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Implications of the Dodd-Frank Act on Corporate Governance Preparation for IPO Issuers

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Thinking of going public? Trying to make sense of the myriad governance choices and best practices IPO issuers are implementing in the current IPO cycle, as well as the new requirements arising from the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")? Below is a summary of the governance decisions for companies going public in the current environment. While it is not exhaustive, this discussion is designed to highlight the key considerations for companies going public and also describe in more detail the most significant implications of the Dodd-Frank Act.

I. Key Corporate Governance Items

Board and Committee Independence

One of your first critical corporate governance decisions will likely be what your board and committee membership will look like post-IPO. An understanding of the rules governing public company board and committee membership is essential in making this decision.

Board Independence. Both the New York Stock Exchange ("NYSE") and the Nasdaq Stock Market ("Nasdaq") rules require that a majority of an issuer's directors be independent, but provide a one-year grace period to achieve majority independence. Although the definitions of independence vary under the NYSE and Nasdaq rules, the fundamental requirement is that the board must affirmatively determine that the individual director has no relationship with the company (either directly or through another organization) that would interfere with the exercise of independent judgment in carrying out the director's board duties. A direct or indirect ownership of a significant amount of stock in the company does not bar a finding of independence. Both the NYSE and Nasdaq have specific rules that define how much annual compensation or other remuneration an individual (or family member) may receive from the company in the three years prior to the determination of independence (generally, $120,000), as well as how much a director's (or family member's) employer can receive from the company without causing the individual to no longer be considered independent.

Audit Committee. Under both NYSE and Nasdaq rules, the audit committee must have at least three directors, all of whom must meet the independence requirements for directors described above as well as additional requirements under Section 201 of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act") and Rule 10A-3 of the Securities Exchange Act of 1934, as amended. Companies completing an IPO have a one-year phase-in period to comply with these requirements, whereby there must be one independent member on the audit committee at the time of initial listing, a majority of independent audit committee members within 90 days thereafter, and a fully-independent audit committee within one year.

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Compensation Committee. Both NYSE and Nasdaq rules require that the compensation committee be composed entirely of independent directors. As is the case with the audit committee, the NYSE and Nasdaq rules currently provide a transition period for IPO companies that permits them to have only one independent member of the compensation committee at listing, a majority after 90 days, and then a fully independent compensation committee within one year. The Dodd-Frank Act also requires that a public company's compensation committee be comprised exclusively of independent directors, but it does not include a one-year transition period. Rather than setting explicit independence standards, the Dodd-Frank Act tasks listing authorities with further defining independence. In formulating this definition, listing authorities are to consider: (i) the source of compensation of the director, including any consulting, advisory, or other fees paid to him by the company; and (ii) whether a director is affiliated with the company, a subsidiary of the company, or an affiliate of a subsidiary of the company. The Dodd-Frank Act provides for rules to be promulgated by July 16, 2011 to clarify these requirements, and therefore it is not clear whether the one-year transition period available under the NYSE and Nasdaq rules for full compensation committee independence will continue to be available. Similarly, it is unclear exactly how the NYSE and Nasdaq may refine or modify their definitions of independence in light of the Dodd-Frank Act's mandate.

Nominating and Corporate Governance Committee. Both the NYSE and Nasdaq rules require that the nominating and corporate governance committee be composed entirely of independent directors, subject to the one-year transition period described above.

Controlled Company Exemption. A controlled company may elect not to comply with (i) the requirement that a majority of its board consist of independent directors and (ii) the requirement that its compensation committee and nominating and corporate governance committee each be composed entirely of independent directors. However, the controlled company exemption does not change the independence requirements for the audit committee. A "controlled company" means a company in which more than 50% of the company's voting power is held by an individual, a group or another company. In addition, in order to take advantage of this exemption, a controlled company must publicly disclose that it is controlled and that it has chosen to use the exemption.

Shareholder Voting

Companies going public must also determine their voting structures post-IPO and the rules by which shareholders will be able to vote in director elections and on other matters. For example, a company may consider whether majority or plurality voting standards should apply and, in certain circumstances, whether a dual-class voting structure is desirable. In addition, a company must decide whether certain items in its charter or other governance matters will require any supermajority voting requirement. Decisions on these issues should consider the likely market reaction, including recommendations published by proxy advisory firms such as Institutional Shareholder Services and Glass, Lewis & Co. Careful planning will allow the company to determine the best plan for both the company and its shareholders going forward. In making these decisions, however, a company must also consider the limitation on broker discretionary voting now required by the Dodd-Frank Act.

