

SECURITIES UPDATE



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Jim's practice is focused in the corporate and business law area. He has worked with a number of public and private clients, including several high-technology companies, and has been involved in various transactions in the corporate and securities field, including numerous mergers, acquisitions and dispositions, initial public offerings, follow-on public offerings, Rule 144A transactions, tender offers and private placements. Jim has also represented several investment banks in connection with public offerings of stock, as well as venture capital firms in connection with their portfolio investments. Jim has written and spoken on issues relating to Massachusetts corporation law.

THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT ESTABLISHES NEW EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE REQUIREMENTS FOR PUBLIC COMPANIES

On July 21, 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Dodd-Frank Act provides for extensive regulation of financial enterprises and implements a number of consumer protections. Title IX of the Dodd-Frank Act, which is referred to as the Investor Protection and Securities Reform Act of 2010 (the "Investor Protection Act"), contains additional requirements for public companies relating to executive compensation and corporate governance.

SHAREHOLDER VOTES ON EXECUTIVE COMPENSATION

Annual Meeting Votes. The Investor Protection Act provides that, at least once every three years, a proxy statement for an annual or other meeting of shareholders in which compensation disclosure is required, must include a separate, nonbinding resolution to approve the compensation of executives as disclosed in the proxy statement (often referred to as "say-on-pay"). The resolution relates to the overall compensation disclosed in the proxy statement (Item 402 of Regulation S-K) and not to particular elements of compensation or the compensation of individual executive officers. In addition, at least once every six years, a proxy statement must include a separate, nonbinding resolution to determine

whether the say-on-pay vote will occur every one, two or three years.

Both resolutions above must initially be considered at the first annual or other meeting of shareholders occurring after January 20, 2011. For calendar-year companies, this effectively means that next year's annual proxy statement must contain a say-on-pay vote as well as a vote on the frequency of say-on-pay votes. While the say-on-pay and frequency provisions are self-executing and do not require the Securities and Exchange Commission (the "SEC") to adopt any implementing rules, we would expect the SEC to issue rules to clarify, for example, whether a company's inclusion of these votes triggers the need to file a preliminary proxy statement and how to present the resolution on the frequency of say-on-pay votes.

Disclosure and Vote on Golden Parachute Compensation. Public companies will be required, in connection with proxy or consent solicitations occurring after January 20, 2011, that relate to an acquisition, merger or similar transaction to disclose "in a clear and simple form" in accordance with rules to be promulgated by the SEC, any "golden parachute" compensation arrangements. These include any agreements or understandings with any named executive officers of the company (or of the acquiring company) concerning any

type of compensation (whether present, deferred or contingent) that is based on or otherwise relates to the acquisition, merger or similar transaction. The proxy statement must disclose such arrangements and the aggregate total of all compensation that may (and the conditions upon which it may) be paid or become payable to or on behalf of such executive officer.

Any proxy statement containing the golden parachute disclosure must also include a separate, nonbinding resolution to approve the golden parachute agreements or understandings as disclosed, unless such compensation has been subject to a prior shareholder say-on-pay vote.

Nonbinding Nature of Executive Compensation Votes; No Broker Discretion.

The executive compensation votes are not binding on the company or its board of directors and may not be construed:

- as overruling a decision by the company or its board;
- to create or imply any change to the fiduciary duties of the company or its board;
- to create or imply any additional fiduciary duties for the company or its board; or
- to restrict or limit the ability of shareholders to make proposals for inclusion in proxy statements relating to executive compensation.

The Investor Protection Act also requires the national securities exchanges to amend their rules to prohibit brokers (as members of national securities exchanges) from voting on executive compensation matters without instructions from the beneficial owner.

Although the new shareholder votes on executive compensation are nonbinding, companies will want to avoid the adverse publicity associated with a negative vote on compensation. Furthermore, a company could suffer adverse recommendations from the proxy voting advisory services if its board

does not respond in a manner deemed appropriate to a negative vote.

SEC Discretion on Executive Compensation Votes. The Investor Protection Act empowers the SEC, by rule or order, to exempt a company or class of companies from the new executive compensation votes and related disclosure. In determining whether to exempt certain companies from the requirements, the SEC must take into account whether the requirements disproportionately burden smaller companies.

COMPENSATION COMMITTEE MATTERS

Independent Compensation Committees. The Investor Protection Act directs the SEC, by rulemaking, to prohibit national securities exchanges and national securities associations (collectively, "stock exchanges") from listing any equity security of a company¹ that does not have a compensation committee composed entirely of independent directors. In determining "independence" for compensation committee purposes, the stock exchanges must consider relevant factors, including:

- the source of compensation of a director, including any consulting, advisory or other compensatory fee paid by the company to the director; and
- whether a director is affiliated with the company, a subsidiary of the company, or an affiliate of a subsidiary of the company.

The definition of "independence" for compensation committee purposes may, but need not be, comparable to the "super independence" definition applicable to audit committee members, which provides that no member of an audit committee can accept any consulting, advisory or other compensatory fee from the company other than in his or her capacity as a member of the board of directors or any committee of the board.

