

August 2010

SECURITIES ALERT: FURTHER ANALYSIS: HOW THE DODD-FRANK CORPORATE GOVERNANCE PROVISIONS WILL AFFECT YOUR COMPANY

In this issue:

Topics Covered
2

SEC Rulemaking
2

*What Will Subtitle E
Require?*
3

*What Should You Be
Doing Now?*
4

*What About Smaller
Reporting Companies?*
6

President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) on July 21, 2010.

Dodd-Frank is an ambitious overhaul of the financial regulatory system, addressing many of the lapses in oversight, judgment, imagination, transparency and accountability that contributed to the 2008 financial crisis.

At 2,300 pages, Dodd-Frank is a monster. Yet it is only a framework for future regulation, delegating essential details and much discretion to financial regulators.

It covers a wide variety of topics, including consumer protection, financial stability and derivatives. Most of the regulatory onus will fall on

commercial and investment banks, hedge funds, derivatives traders, and consumer financial providers. However, Title IX, Subtitle E (Subtitle E) is directed at public companies, and mandates critical changes in proxy disclosure and shareholder rights that could fundamentally impact compensation practices and investor relations.

Subtitle E takes effect six months after the enactment date and will be implemented by SEC and stock exchange rules. ***The changes will be in effect for next year's proxy season, thus meriting prompt attention by management, boards and compensation committees.***

Topics Covered

Subtitle E covers the following topics:

- Say on pay
- Say on golden parachutes
- Compensation committee and advisor independence
- Enhanced disclosure of the relationship between pay and performance
- Internal pay equity disclosure
- Employee and director hedging
- Clawbacks
- Shareholder proxy access
- Broker discretionary voting

SEC Rulemaking

The SEC has not yet proposed formal rules under Subtitle E, but Chairperson Mary Schapiro announced in a July 27 speech the intention to propose a series of implementing rules that will be effective for next year's proxy season.

What Will Subtitle E Require?

Say on Pay. Companies must give shareholders an advisory non-binding vote on executive compensation. Shareholders must also determine whether the say on pay vote will occur every one, two or three years. The timing proposal must appear in next year's proxy statement.

Say on Golden Parachutes. To the extent any "golden parachute" is not approved as part of a previous say on pay vote, companies soliciting shareholder approval of a merger or other transaction that would trigger golden parachute payments must also solicit a non-binding shareholder vote on those arrangements.

Compensation Committee and Advisor Independence. Stock exchanges must amend listing standards to require that compensation committees meet enhanced independence requirements which are being developed by the SEC. We anticipate these will be comparable to the audit committee independence standards in SEC Rule 10A-3. Companies must disclose whether the committee retained a compensation consultant, whether the consultant's work raised any conflict of interest, the nature of any such conflict, and how it was addressed. The SEC has announced it will adopt conflict of interest standards for compensation consultants.

Pay and Performance. Companies must compute and graph the relationship between executive compensation and company financial performance, as measured by share price appreciation and dividends.

Internal Pay Equity. Companies must disclose the median annual total compensation of all employees, the annual total compensation of the CEO and the ratio of median employee compensation to CEO compensation.

Hedging. Companies must disclose whether employees or directors are permitted to hedge against the value of their equity compensation.

Clawbacks. If a company restates its financials due to material noncompliance with financial reporting requirements, it must reclaim from current and former executives incentive compensation they received that exceeded the amount payable under the restatement. Companies must also adopt and disclose a clawback policy.

Governance. The SEC will adopt proxy access rules that allow significant shareholders to include director nominees in company proxy materials. An SEC rule requiring disclosure of the reason why the offices of Chairman and CEO are either separated or combined was codified in Subtitle E. Brokers will be prevented from using discretionary voting authority in director elections and compensation issues, including say on pay. The SEC may also restrict discretionary voting on other issues.

What Should You Be Doing Now?

Say on Pay. Say on pay will be effective for the first shareholder meeting occurring six months after the enactment date. Compensation committees should consider addressing any shareholder concerns about their policies before the say on pay vote is held. The initial say on pay vote will be pivotal, setting the tone for future votes (and the frequency at which they're held), and closely monitored by shareholders, regulators and the media.

Shareholder rejection of a say on pay proposal would be embarrassing. To avoid this result, we recommend companies revisit their Compensation Discussion and Analysis (CD&A) and clearly and effectively describe how and why compensation policies promote shareholder interest and respond to their concerns.



Companies should consider the length and complexity of their CD&A and make it more compelling to ensure shareholder support. This may involve more graphics, less boilerplate, and a greater focus on analytic tools such as tally sheets, wealth accumulation analysis, walkaway numbers and internal pay equity.

Pay and Performance. One of the central issues in say on pay will be the relationship between incentive pay and corporate performance. Attention in CD&A to such things as cash and equity incentive mix, discretionary overrides, and incentive risk analysis would provide a clearer picture and help attract shareholder support.