The Dodd-Frank Act requires national securities exchanges to prohibit brokers from voting on the election of directors, executive compensation matters or other significant matters as determined by the Securities and Exchange Commission (the "SEC"), unless the broker has received specific voting instructions from the beneficial owner. Limiting broker discretionary votes will likely result in activist shareholders and proxy advisory firms having greater influence on shareholder votes. Companies may find it more difficult to gain the necessary votes for director re-elections or to gain support for their compensation related matters. In addition, public companies will likely have to undertake increased proxy solicitation efforts to gain support for certain matters and embark upon ongoing communication with influential shareholders without violating Regulation FD.

Based on our survey of recent trends in the IPO market, the majority of companies going public in 2010 continue to adopt plurality voting standards with respect to the election of directors. However, in response to increased shareholder activism, many larger seasoned public companies have now moved away from plurality voting and implemented some form of majority voting. The limitation on broker discretionary voting now required by the Dodd-Frank Act may influence the voting structure decisions made by public companies, and the impact of this new limitation on future director elections remains to be seen.

Anti-Takeover Measures

Anti-takeover measures are typically structural defenses implemented by a public company to hinder or prevent attempts by third parties to take control of the company. Some of these measures include:

- blank check preferred stock;
- a poison pill;
- limitations on the ability of shareholders to call special meetings of the shareholders;
- a staggered board;
- limitations on the ability of shareholders to act by written consent;
- advance notice requirements for shareholder proposals; and
- providing for the ability of the board to amend the company's bylaws without shareholder consent.

Companies going public should carefully consider which of these measures are in the best interests of the company and its shareholder base.

It is currently common among recently public companies as well as seasoned issuers to implement blank check preferred stock and advance notice requirements for shareholder proposals. Conversely, it is not very common for these companies to implement poison pills. It is more common than not for companies to impose some form of limitation on the ability of their shareholders to call special meetings and to act by written consent. Every company considering an IPO will need to decide which anti-takeover measures to include in light of market practices at the time.

II. Additional Dodd-Frank Act Provisions

The Dodd-Frank Act provides for additional rules regarding corporate governance, executive compensation and disclosure that will affect companies going public. A number of these rules will be fleshed out by SEC rulemaking during the upcoming months.

Proxy Access

One of the most controversial new rules adopted by the SEC on August 25, 2010 (as authorized by the Dodd-Frank Act) permits eligible shareholders (or groups of shareholders) to nominate candidates for director in a public company's proxy materials so long as such shareholders are not otherwise prohibited from doing so by applicable state or foreign law or the company's governing documents. A shareholder (or group) will be eligible if it has beneficially held both voting and investment power over securities representing at least 3% of a company's voting power for three years prior to submitting the nomination to the company. Short positions in securities must be deducted when determining the 3% threshold, and the right to acquire securities underlying options cannot be counted.

Under the new rules, shareholders in the aggregate may not nominate more than 25% of the company's board of directors or one nominee, whichever is greater. In addition, nominating shareholders must certify that they are not seeking to change control of the company. If a company receives shareholder nominations for more candidates than it is permitted to include under the rules, the company must include the nominees of the shareholders holding the highest percentage of voting power. The new rules were scheduled to become effective as of November 15, 2010, for the 2011 proxy season. However, on October 4, 2010, the SEC issued a stay on their effectiveness until resolution of a legal challenge to the validity of the proxy access rules currently pending in the United States Court of Appeals.

Companies considering an IPO will need to be prepared for the possibility of contested director elections and increased shareholder activism once they go public as a result of these new rules. If a company's board is perceived as performing poorly, large shareholders or groups of shareholders may challenge seats held by existing directors. Not only does this risk changing the composition of the board, it also adds a costly element to proxy solicitations and increased administrative burdens for the company. In addition, companies will need to review their advance notice provisions to insure they will be consistent with the new rules and may want to consider adopting clear and objective director qualification requirements.

Clawback Policies

"Clawback" requirements are intended to recoup compensation from executives in circumstances where it is later determined that there were financial accounting issues requiring restatements of the company's financial statements. Interest in clawback requirements initially arose following the Enron, Worldcom and other corporate scandals as part of a larger attempt to prevent executives from retaining oversized compensation in cases where material financial and accounting irregularities are later uncovered.

The Sarbanes-Oxley Act included a federally-mandated clawback provision. Under this provision, if a public company is required to prepare an accounting restatement due to the material noncompliance by the company, as a result of misconduct, with any financial reporting requirements, the chief executive officer and chief financial officer must disgorge any bonus, other equity or incentive-based compensation, and any profits from sales of the company's stock received during the 12-month period following the public issuance or filing with the SEC (whichever occurs first) of the noncompliant financial information. However, this clawback provision has only been enforced by the SEC, and it has not provided the company or its shareholders with a private right of action to seek disgorgement on their own.

