Deloitte.

The Dodd-Frank Act's impact on public companies: After one year

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For Deloitte documents referenced in this publication, see Deloitte's Center for Corporate Governance website at www.corpgov.deloitte.com.

Introduction

When President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act on July 21, 2010, it was only the first chapter in the financial regulatory reform process. The legislation required hundreds of rulemakings by numerous agencies, as well as dozens of studies and the creation of new regulators and new areas of responsibility for existing regulators. As a point of comparison, the Sarbanes-Oxley Act of 2002 required the SEC to adopt 16 rules and conduct fewer than 10 studies.

The Dodd-Frank Act is largely focused on the financial services sector. However, there are likely to be secondary effects on nonfinancial companies that arise from the financial sector reforms. For example, the focus on reducing the risk in lending practices may result in banks passing through increased costs to their customers, especially those considered to be higher risk.

Extensive new regulations for over-the-counter (OTC) swaps are still taking shape, but certain of those reforms may affect nonfinancial companies that are end-users of those instruments. The Dodd-Frank Act requires central clearing of most OTC swaps and, although some nonfinancial companies that use swaps to hedge or mitigate a commercial risk may be exempt, the processes end-users may need to put in place to take advantage of the exemptions are not yet clear.

A number of the reforms aimed at the credit rating agencies also may have secondary impacts on a broad group of companies, because as the credit raters come under more regulatory scrutiny, their ratings processes may change and new players may enter the market. Moreover, the move away from regulatory reliance on the nationally recognized statistical ratings organization (NRSRO) designation also may affect companies that have relied on NRSRO ratings in certain types of offerings.

The overall impact of the Dodd-Frank Act on the SEC's agenda and operations also is relevant to many companies. In the short term, its required implementation activities are likely to dominate the agenda. By all accounts, the SEC has been working diligently; it has already completed more than a dozen rules, proposed more than three times that many, and completed numerous studies and reports to Congress. This is in addition to forming new groups and offices to address requirements of the act. Nonetheless, the SEC has fallen behind on a number of statutory deadlines, so implementation is likely to continue to be a focus. Over the longer term, the act, as well as certain other pressures the agency has been under, promise a continued focus on enforcement activities and investor advocacy.

In addition to the secondary effects of the financial sector reforms, there are many provisions of the Dodd-Frank Act that are directly relevant to a larger group of public companies in various industries, although the impact may vary by industry and size of company. Implementation of some of these provisions has been completed, and implementation of a substantial number is under way or still to come.

The provisions of the act that directly influence a potentially broad group of public companies are discussed in more detail below. They include provisions related to small-company exemptions from the auditor attestation requirement related to internal control over financial reporting; mineral, mining, and extraction industry disclosures, including disclosures regarding the use of "conflict minerals" in manufacturing; the asset-backed securitization process; corporate whistleblower programs; and corporate governance and executive compensation reforms.

This publication is divided into four sections: first, a discussion of the latest developments related to proxy access, followed by sections devoted to finalized rules, rules currently under way, and rules yet to come. The current status of each of the rulemakings is available at the Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act page on the SEC's website.

The latest development: proxy access

Proxy access

After many years of debate, the Dodd-Frank Act gave the SEC authority to move forward with regard to proxy access.

The SEC acted quickly and issued its final rule on proxy access on August 25, 2010. The final rule would have permitted shareholders who owned, either individually or in aggregate with other shareholders, at least three percent of a company's voting stock for at least three years, to nominate director candidates for up to 25 percent of the company's director seats and to include these candidates in the company's proxy materials.

On October 2, 2010, the SEC announced it would delay implementation of its final rule on proxy access pending the outcome of a legal challenge brought by the U.S. Chamber of Commerce and the Business Roundtable, which claimed that the rule was arbitrary and capricious and that "the SEC failed to properly assess the rule's effects on 'efficiency, competition and capital formation' as required by law."

On July 22, 2011, the U.S. Court of Appeals for the District of Columbia issued its opinion agreeing with the U.S. Chamber of Commerce and the Business Roundtable that the SEC failed to study the cost of fighting a challenge from shareholders. Thus, the proxy access rule was overturned, and it is not yet clear what the SEC will do next.