[1] The compensation committee independence requirement does not apply to controlled companies, limited partnerships, companies in bankruptcy proceedings, open-ended management investment companies registered under the Investment Company Act of 1940, or foreign private issuers that provide annual disclosure to shareholders of the reasons that they do not have independent compensation committees.

The stock exchanges may exempt particular relationships from the independent compensation committee requirements, taking into consideration the size of a company and other relevant factors.

Compensation Consultants, Legal Counsel and Other Compensation Committee

Advisers. The Investor Protection Act also provides that the compensation committees of listed companies may only select a compensation consultant, legal counsel or other compensation committee adviser (collectively, "compensation adviser") after taking into consideration factors that affect the independence of the compensation adviser. The SEC must identify the factors that affect independence, which must be "competitively neutral" among categories of compensation advisers and preserve the ability of compensation committees to retain the services of members of any such category. Such factors must include:

- the provision of other services to the company by the person that employs the compensation adviser;
- the amount of fees received from the company by the person that employs the compensation adviser, as a percentage of total revenue of the person that employs the compensation adviser;
- the "conflict of interest" policies and procedures of the person that employs the compensation adviser;
- any business or personal relationship of the compensation adviser with a member of the compensation committee; and
- any stock of the company owned by the compensation adviser.

The compensation committee may, in its sole discretion, retain or obtain the advice of a compensation adviser and will be directly responsible for the appointment, compensation and oversight of the work of the compensation adviser. Each company, in turn, must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to compensation advisers.

The provisions relating to compensation advisers may not be construed to require a compensation committee to implement or act consistently with the advice or recommendations of the compensation adviser or affect the ability or obligation of a compensation committee to exercise its own judgment in fulfillment of its duties.

Proxy Disclosure Regarding Compensation

Consultants. In any proxy statement for an annual meeting of shareholders (or a special meeting in lieu thereof) occurring on or after July 21, 2011, each company must disclose, in accordance with rules to be promulgated by the SEC, whether the compensation committee retained or obtained the advice of a compensation consultant and whether the work of such consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed. The new disclosure is comparable to disclosure currently required by Item 407(e)(3)(iii) of Regulation S-K, which requires disclosure of the role of compensation consultants in determining or recommending executive and director compensation. This new provision will likely place more pressure on companies to avoid engaging compensation consultants whose independence could be questioned.

SEC Rulemaking and Exemption Authority.

Not later than July 16, 2011, the SEC must direct (by rulemaking) the stock exchanges to prohibit the listing of any security of a company² that is not in compliance with the new compensation committee and compensation adviser rules. The SEC's rules must provide companies with a reasonable opportunity to cure any defects that would be the basis for a prohibited listing. In addition, the rules must permit a stock exchange to exempt a category of companies from the requirements (taking into account, in particular, the potential impact of the requirements on smaller companies).

EXECUTIVE COMPENSATION DISCLOSURE

Pay Versus Performance. The SEC must adopt rules requiring each company to disclose in its proxy statement for an annual meeting of shareholders

[2] Controlled companies are exempt from all of the compensation committee and compensation adviser requirements.

information showing the relationship between executive compensation actually paid and the financial performance of the company, taking into account any change in the value of the shares of stock and dividends and any distributions. Congress did not impose a deadline for SEC adoption of the "pay-versus-performance" rules, which may include a graphic representation of the information required to be disclosed.

Pay Parity Ratios. The SEC must also amend Item 402 of Regulation S-K to require disclosure of:

- the median of the annual total compensation of all employees of the company, except the chief executive officer (the "Median Compensation");
- the annual total compensation of the chief executive officer (the "CEO Compensation"); and
- the ratio of the Median Compensation to the CEO Compensation.

Total compensation of employees would be calculated in the same manner as the "Total" amount in the Summary Compensation Table of Item 402 of Regulation S-K (as in effect as of July 20, 2010), which may require substantial effort on the part of companies to determine.

Congress did not impose a deadline for SEC adoption of the pay parity rules.

RECOVERY OF ERRONEOUSLY AWARDED COMPENSATION

The SEC is required to adopt rules prohibiting stock exchanges from listing any security of a company that does not develop and implement a policy relating to the recovery of erroneously awarded compensation. Such a "clawback" policy must provide:

- for disclosure of the company's policy on incentive-based compensation that is based on financial information required to be reported under the securities laws; and
- that, in the event the company is required to prepare an accounting restatement due to the material noncompliance of the company with any

financial reporting requirement under the securities laws, the company will recover from any current or former executive officer who received incentive-based compensation (including stock options) during the three-year period preceding the date on which the company is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.

Although the provisions of the Investor Protection Act are conceptually similar to the forfeiture provisions in Section 304 of the Sarbanes-Oxley Act of 2002 ("SOX"), the scope of the new provision is much broader. Section 304 of SOX relates to an accounting restatement resulting from misconduct (versus material noncompliance) and applies only to the chief executive officer and chief financial officer of the company. Under Section 304, the chief executive officer and chief financial officer would need to reimburse the company for any bonus or other incentive-based or equity-based compensation received during the 12-month period (rather than the three-year period) following the first public issuance or filing of the applicable financial statements. The chief executive officer and chief financial officer would also need to reimburse the company for any profits realized from the sale of company securities during that 12-month period.