The Dodd-Frank Act goes further, in that it requires listed companies to adopt clawback policies. Pursuant to the Dodd-Frank Act, when a listed company prepares an accounting restatement as a result of its material noncompliance with any financial reporting requirement, the company must recover all incentive-based compensation (including stock options) paid to current or former executives during the three years preceding the date on which the restatement is required. There is no requirement that the restatement be triggered by the misconduct of the company or any employee. The amount of compensation recoverable is the excess of what was actually paid to the executive over the amount that would have been paid under the accounting restatement. Companies must also publicly disclose their clawback policies. The SEC expects to propose rules on clawbacks by July 2011.

The Dodd-Frank Act requires that the policy cover the "executive officers" of the company. A company going public should consider whether it would be appropriate to expand the reach of the clawback policy to also include highly compensated employees who are not executive officers, or indeed whether all employees should be subject to the policy. In addition, the company may want to consider expanding its policy to include, for example, misconduct that does not result in an accounting restatement. Furthermore, a company may opt to include the recoupment of other forms of compensation in its policy other than just "incentive based compensation", as required by the Dodd-Frank Act. Finally, a company considering an IPO will need to determine who in the company will be responsible for administering and enforcing the policy.

Mandatory Say-on-Pay Vote

Under the Dodd-Frank Act, domestic public companies must provide shareholders with the right to cast a non-binding "say-on-pay" vote approving the company's executive compensation as it is disclosed in the compensation discussion and analysis section of the company's proxy statement and accompanying tabular and narrative disclosure. The SEC proposed say-on-pay rules on October 18, 2010 and final rules are expected by year end.

On the occasion of the first say-on-pay vote, shareholders must be given the opportunity to vote on both (i) the say-on-pay resolution and (ii) a separate resolution to determine whether the company's say-on-pay vote will be held every one, two or three years. Thereafter, shareholders must be given the opportunity to re-determine the frequency of the say-on-pay vote at least once every six years. The say-on-pay vote is non-binding and will not be construed as overruling the compensation decisions of the company's board of directors, imposing additional fiduciary duties on the board, or limiting shareholders' ability to make compensation-related proposals for inclusion in proxy statements.

A negative vote on say-on-pay, while not binding on the company, is likely to have a deleterious effect on shareholder relations and may, as a practical matter, require that companies modify their pay practices in response to shareholders' concerns. When considering an IPO, companies must place an emphasis on thoughtful compensation design and should take steps to ensure that shareholders have a reasonable understanding of both the company's compensation program and the reasons for the compensation decisions the company has made.

Disclosure and Vote on Golden Parachutes

Proxy statements and consent solicitations filed by domestic public companies in connection with mergers, acquisitions and major asset sales are required by the Dodd-Frank Act to describe, in clear and simple form, any arrangements with named executive officers of the company or the acquiring company concerning compensation (whether present, deferred or contingent) that is related to the transaction. Companies will also be required to disclose the aggregate amount of compensation that will be paid or may become payable to the named executive officers (together with the conditions to payment) as a result of the transaction. The SEC proposed say-on-golden parachute pay rules on October 18, 2010 and final rules are expected by year end.

The proxy statement also must provide shareholders the opportunity to cast a separate non-binding vote to approve these payments, unless the arrangements have been previously disclosed in accordance with SEC requirements and subject to a general say-on-pay vote. As is the case with the say-on-pay vote, the “golden parachute” advisory vote will not overrule the board’s compensation decisions or impose additional fiduciary duties on the board. This provision applies to all meetings occurring after the proposed rules become effective. Like say-on-pay, this requirement applies only to U.S. companies and not to foreign private issuers.

Companies going public should consider establishing their “golden parachute” arrangements concurrently with the IPO or shortly thereafter. If the arrangements have been subjected to a general say-on-pay vote and disclosed in the manner required by the SEC, the company may be able to avoid going back to its shareholders later for a separate vote on the arrangements at the time of a transaction.