Meredith Cross, director of the SEC's Division of Corporation Finance, which led the rulemaking effort, said in a statement: "We are disappointed by today's decision. We are considering our options going forward. We note that our rule allowing shareholders to submit proposals for proxy access at their companies, which we adopted at the same time, is unaffected by the court's decision."[1]

Regardless of the status of the proxy access rule, companies should continue to consider the skills, background, and experiences of their directors. Further, companies should be prepared to communicate to shareholders how the current slate of directors meets the need to oversee the company's execution of its strategy. In addition, company management and boards should be prepared to respond to potential shareholder proposals related to director nominations. Management should be engaging its largest shareholders to discuss topics such as director qualifications and to understand whether shareholders have any feedback, comments, or concerns before the next proxy season.

For more information on the original proxy access rules from the SEC, see Deloitte's *Hot Topics* article, Proxy Access – Coming Soon to a Public Company Near You.

1 At the same time it adopted the proxy access rules, the SEC amended Exchange Act Rule 14a-8(i)(8) to narrow the so-called "election exclusion" and to provide that companies must include in their proxy materials, under certain circumstances, proposals from shareholders that seek to establish a procedure in the company's governing documents for the inclusion of shareholder director nominees in company proxy materials. Meredith Cross's comments may have been intended to remind shareholders of this alternative means of achieving proxy access.

The current landscape: what has already happened?

Direct impact on public companies

Exemption for "small caps" from Sarbanes-Oxley Section 404(b)

The Dodd-Frank Act allowed the permanent exemption of small companies from the requirement for an independent outside audit report on internal control over financial reporting (ICFR) and required the SEC to study whether there could be areas for improvement for processes currently undertaken by companies with a market cap between $75 and $250 million.

On September 15, 2010, the SEC issued a final rule providing that Section 404(b) of the Sarbanes-Oxley Act is not applicable to "any audit report prepared for an issuer that is neither an accelerated filer nor a large accelerated filer."[2] It is important to note that Section 404(b) only addresses the auditor attestation requirement related to a company's ICFR; companies subject to the exemption are still required to provide a management assessment of the effectiveness of ICFR pursuant to Section 404(a) of the Sarbanes-Oxley Act.

The SEC published the required study on April 22, 2011, concluding that "auditor involvement in ICFR promotes more accurate and reliable disclosure." It made the following two broad recommendations:

- Section 404(b) should continue to apply to domestic registrants and foreign private issuers whose market capitalization is between $75 million and $250 million.
- Activities should be identified and implemented that could further improve how Section 404(b) is applied. For example, the SEC suggested that the PCAOB consider offering observations on the basis of what it notes in conducting inspections of PCAOB-registered audit firms.

Many of the smaller companies subject to the exemption had been awaiting a permanent exemption since the passage of the Sarbanes-Oxley Act in 2002 and the subsequent temporary exemptions issued by the SEC. Although they will not have to comply with the requirement for an independent audit, these smaller reporting companies still will be required to include management's attestation; consequently, they need to maintain a substantive and effective internal control framework and process. They should remain focused on ICFR and their own evaluation and attestation.

Whistleblower program

The whistleblower provision is one of the more controversial provisions of the Dodd-Frank Act. It requires the adoption of rules related to incentive awards by the SEC for whistleblowers who supply "original source information" and provides certain additional protections for those whistleblowers.

The SEC issued its final rules on the whistleblower program on May 25, 2011. These rules provide for rewards of 10 percent to 30 percent of monetary sanctions for whistleblowers who provide the SEC with original information leading to securities law enforcement actions that recover more than $1 million. In determining the $1 million threshold, aggregation of multiple sanctions arising from information provided by a single source is permissible. The final rules also define those eligible to receive awards, including a discussion of culpable whistleblowers. Although the final rules do not mandate whistleblowers to report through their company's internal hotline before reporting to the SEC, they do include several provisions to encourage internal reporting.

In an October 29, 2010, report to Congress, which was mandated by the Dodd-Frank Act, the SEC revealed that $452 million has been allocated for potential whistleblower awards.

2 These terms are defined in Rule 12b-2 of the Securities Exchange Act of 1934 and generally include those companies with less than $75 million public float.

Proponents of the rules argue that they are supported by the congressional mandate in the Dodd-Frank Act, and that they strike a balance between SEC enforcement actions and internal reporting. Opponents say that the program may overwhelm the SEC's Office of the Whistleblower by motivating whistleblowers to go directly to the SEC without first trying internal channels. Others are concerned that companies' internal reporting systems could be undermined, thus delaying the detection of potential securities violations.

