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Governance Changes Under Dodd-Frank: What To Do and When

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The Dodd-Frank Act mandates a variety of changes to the governance, disclosure and compensation practices of all public companies. Many of the provisions of the Act require further SEC rulemaking and interpretation before definitive responses can be implemented, but companies should become familiar with the pending changes and take preparatory steps where possible. The purpose of this memo, which we will periodically update, is to provide a framework for our recommendations by highlighting certain actions companies should consider taking immediately, as well as certain key provisions of the Act which will require responses in the longer term.

Immediate Action Items

Prepare for Proxy Access and the Upcoming Proxy Season. As a result of their publication in the Federal Register today, the new proxy access rules will become effective on November 15, 2010, and will apply to the 2011 proxy season for companies (other than small reporting companies) that mailed their 2010 proxy statements on or after March 15, 2010. In our recent memo, we outlined certain steps that companies should consider now in light of the adoption by the SEC of the new regime. These include enhancing investor relations and shareholder communications programs, monitoring the company's investor base and shareholder filings, updating changes to advance notice and director qualification by-laws and corporate governance policies, and reviewing the size and makeup of the board. Issuers should monitor the application of the new rules, and keep directors apprised of any significant developments. As limitations on broker discretionary voting continue to put pressure on obtaining quorums and passage of important mandates, companies may wish to consider the need for more aggressive proxy solicitation efforts and selective investor outreach.

Review Board Agendas in Light of Regulatory Changes. The coming year will necessarily bring a large number of governance changes, and advance

planning for implementation of those changes will be hampered by the current lack of clarity around the new rules. In order to enable timely reactions when needed, it is important that directors be kept apprised of new information about the rules as it becomes available. To this end, companies are advised to consider periodic board update sessions on rulemaking as it continues.

Review (or Consider Adopting) Hedging Policies. Disclosure of whether employees or directors are allowed to hedge company stock will soon be required (and will cover certain transactions which are not addressed by many companies' existing anti-hedging policies). Companies should review their anti-hedging policy with an eye to bringing it in line with the transactions and persons covered by the new disclosure requirement. Companies that do not have a policy on hedging may want to adopt one.

Participate in the SEC Rulemaking Process for Whistleblower Bounties. The Act creates a system of cash incentives to encourage and reward whistleblowers who come forward to the SEC. As we noted in a recent memo, the new rules unfortunately create a major financial incentive for employees with knowledge of wrongdoing to bypass corporate compliance systems and ethics mechanisms. Substantial SEC rulemaking is required to implement the changes. We recommend that companies urge the SEC to implement the new whistleblower regime in a way that will support rather than undermine corporate compliance systems. The enactment of the Act is also an occasion for a company to review the overall structure of its compliance and ethics policies and procedures, with an eye to finding more effective ways to embed a compliance component in day-to-day operations. There is a need to think creatively about the most effective ways to communicate to employees the importance of surfacing their concerns internally. Management should seek to develop meaningful incentives for employees to make use of corporate compliance and ethics reporting mechanisms. Maintaining a corporate culture in which all personnel understand that conducting business ethically is a shared and important value will be a cornerstone of this effort.

Establish a Board Review Process for Derivatives Transactions. Companies intending to rely on the "end-user exemption" to the new swap clearing requirements must have their actions in reliance on the exemption reviewed and approved by an "appropriate committee" of the board. Companies should undertake an assessment of their current and expected derivatives activity, including a planned review of the new requirements with the board which includes a discussion of the appropriateness of relying on the clearing exemption. If it is determined that the exemption may be used, a board review process should be implemented. While the audit committee may initially appear to be the appropriate body to assume this responsibility, alternatives should be carefully considered in light of the already substantial workloads borne by audit committee members. Once a committee has been selected, its charter should be revised to reflect this new function.

Longer Term Considerations

Many of the initiatives of the Act take the form of sweeping pronouncements that will only come into effect after the SEC has adopted implementing regulations. Others are automatically effective but nevertheless require SEC interpretation or rulemaking as a practical matter.

Compensation Related Matters

The Act introduces an extensive new regime of requirements related to compensation practices and disclosure. We have discussed certain of the new requirements in detail in a previous memo, including the requirement to hold shareholder votes on executive compensation, both periodically and in connection with extraordinary corporate transactions, heightened independence requirements for compensation committee members and advisors, and clawback policy requirements. In addition, the SEC must adopt rules requiring disclosure of the relationship between executive compensation and corporate financial performance, and of the ratio of the median annual total compensation of a company's employees (excluding its chief executive officer) to the total annual compensation of its chief executive officer. As we have previously stated, we anticipate that this disclosure requirement may present significant challenges for issuers without any corresponding benefit to investors, and advise companies to pay particular attention to development of the specific rules in this area.

General Corporate Governance Matters

Broker Discretionary Voting and Advance Voting Instructions. As noted above, the Act further curbs broker discretionary voting. In connection with its examination of "proxy plumbing" matters, the SEC has requested comment on the advisability of permitting advance voting instructions by shareholders to their brokers (for example, whether brokers should be permitted to vote shares based on an advance shareholder instruction always to vote either for or against management unless otherwise specified). We recommend that companies consider engaging with the SEC regarding the advisability of this concept, and whether it might prevent further erosion of the voting power of retail shareholders.

Conflict Minerals. The Act includes a direction to the SEC to promulgate regulations requiring new disclosures from issuers that manufacture products using "conflict minerals" (which includes specified minerals like gold and columbite-tantalite as well as anything else the Secretary of State determines from time to time to be financing conflict in central Africa). Because tiny amounts of these minerals are often used in electronic components like capacitors, which are found in a wide variety of products, including computers, mobile phones and automobiles, these new rules will increase the due diligence and disclosure burden on a wide range of companies, compelling them to carefully review their supply chain to identify the use and source of any such minerals. We hope that the SEC will adopt a practical approach towards this requirement as well.

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Many provisions of the Act may have as yet unforeseen consequences. Furthermore, a number of provisions of the Act which currently appear duplicative of existing rules (for example, the required disclosure regarding the separation of the Chairman and CEO roles) may in fact turn out to expand or modify disclosure or compliance requirements as rulemaking and interpretation continues. We will continue to monitor developments and will provide updates as warranted.

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