Compensation Committee Adviser Independence

The Dodd-Frank Act provides that the compensation committee of a public company may, in its sole discretion, obtain advice of consultants, legal counsel and other advisers, and also must be directly responsible for the appointment, oversight and compensation of these advisers. Companies are required to provide funding for the adviser compensation determined by the committee. In selecting its advisers, compensation committees must take into account factors affecting independence. The Dodd-Frank Act directs the SEC to identify independence factors that are competitively neutral among categories of consultants, legal counsel and other advisers, and provides the following partial list of considerations:

- provision of other services by the adviser’s employer;
- the amount of fees paid to the adviser’s employer, considered as a percentage of the employer’s total revenues;
- the policies and procedures of the adviser’s employer that are designed to prevent conflicts of interest;
- any business or personal relationship between the adviser and a member of the compensation committee; and
- the adviser’s ownership of stock of the company.

The SEC expects to propose rules by December 2010 and to adopt final rules by July 2011. The compensation consultant independence provisions do not apply to “controlled companies.”

The Dodd-Frank Act does not actually require that consultants be independent. Rather, in any proxy statement filed on or after July 20, 2011, public companies must disclose (in accordance with rules to be established by the SEC):

- whether the compensation committee retained a consultant;
- if the consultant’s work raised a conflict of interest; and
- if so, how that conflict is being addressed.

Companies considering an IPO must be prepared to conduct such an analysis and to report accordingly in connection with the company’s proxy statement.

Chairman and CEO Disclosures

The Dodd-Frank Act directs the SEC to issue rules by January 17, 2011, requiring all public companies to disclose the reasons why it has the same or different persons serving as chairman of the board and chief executive officer. Current SEC rules already require public companies to disclose why they have determined that their leadership structure is appropriate. Therefore, it is unlikely that the new SEC rules will create any significant additional disclosure requirements. Nevertheless, companies considering an IPO will be forced to analyze their leadership structure to determine whether any changes are merited and how they will explain the reasons for their leadership structure.

Hedging

Under the Dodd-Frank Act, a public company must disclose whether all employees (not only executive officers) or directors (or their designees) can hedge against decreases in the value of stock granted as compensation or otherwise directly or indirectly held by the employee or director. While there is no explicit prohibition on hedging, the required disclosure will force companies who permit hedging, or who do not have a hedging policy, to consider how that appears to shareholders and the general public. The SEC expects to propose rules by July 2011. Companies contemplating an IPO should consider adopting or revising hedging policies, and ensuring that all employees and directors are covered by the policy.

Additional Compensation-Related Disclosures

The Dodd-Frank Act requires public disclosure of (i) the relationship between compensation actually paid to the company's named executive officers and the financial performance of the company, taking into account any change in the stock value and dividends paid; and (ii) the median total annual compensation of all employees (other than the chief executive officer), the annual total compensation of the chief executive officer, and the ratio of these two amounts. Total compensation would be calculated in the same manner as in the summary compensation table. The SEC expects to propose rules on these measures by July 2011.

Companies considering an IPO should revisit the compensation packages of their named executive officers to be sure they are comfortable with the ratios that will need to be disclosed. In addition, gathering the data required to calculate the ratio of all employees' compensation to that of the chief executive officer will likely be a large undertaking that will require careful advance planning.

Whistleblower Protection

The Dodd-Frank Act provides enhanced protections and monetary incentives for corporate whistleblowers. Whistleblowers who voluntarily provide original information about violations of securities or commodities laws could be awarded between 10% and 30% of any monetary sanctions above $1 million. In addition, anti-retaliation rights have been expanded to provide whistleblower employees with the right to a jury trial and to require employers guilty of retaliation to reinstate the whistleblower and pay back-pay and applicable attorney fees. Furthermore, the Dodd-Frank Act expands whistleblower protection rights under the Sarbanes-Oxley Act to employees of non-public subsidiaries of public companies.

New monetary incentives and protections for whistleblowers will likely encourage increased reporting of securities law violations. Companies considering an IPO would be well served to review their existing whistleblower policies and procedures to insure that they provide for effective internal reporting and the maximum opportunity to address potential issues internally. In addition, companies with subsidiaries that will not be public should insure that these subsidiaries understand and implement appropriate whistleblower policies and procedures to protect against Sarbanes-Oxley Act whistleblower claims by their employees.

III. Conclusion

Companies considering an IPO will face many governance and related decisions leading up to the IPO, but an understanding of the key provisions and issues involved will aid in the decision-making process. In addition, recognizing how the Dodd-Frank Act's rules affect the traditional governance and disclosure landscape should help in the planning process. Although many of the Dodd-Frank Act requirements are still subject to further rulemaking by the SEC, their impact, as well as the impact of other pre-existing governance rules, should be addressed by any company considering going public. Although at first blush these decisions may seem daunting, with the help of counsel, a company going public can work its way through the options to make effective decisions and be well prepared for the post-IPO world.