There are several measures that companies and boards of directors should consider in light of these regulations. Companies should assess the strength of their reporting systems and work with employees and stakeholders to maintain a strong awareness of internal reporting mechanisms and whistleblower protections and to encourage their use. In addition, companies should ensure that the tone at the top and specific messaging regarding internal reporting mechanisms are being received by employees and other key constituencies as intended.

Corporate governance

Disclosure of leadership structure

The Dodd-Frank Act required the SEC to establish rules regarding proxy disclosure of why companies have selected to either separate or combine the roles of the chairman and the CEO.

Prior to the act, the SEC already had adopted final rules in this regard, which became effective February 28, 2010. The final rules require disclosure of a company's decision to either split or combine the roles of CEO and chairman, along with reasons for the decision and discussion of why the chosen structure is most appropriate. If a company has chosen a combined CEO and chairman position and has provided for a lead director, additional disclosure is required related to why the company has chosen a lead director and that individual's responsibilities.

Board leadership structure, or the separation or combination of the CEO and chairman positions, is not a new governance topic. But boards are increasingly thinking about and discussing the leadership structure in the context of CEO succession planning and strategy. Many of the concepts regarding separate board leadership are outlined in a 2008 Yale Millstein Center for Corporate Governance and Performance working paper, *Chairing the Board: The Case for Independent Leadership in Corporate North America.*

Companies must consider their disclosures in this regard and should use a clear and transparent process to determine the most appropriate leadership structure given their specific circumstances. Factors to consider include the company's governance principles; shareholder and other stakeholder views on the subject; and the leadership, professional, and technical attributes the company is looking for in its leaders and whether the current structure satisfies those criteria.

Broker discretionary voting

This provision of the Dodd-Frank Act requires the SEC to issue rules prohibiting brokers from voting shares for director elections, executive compensation, or other significant matters, as determined by the SEC, unless specific instructions are provided to the broker by the owner.

On July 1, 2009, the SEC approved exchange rules regarding broker voting on director elections.

On September 9, 2010, the SEC approved exchange rules regarding broker voting on executive compensation matters.

The SEC is expected to propose rules defining "other significant matters" for the purpose of exchange standards regarding broker voting of uninstructed shares.

See Deloitte's *Hot Topics* article, SEC Sets Final Whistleblower Rules, for further information.

According to Spencer Stuart's 2010 *U.S. Board Index,* 40 percent of S&P 500 companies had a split chairman/CEO structure, with 19 percent having a truly independent chairman. These percentages are up from 27 percent and 9 percent, respectively, in 2004 and from 35 percent and 13 percent, respectively, in 2007. Further, in 2010, 92 percent of S&P 500 boards reported having a lead or presiding director, down slightly from 95 percent in 2009. Those that did not designate this role typically have an independent chairman. Of the 92 percent of boards with a lead or presiding director, 52 percent have lead directors and 48 percent have presiding directors, including those identified as chairman of executive sessions.

See Deloitte's special edition *Hot Topics* article, Who's at the Helm of Your Company's Ship?, for further information.

As a result of the rulemakings, brokers are no longer allowed to vote on behalf of the shareholder in director elections or on executive compensation matters without receiving specific instructions from the shareholders. This will expand to cover "other significant matters" when and if the SEC adopts rules. Although there was debate regarding the impact the expanded prohibition on uninstructed broker voting might have on executive compensation and other significant voting matters, there appears to have been little effect thus far.

Nevertheless, boards and management should be aware of the composition of their investor base. They may want to run specific campaigns to retail shareholders who use their brokers for voting to the extent those investors could have an impact on the overall vote or the ability of the company to achieve a quorum.

For more information, see Deloitte's publication Getting an "A" on Say on Pay. Deloitte reviewed the voting results for more than 2,600 companies, and shareholders are overwhelmingly supporting compensation committee decisions regarding executive compensation. Almost 70 percent of companies received more than 90 percent shareholder "for" votes. Another 16 percent received between 80 and 90 percent support.

Executive compensation

Say on pay, say on frequency, say on golden parachutes

With the continuing dialogue on executive compensation and a recent increase in "say-on-pay" proposals, it was not surprising to see a provision in the Dodd-Frank Act calling for mandated say-on-pay and other executive compensation provisions.