Hold Through Retirement. To make incentives more meaningful, companies are adopting "hold to retirement" or "hold through retirement" policies to promote long-term value creation.

Clawbacks. Even companies that have adopted clawbacks may want to re-assess them. The Dodd-Frank trigger threshold is lower than in Sarbanes-Oxley. Shareholders see little humor in awarding executives on the basis of financials that turn out to be wrong.

Perquisites. Companies have become more conservative about perks. This can be a sensitive issue if workers have been laid off. Committees are reviewing perks to determine if they are truly necessary to attract and retain talent.

Severance and Change in Control Benefits. Some companies have limited post-employment compensation in an effort to address shareholder concerns. Although shareholders will only have an advisory vote on golden parachutes when voting on a change in control (CIC) transaction, committees may want to think proactively about these arrangements. Their purpose — to ensure officers remain focused on consummating transactions that may be good for shareholders but uncertain for their own futures — remains valid. Yet committees may want to consider enhancements, such as double triggers and application of wealth accumulation analysis to post-CIC awards, to ensure their policies are shareholder-friendly. Adopting these proactive changes could provide an opportunity to more fully and sympathetically explain the rationale behind CIC arrangements in CD&A.

Focus on Risk. The financial crisis and the SEC's recent proxy disclosure enhancements have focused shareholders on the connection between incentive compensation and excessive risk. Although the target of this attention is primarily financial company executives who were highly compensated for horrifically risky bets, all companies would do well to provide greater clarity about how risk is evaluated in the incentive process.

Compensation Committee and Advisor Independence. Most committees already meet the enhanced independence standards contemplated by Subtitle E, but it's always good to reevaluate committee independence every year, not merely for technical compliance, but also from a qualitative perspective.

Title E does not require a "compensation committee expert," but the business of making compensation has become more complex. Seeking committee members with experience in the area can only help. At the very least, committee members need independent judgment and the ability to ask tough questions.

Late last year, the SEC adopted rules requiring disclosure of fees paid to compensation consultants when they also provide non-compensation services. SEC rules will now require the committee to consider a consultant's independence before engaging it. We're not certain this will acquire the formality of the auditor independence certification process, but believe that may be an apt analogy.

It's unclear whether committees will be required to engage their own outside counsel. We appreciate both committees' desire for independent advice and General Counsels' concern over larger cat herds. Unless the SEC mandates otherwise, we believe this will remain a judgment call.

Internal Pay Equity. Subtitle E does not require any particular analysis of internal pay equity information, although it's possible the SEC's rules will require some context around these numbers.

We appreciate the sensitivity about the disparity between CEO and worker compensation, but recognize this is a complicated issue that requires further context. Committees typically examine the relationship between CEO pay and that of other executives, so the CEO – worker analysis already has a platform. If you have a strong CEO whose leadership and vision are important to the company, then

CD&A should articulate that. Most CEOs occupy that office for a reason. Companies would do well to explain this and not be apologetic about it. This is a different narrative than benchmarking, which revolves around what it takes to attract talent in a competitive market.

Hedging. Subtitle E requires the SEC to adopt rules mandating disclosure of whether employees or directors (or their designees) are permitted to purchase financial instruments (including prepaid variable forwards, equity swaps, collars and exchange funds) designed to hedge any decrease in the market value of equity securities granted as compensation or otherwise held.

Although having most of your net worth tied up in company stock can be anxiety-producing, betting against your company can be a serious problem. Not only does it show a lack of commitment to fellow shareholders, but it also hinders the purpose behind incentive compensation by reducing downside risk, exposes the company to moral hazard, and should violate your insider trading policy.

Shareholder Engagement. Say on pay could be a blessing in disguise that brings large shareholders and management together in productive dialogue. Shareholders have a legitimate concern about the relationship between pay and performance. Engaging large shareholders by seeking their input can help solidify management-owner relations, provide shareholders with valuable insight into the compensation process, and gain important allies in say on pay votes.

What About Smaller Reporting Companies?

The SEC is empowered to exempt smaller reporting companies from some or all of Subtitle E.

Non-Accelerated Filers Catch a Break on SOX 404(b)

Section 404(a) of Sarbanes-Oxley requires a quarterly management assessment of the effectiveness of internal control over financial reporting. Section 404(b) requires an annual auditor's attestation of that assessment. The SEC has delayed imposing the attestation requirement on smaller reporting companies until next year, but Dodd-Frank has amended 404(b) to exempt non-accelerated filers once and for all from that obligation.

