiting from their conduct
- Prevent individuals with compliance obligations – lawyers, auditors, internal compliance personnel – from using their positions to reap bounties
- Avoid receiving frivolous or bad faith claims, or claims based on information received through unlawful actions
Dodd-Frank Act: Whistleblower Bounty Program

Problems with the Whistleblower Bounty Program

- The proposed rule attempts to dissuade employees from bypassing internal corporate compliance programs, by allowing a whistleblower to remain eligible for a bounty if he reports the same information to the SEC within 90 days after first reporting to the company's internal compliance program. However, the whistleblower is not required to internally report in the first instance, though that may increase his bounty from the SEC. Even if he does, the company may be diligently investigating the matter but unable to resolve it within 90 days. Alerting the SEC in 90 days may not result in a different outcome except to raise the cost of investigation and remediation
  - The SEC may contact the company to give the company an opportunity to investigate and report back
- While employees who are criminally convicted may not receive a bounty, a whistleblower who is otherwise culpable may receive a bounty
Dodd-Frank Act: Whistleblower Bounty Program

Action Items

- Monitor the status of the SEC rulemaking

- Review existing internal corporate compliance programs with internal auditor and legal counsel. Ensure the programs appropriately incentivize internal reporting by employees

- Consider whether new record-keeping procedures should be implemented in light of new whistleblower retaliation cause of action and extended statute of limitations

- Be aware of new whistleblower incentives when deciding whether to conduct an internal investigation or self-report to the SEC

- Reinforce "tone from the top" of strict ethical and legal compliance

- Continue to inform employees of the existing corporate compliance reporting system (complaint hotline, etc.)
Dodd-Frank Act
404 Exemption
Section 989G of the Dodd-Frank Act grants a permanent exemption of smaller reporting companies from the Sarbanes-Oxley auditor attestation requirement.

Auditor attestation requirements will only apply to accelerated filers and large accelerated filers.
Dodd-Frank Act
Revised Accredited Investor Standard
Dodd-Frank Act: Revised Accredited Investor Standard

- Revised Accredited Investor Standard:
  - Section 413 of the Dodd-Frank Act modifies the "accredited investor" standard applicable to natural persons by excluding the value of a principal residence in determining whether a person has a net worth of at least $1 million.

- Action items:
  - Companies relying on the Regulation D safe harbor for an offering of securities need to incorporate the revised accredited investor standard into their private placement memoranda and subscription documents.
Questions and Answers

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