The SEC has adopted final rules on shareholder advisory votes for executive compensation, including the frequency of those votes. The new rules, which became effective January 21, 2011, specify that shareholder advisory "say-on-pay" votes required under the Dodd-Frank Act must occur at least once every three years and that companies are required to hold a "say-when-on-pay" vote at least once every six years to allow shareholders to decide how often they would like to be presented with the say-on-pay vote. Further, the final rules addressing shareholder advisory votes on golden parachutes became effective April 25, 2011, and the rules on deferred say-on-pay and say-when-on-pay shareholder advisory votes for smaller reporting companies will be effective January 21, 2013.

See Deloitte's special edition *Hot Topics* article, SEC Announces Executive Compensation Rulings, for further information related to these rulemakings.

As it is with many shareholder proposals and topics, the underlying theme in these rules is shareholder engagement. Although the say-on-pay and say-when-on-pay shareholder votes are advisory and nonbinding, discussions with shareholders regarding their views on executive compensation policies are likely to become increasingly prevalent.

The 2011 proxy season results to date may indicate that shareholders are becoming more active, and many companies are engaging with at least their largest shareholders, which are primarily institutional investors. It is interesting to note that very few companies attempted to gain shareholder approval for their golden-parachute arrangements under the regular say-on-pay approval process. This sets the stage for companies that are undergoing a change-in-control transaction to request shareholder approval in a nonbinding vote just before the closing of a transaction. Companies should consider consulting with attorneys and advisers in getting a majority of shareholders to vote in favor of such arrangements, as potential outcomes could include lawsuits claiming corporate waste and breach of fiduciary duty.

Provisions that are under way

Potential direct impact on public companies

Rating agencies and asset-backed securities

The Dodd-Frank Act includes many provisions with potential wide-ranging impact that are intended to reform how NRSROs operate and the asset-backed securities (ABS) marketplace. Implementation of reforms in these areas is under way.

The act imposed on NRSROs essentially the same securities-law liability standard for ratings opinions included in prospectuses as outside auditors have for financial statement opinions. Other provisions require operational changes at the NRSROs, including changing personnel, governance, and business practices; requiring certain annual reporting; and additional disclosures about ratings methodologies and historical ratings performance. Additionally, on the second anniversary of enactment, the act calls for removal of references to credit ratings—and, by extension, the NRSROs themselves—from a number of basic laws, including the Federal Deposit Insurance Act, the Investment Company Act, and the Securities Exchange Act. On that same date, the Dodd-Frank Act requires a study by the SEC to Congress on whether NRSROs should be assigned by a central board.

The SEC has indefinitely waived the requirement that ratings opinions be included in registered offerings. The SEC approved a proposed rule, with a comment period likely to end in mid-October, revisiting certain items from a 2010 proposal and introducing new ones that would amend shelf registration requirements for ABS to eliminate reliance on ratings altogether.

In a separate rule, the SEC amended shelf eligibility requirements on Forms S-3 and F-3 by replacing the use of credit ratings with other measures of creditworthiness, including measures based on the amount of nonconvertible securities a registrant has issued (for cash) or has outstanding, each for defined periods of time. Further, the SEC has proposed supporting rules related to operational changes in the NRSROs, and comments were due by August 8. The SEC is also establishing a required Office of Credit Ratings and preparing to conduct annual examinations of NRSROs and publish the resulting reports. Finally, unless the study finds a better alternative, the SEC is instructed to implement the central assignment system for NRSROs.

As for ABS reforms, the SEC has already adopted enhanced disclosure rules requiring issuers to conduct and disclose the results of additional due diligence on securitized assets beginning in 2012, keeping these registered ABS offerings in the public reporting system for life. The various banking regulatory agencies, along with the SEC, are developing a rulemaking proposal to implement a Dodd-Frank Act requirement for issuers to retain 5 percent of the credit risk in an ABS deal. Given the complexity of the details about various ways to measure and retain that 5 percent credit risk, along with the market, operational, capital, and financial reporting implications of each, the agencies involved in the rulemaking extended the original comment deadline from June 10, 2011, to August 1, 2011.

NRSROs have stopped allowing issuers to include ratings opinions in their offering materials and are expanding the inquiries that form the basis of their ratings as a result of the Dodd-Frank Act. Issuers are evaluating their new diligence and disclosure responsibilities and developing strategies to comply, beginning in 2012. Accountants and other third parties that have traditionally assisted issuers and underwriters privately with ABS offerings are assessing whether and how their services fit in a future characterized by widespread disclosure.