Congress did not impose a deadline for the SEC to adopt rules implementing the new "clawback" requirements.

DISCLOSURE REGARDING EMPLOYEE AND DIRECTOR HEDGING

The SEC must also adopt rules requiring a company to disclose in any proxy statement for an annual meeting of shareholders whether any employee or director, or any designee of such employee or director, is permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities:

- granted to the employee or director by the company as compensation; or
- held, directly or indirectly, by the employee or director.

Congress did not impose a deadline for the SEC to adopt rules implementing these hedging disclosure provisions.

PROXY ACCESS - SHAREHOLDER NOMINEES TO THE BOARD OF DIRECTORS

The Investor Protection Act authorizes (but does not require) the SEC to issue rules permitting the use by shareholders of a company's proxy solicitation materials for the purpose of nominating individuals to the company's board of directors. The SEC may, by rule or order, exempt a company or class of companies from the proxy access requirement, taking into account, among other things, any disproportionate burden on smaller companies.

In June 2009, the SEC proposed rules providing for inclusion in a company's proxy materials of certain shareholder nominees to the board of directors (SEC Release No. 33-9046, June 10, 2009), but there was uncertainty as to the SEC's authority to promulgate these rules. The SEC has not yet acted on the June 2009 proposal.

DISCLOSURE REGARDING CHAIRMAN AND CEO STRUCTURES

Not later than January 17, 2011, the SEC must issue rules requiring a company to disclose in its annual proxy statement the reasons why it has chosen the same person (or different persons) to serve as chairman of the board of directors and chief executive officer. Comparable disclosure is currently required under Item 407(h) of Regulation S-K, but the new law could prompt further requirements in this area.

ELIMINATION OF SOX 404(B) ATTESTATION REPORT FOR SMALLER COMPANIES

Section 404(b) of SOX provides for the issuance of an attestation report by registered public accounting

firms on a company's internal control over financial reporting. For years, the SEC had been delaying the implementation of the Section 404(b) requirement for non-accelerated filers, and now the Investor Protection Act eliminates the requirement for companies that are neither "large accelerated filers" nor "accelerated filers" (i.e., basically non-accelerated filers and smaller reporting companies).

The Investor Protection Act also directs the SEC to conduct a study to determine how the SEC could reduce the burden of complying with Section 404(b) of SOX for companies whose market capitalizations are between \$75,000,000 and \$250,000,000. The SEC must submit its report to Congress by April 21, 2011.

PUBLIC COMPANIES - UPCOMING AGENDA ITEMS

As the SEC promulgates numerous rules over the next several months, public companies will need to take a number of actions to address issues under the Investor Protection Act. In addition to updating executive compensation and corporate governance disclosure, each public company will need to:

- *Examine the Composition of its Compensation Committee.* Members of compensation committees often have to meet several definitions of "independence": the basic "independence" definition under stock exchange rules, the "outside director" definition under Section 162(m) of the Internal Revenue Code and the "non-employee director" definition under Rule 16b-3 under the Securities Exchange Act of 1934. Compensation committee members will soon have to meet some form of "super independence" definition to be promulgated by the applicable stock exchange. The membership of the compensation committee has to be reviewed in light of all of these definitions. Compensation committee questionnaires will also have to be revised to reflect the myriad of regulatory requirements.
- *Revise its Compensation Committee Charter.* The Compensation Committee Charter will have to be revised to address membership qualifications,

authority to engage compensation advisers, funding authority, etc.

- *Adopt Compensation Committee Guidelines for the Engagement of Compensation Consultants, Legal Counsel and Other Compensation Committee Advisers.* Compensation committees should seriously consider adopting guidelines for the engagement of compensation consultants, legal counsel and other compensation committee advisers. These guidelines would reflect the considerations of independence promulgated by the SEC and the stock exchanges. It is unclear whether "bright line" tests will be adopted by the regulators or if compensation committees will simply assess all the factors affecting independence and then make a decision based on the facts and circumstances. Compensation committees should also review existing compensation advisers, including legal counsel, in light of the final rules. Compensation committees may ultimately decide to engage legal counsel and compensation consultants with no connection to management or the board of directors.
- *Adopt a Policy to Recover Erroneously Awarded Compensation.* After the applicable stock exchange issues listing requirements on the development and implementation of policies to recover erroneously awarded compensation, each board of directors will need to adopt such a policy.

- *Consider Adopting a Policy Regarding Hedging Activities by Directors and Employees.* Each public company should consider whether to adopt a policy regarding hedging activities by its directors and employees. A policy is not mandated by the Investor Protection Act, but companies must disclose whether directors and employees are permitted to engage in such hedging activities. There may also be institutional shareholder pressure to adopt such policies.

If you have any additional questions regarding this Update or have any other Securities Law needs, please contact any member of the Securities Law Group.

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