FOR MORE INFORMATION



If you have any questions about the developments summarized in this alert, please contact:

- Marc Salle at 816.360.4137 or msalle@polsinelli.com

Corporate Finance and Securities Attorneys

William W. Mahood III,
Chair
Kansas City
816.360.4350
wmahood@polsinelli.com

Amy C. Abrams
Kansas City
816.572.4654
aabrams@polsinelli.com

Orren S. Adams
St. Louis
314.889.7071
oadams@polsinelli.com

Charles R. Berry
Phoenix
602.650.2030
cberry@polsinelli.com

Paul J. Cambridge
St. Louis
314.552.6893
pcambridge@polsinelli.com

Geoffrey D. Fasel
Kansas City
816.360.4223
gfasel@polsinelli.com

Phillip P. Guttilla
Phoenix
602.650.2327
pguttilla@polsinelli.com

Larry K. Harris
St. Louis
314.889.7063
lharris@polsinelli.com

Scott M. Herpich
Kansas City
816.360.4150
sherpich@polsinelli.com

Andrew T. Hoyne
St. Louis
314.552.6876
ahoyne@polsinelli.com

Paul G. Klug
St. Louis
314.552.6832
pklug@polsinelli.com

Gregory M. Kratofil, Jr.
Kansas City
816.360.4363
gkratofil@polsinelli.com

Philip N. Krause
Kansas City
816.691.3727
pkrause@polsinelli.com

Cortney E. Lang
Kansas City
816.572.4645
clang@polsinelli.com

Brian K. Moll
Phoenix
602.650.2302
bmoll@polsinelli.com

Michael F. Patterson
Phoenix
602.650.2038
mfpatterson@polsinelli.com

Jay E. Pietig
Kansas City
816.360.4183
jpietig@polsinelli.com

William E. Quick
Kansas City
816.360.4335
wquick@polsinelli.com

Ronald G. Rossi
Denver
720.931.1180
rrossi@polsinelli.com

Michael A. Sabian
Denver
720.931.8153
msabian@polsinelli.com

Marc A. Salle
Kansas City
816.360.4137
msalle@polsinelli.com

William M. Schutte
Kansas City
816.360.4115
wschutte@polsinelli.com

Kelly Sullivan-Deady
Kansas City
816.360.4278
ksullivan@polsinelli.com

Kevin R. Sweeney
Kansas City
816.572.4638
krsweeney@polsinelli.com

Andrew M. Wilcox
Kansas City
816.360.4288
awilcox@polsinelli.com

About Polsinelli Shughart's Corporate Finance and Securities Group

Whether a private or public company, our Corporate Finance and Securities attorneys have the expertise and insight to help you get deals done. We have represented a diverse range of clients from small businesses and venture capitalists to Fortune 100 companies. Our attorneys have played a vital role in helping clients achieve successful results through:

- Securities offerings (public, private, limited and exempt)
- Tender offers
- Mergers and acquisitions
- Mezzanine finance transactions
- Venture capital transactions

Because of our firm's entrepreneurial background, we have represented some of the Midwest's hottest new companies with private placement offerings - including one of the fastest growing Internet security companies and a pioneer in the field of alternative energy.

Our public securities practice is exemplified by our representation of two of the Federal Home Loan Banks in connection with their Securities and Exchange Commission reporting obligations. Members of our firm also have experience advising some of Kansas City's leading public companies on their Exchange Act reporting and compliance and the public offering of equity and debt securities.

With a former general counsel to the Kansas Securities Commission and a former employee of the Securities Exchange Commission on our team, we bring a comprehensive perspective to every deal. Whether you are private or public, we are a committed team of energetic workers and innovative thinkers ready to help you tackle your next big deal. To learn more about our services, visit us online at www.polsinelli.com.

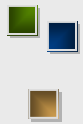
If you know of anyone who you believe would like to receive our e-mail updates, or if you would like to be removed from our e-distribution list, please contact Therese O'Shea via e-mail at toshea@polsinelli.com.

Polsinelli Shughart PC provides this material for informational purposes only. The material provided herein is general and is not intended to be legal advice. Nothing herein should be relied upon or used without consulting a lawyer to consider your specific circumstances, possible changes to applicable laws, rules and regulations and other legal issues. Receipt of this material does not establish an attorney-client relationship.

Polsinelli Shughart is very proud of the results we obtain for our clients, but you should know that past results do not guarantee future results; that every case is different and must be judged on its own merits; and that the choice of a lawyer is an important decision and should not be based solely upon advertisements.

Polsinelli Shughart® is a registered trademark of Polsinelli Shughart PC.

About Polsinelli Shughart PC



With more than 500 attorneys, Polsinelli Shughart PC is a national law firm that is a recognized leader in the areas of business litigation, financial services, bankruptcy, real estate, business law, labor and employment, construction, life sciences and health care. Serving corporate, institutional and individual clients regionally, nationally and worldwide, Polsinelli Shughart is known for successfully applying forward-thinking strategies for both straightforward and complex legal matters. The firm can be found online at www.polsinelli.com.