Conflict minerals and mining and extraction industry disclosures

Among the more "miscellaneous" requirements of the Dodd-Frank Act, in that they do not seem to have a nexus to the financial crisis, are the specialized disclosure provisions related to so-called "conflict minerals" and disclosures specific to the mining and extraction industry.

On December 15, 2010, the SEC proposed rules to implement three separate requirements of the Dodd-Frank Act.

According to the SEC's rule proposal for Section 1503 of the Dodd-Frank Act, the mine safety disclosure proposal would require public companies "that are operators, or that have a subsidiary that is an operator, of a coal or other mine," to provide periodic reports to the SEC regarding "health and safety violations, orders and citations, related assessments and legal actions, and mining-related fatalities."

Another proposal rule issued by the SEC for Section 1504 of the Dodd-Frank Act would require resource extraction issuers "to include in an annual report information relating to any payment made by the issuer, or by a subsidiary or another entity controlled by the issuer, to a foreign government or the Federal Government for the purpose of the commercial development of oil, natural gas, or minerals." The information required would include the "type and total amount of payments made."

The proposed SEC rule for Section 1502 would require companies to file disclosures and reports with the SEC related to the use of conflict minerals originating in the Democratic Republic of the Congo and surrounding countries, as designated by the State Department, that are necessary to the functionality or production of products manufactured. The affected companies would be required to furnish, in a separate report, "a description of the measures taken by the [company] to exercise due diligence on the source and chain of custody of its conflict minerals." This report would have to be audited by an "independent private sector auditor" in accordance with the standards of the Government Accountability Office.

While the act set a deadline of April 2011 for final rules for all three of these provisions, none of the three have yet been adopted; the SEC expects to adopt final rules in the late summer or early fall of 2011.

From the conflict minerals perspective, questions about the rule proposals' provisions are numerous and varied. Some have commented that the proposed rules are unclear as to the level of inquiry a company must undertake to fulfill its obligations. A cost-benefit question also has been raised, because it is foreseen that such procedures would be difficult and expensive. Other concerns include the nature and form of the independent private sector audit and the lack of clarity with regard to the required audit procedures.

Unlike the other specialized disclosure proposals, whose impacts are expected to be limited to certain industries, the effect of the conflict minerals provision is expected to be far-reaching. The reasons include:

- The designated conflict minerals are used in the production of numerous products in many industries, including electronics, technology, telecommunications, aerospace, automotive, health care devices, industrial products, and jewelry manufacturing.
- The SEC proposes to include both manufacturers and companies that contract for the manufacture of their products, including retailers with private-label products where the retailer influences the manufacturing process.

In fact, the SEC estimated that as many as 6,000 public companies could be affected, and it is not surprising that of the three specialized disclosure proposals, the one involving conflict minerals has generated the most interest.

As a result of these provisions and proposed rules, companies need to consider their processes to gather the information they will need to disclose. For conflict minerals, such processes will extend to identifying the sources for their products.

Corporate governance

Financial services industry risk committees

This provision of the Dodd-Frank Act calls for certain nonbank, public financial companies and certain public bank holding companies to form a separate risk committee. Based on the legislation, risk committees will be held responsible for risk oversight in the organization. They must include the appropriate number of independent directors, as determined by the board of governors, based on factors that include the nature and size of the organization. They also are required to include at least one risk management expert, as defined by the act.

There is no direct requirement for the SEC with regard to this provision. The Federal Reserve Board is required to issue its final rule on the implementation of this section by July 21, 2012, and the rules must be effective no later than October 21, 2012. The Federal Deposit Insurance Corporation has approved a joint notice of proposed rulemaking with the Federal Reserve Board to implement resolution plan requirements for certain nonbank financial companies and bank holding companies. The comment period closed June 10, 2011.

Companies that are required to have a separate risk committee should be careful to not concentrate risk oversight into one committee, because the full board is ultimately accountable for risk oversight. Other board committees may still play a significant role in risk oversight; for example, the audit committee should still oversee financial risks and oversee the policies and procedures of the risk management program.

It may be useful for companies to revisit the board and committee charters to ensure that responsibilities regarding risk are outlined clearly and concisely. The board of directors will need to consider how the addition of a risk committee will affect current board committees and the separation of roles. Additionally, nominating committees should consider what qualifications are necessary in a "risk expert" and how the company will obtain such an expert. The board and nominating committee may leverage knowledge gained in identifying financial experts for the audit committee.

Risk committees are not currently required as a standing committee of public companies. In a Deloitte research analysis of 398 companies included in the S&P 500 index who filed proxies between February 28, 2010, and July 1, 2010, only 4 percent had a separate board risk committee, which increased to 16 percent when focusing specifically on the financial services industry.

Executive compensation

Compensation committee and adviser independence

The Dodd-Frank Act includes a provision that requires the SEC to issue rules related to compensation committee and adviser independence.

On March 30, 2011, the SEC proposed rules regarding exchange listing standards for compensation committee independence and factors affecting compensation adviser independence. Further, the SEC proposed disclosure rules regarding compensation consultant conflicts. The proposed rules require U.S. publicly traded companies to have compensation committees that include only independent directors. The proposed rules allow the securities exchange and association listings to define independence, but offer several considerations for evaluating independence, such as the nature of the director's compensation, as well as any relationships between the director and the issuer.

Compensation committees will be responsible for appointing, compensating, and overseeing compensation consultants and other advisers. The rules do not require the advisers to be independent, but do require that the committee consider the adviser's affiliations with the issuer, any relationships between the adviser and any of the compensation committee members, and any direct financial relationship between the issuer and the adviser, including stock ownership, in assessing whether the adviser is independent.

The SEC is expected to adopt final rules in these areas between August and December 2011. Additionally, between July and December 2012, the SEC is expected to report to Congress on a study and review of the use of compensation consultants.

These requirements expand on the SEC's December 2009 enhanced proxy disclosure rules, which require companies to disclose services provided by advisers and the associated fees. The extent to which this provision will affect current practice or differ from current listing standards will rest with the exchanges' adoption of formal standards.

When implemented, independent compensation committee rules are likely to affect not only the compensation committee, but also the nominating committee, because it will be the nominating committee's task to determine whether to change director qualification policies and search criteria to comply with the independence standards. This will require companies to have a clear and open communication channel between the nominating and compensation committees to help ensure that the compensation committees' views are reflected in the board's director retention policies and procedures, as implemented by the nominating committee. Nominating committees, specifically, and boards, in general, should think proactively about the effects of this provision on existing structures and how they may need to change practices to comply with the new standards.

Financial services industry incentive-based compensation

Certain substantive requirements for incentive-based compensation for certain financial services industry companies are included in the provisions of the Dodd-Frank Act, specifically related to determining that incentive-based compensation programs do not encourage excessive risk-taking.

The SEC has proposed rules jointly with other regulators regarding disclosure of, and prohibitions of, certain executive compensation structures and arrangements at "covered financial institutions." The rules would prohibit incentive-based compensation structures that the regulators determine encourage inappropriate risks by covered institutions. Financial institutions also will be required to report to the applicable federal regulator all incentive-based compensation arrangements offered to employees. Financial institutions with less than $1 billion in assets will be exempt from this requirement. Further, the joint regulators recommend that, for certain institutions, a percentage of the incentive-based compensation be deferred for a period of time, and that the final compensation paid will reflect company performance over the applicable period. These rules are slated to be finalized between January and June 2012.

By the time the Dodd-Frank Act was adopted, the Federal Reserve had already issued final guidance, "Sound Incentive Compensation Policies," that requires banking organizations to regularly review and evaluate their incentive compensation arrangements for select groups of employees. In general, the provisions of the Dodd-Frank Act further support the Federal Reserve's final guidance. Establishing a definition of "excessive" compensation, fees, and benefits will likely be difficult, as it is highly subjective and each company is unique.

Based on this provision and proposed rules, certain financial services companies should consider whether their compensation structures encourage excessive risk-taking; similar consideration could benefit all public companies in general. Depending on the results of the evaluation, companies may consider restructuring their incentive-based compensation policies to mitigate potential risks.

Still to come

Executive compensation

Incentive compensation clawbacks

The Dodd-Frank Act directs the SEC to establish rules requiring companies to develop a policy mandating the recovery of "excess" incentive compensation paid to executive officers in the event of an accounting restatement due to material noncompliance with financial reporting requirements, regardless of whether the executive officer was involved in misconduct that led to the restatement. Excess incentive compensation is equal to the difference in the amount paid and the amount that would have been paid if the restated earnings amount had been reported properly. The "clawback" policy must require a company to recover the amount of excess incentive compensation paid within three years of the restatement. The policy would apply to any current or former executive officer.

The rules are slated for proposal by the SEC between August and December 2011 and are expected to be finalized between January and June 2012.

Existing proxy statement rules already require disclosure of clawback provisions, to the extent a company has them, in the Compensation Discussion and Analysis (CD&A) section of its proxy statement. To date, there are a number of large companies that have voluntarily adopted clawback policies to ensure any excess amounts paid prior to a restatement of earnings are recouped from participants. The new legislation is much broader than the majority of clawback policies voluntarily adopted by companies and those of the Sarbanes-Oxley Act, which required clawbacks only for CEOs and CFOs, because it applies to all executive officers, not just those who were engaged in misconduct that resulted in a financial restatement.

It is likely that most companies will need to modify their clawback policies or adopt new ones to comply with the Dodd-Frank Act, which will expand the number of executives who will be covered, potentially including all of the Section 16 officers[3] of a company. It is expected that most companies will wait for the SEC guidance before doing so.

Pay versus performance disclosure and pay equity disclosure

The Dodd-Frank Act requires the SEC to amend the proxy statement rules to require companies to disclose the following in their annual proxy statements or any solicitation materials for an annual shareholder meeting:

- Information regarding the relationship between financial performance, which includes changes in total shareholder return, and executive compensation actually paid
- The dollar amount of median annual total compensation for all employees of the organization, excluding the CEO, and annual compensation for the CEO, along with the ratio of CEO total compensation to the employee median total compensation.

The SEC is expected to propose rules regarding disclosure of pay-for-performance and pay ratios between January and June 2012.

Many questions are being raised with regard to the practicality of obtaining the required information for the pay ratio disclosure. There is a bill in the House of Representatives (H.R. 1062: *Burdensome Data Collection Relief Act*) that, in part, serves to repeal Section 953 of the Dodd-Frank Act. The bill is making its way through Congress.

3 The Securities and Exchange Act of 1934 requires directors, officers, and principal stakeholders to file certain statements related to ownership of company securities. A Section 16 officer refers to individuals such as the president, chief executive officer, chief financial officer, chief accounting officer, and the like.

Because internal pay ratios are difficult to compare across companies as a result of differences in workforce composition, organization structure, and so forth, companies may consider voluntarily providing additional data illustrating how the CEO's compensation compares to that of different employee groups. Companies may also want to add a discussion to the CD&A that explains how the company has created internal pay equity among various groups of employees. For many companies, especially those that are global or decentralized, the calculation of total compensation for every employee could require a significant amount of time and effort. The relationship of pay and performance may be different depending on the type of performance metrics and how pay is defined. Thus, companies may want, or need, to provide a detailed discussion in the proxy statement, under the CD&A section, on the relationship between pay and performance.

Hedging disclosure

The Dodd-Frank Act calls for the SEC to issue rules requiring disclosure in the proxy materials of whether employees and directors are allowed to hedge the value of any equity securities granted to them or that are otherwise owned by the director or employee.

The SEC is expected to propose rules regarding hedging by employees and directors between January and June 2012.

This provision is important for investors and other stakeholders who are interested in understanding whether directors, executives, and other company employees are permitted to purchase financial instruments that serve to protect against downward changes in the company's stock value. In some cases, executives and other parties own financial instruments whose values will likely change in the opposite direction of fluctuations in the company's securities prices, so as to not change the individuals' overall financial health. It is not clear whether the implementation of this disclosure requirement will cause modifications in company policy.

If this provision causes companies to forbid purchases of hedging instruments by directors and employees to counteract movement in the value of the company's equity securities, it may cause companies to compensate these parties for loss of hedging abilities through other forms of compensation. Additionally, other methods may emerge for these parties to continue to avoid declines in company stock prices.

Conclusion

As this summary demonstrates, a number of important provisions of the Dodd-Frank Act applying to a broad group of public companies already have been implemented, but a significant number remain. In addition, the continued implementation of the provisions of the act that are focused on the financial services sector could affect businesses outside that sector. Therefore, companies should continue to watch for developments, even as they adjust to new regulatory requirements. It may be some time before implementation reaches a steady state.

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