The Dodd-Frank Act Addresses Corporate Governance

Internal Controls, Whistleblower Provisions, and Disclosure Regulations

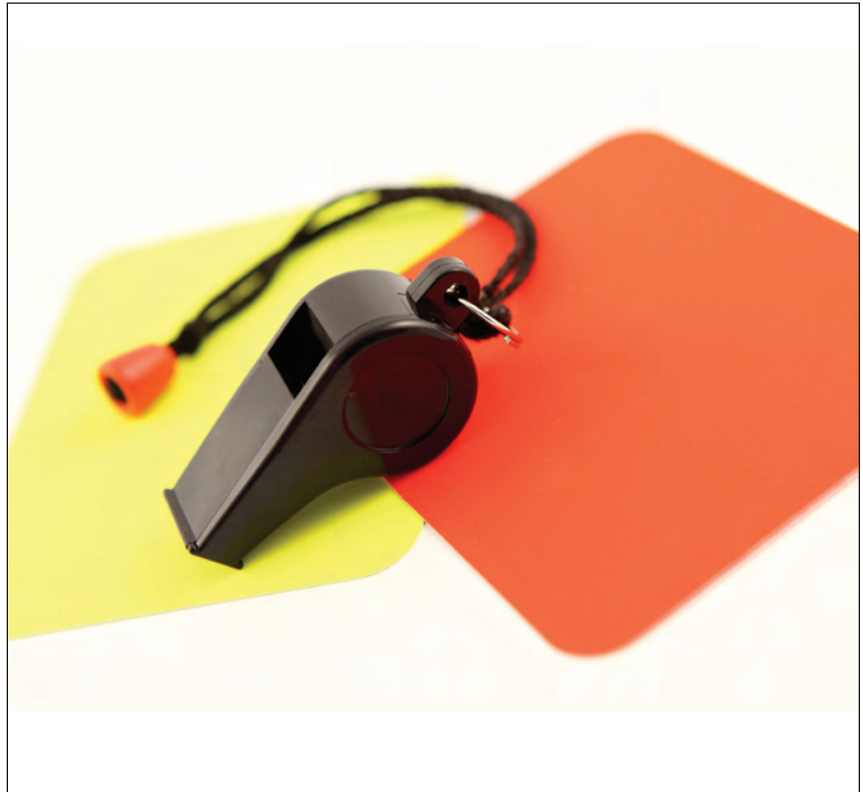
By Josef Rashty

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act includes many provisions that federal regulators, including the SEC, have not yet been able to fully adopt and implement. Although the Dodd-Frank Act focuses mostly on the financial services sector, secondary provisions in the act impact the corporate governance and compliance programs of any nonfinancial publicly held companies.

The Dodd-Frank Act deals with numerous aspects of corporate governance, executive compensation, public company disclosures, and whistleblower procedures and protections, as well as mining and use of certain minerals. These requirements may potentially impact any industry in the United States.

The corporate governance and compliance programs of every publicly held corporation—not just those in the financial sector—may be affected by the following four provisions in the Dodd-Frank Act:

- Exemption from section 404(b) of the Sarbanes-Oxley Act
- Whistleblower rules
- Disclosure requirements for executive compensation in proxies and annual reports
- Disclosure requirements for the use of conflict minerals.



Exemption from Section 404(b) of the Sarbanes-Oxley Act

In response to the Dodd-Frank Act mandate, on September 15, 2010, the SEC issued a final rule, effective September 21, 2010, that public companies with a public float of $75 million or less were exempt from obtaining an independent auditor's report on the effectiveness of their internal control over financial reporting (ICFR) under section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX). This exemption, however, does not extend to management's assessment of the effectiveness of ICFR, which continues to be required under SOX section 404(a).

In addition, on April 22, 2011, the SEC published the results of a study, mandated by the Dodd-Frank Act, that addressed whether it could reduce the costs of compliance with section 404(b) for public companies with a public float between $75 million and $250 million. The SEC concluded that "auditor involvement promotes more accurate and reliable reporting" in the assessment of ICFR for publicly held companies; as a result, it found that SOX section 404(b) should continue to apply to such companies.

Whistleblower Rule

On May 25, 2011, the SEC issued a final rule (which narrowly passed by a 3–2 vote) to implement the whistleblower provisions under section 21F (added by section 922 of the Dodd-Frank Act) of the Securities Exchange Act of 1934. The final rule provides financial rewards for whistleblowers who provide the SEC with "original information" leading to securities law enforcement actions that result in a recovery of more than $1 million.

The Dodd-Frank Act's whistleblower provisions create a system of financial incentives and protections to encourage those with information about possible violations of the securities or commodities laws to submit their complaints directly to the SEC.

Whistleblowers can receive between 10% and 30% of any amounts obtained in a successful regulatory enforcement action with sanctions of $1 million or more brought as a result of the tip.

The SEC mandate encourages, but does not obligate, whistleblowers to report the information internally first. In addition to addressing the amount of the awards and the eligibility criteria, the final rule discusses the antiretaliatory provisions of section 21F and the eligibility of whistleblowers who are culpable of misconduct to receive awards.

As part of the Dodd-Frank Act's effort to modify the SEC's authority and operations to better protect the investing community, the SEC created the Office of the Whistleblower (www.sec.gov/whistleblower). This office is responsible for the management and administration of whistleblower programs. The SEC has also launched a new webpage for whistleblowers to report possible federal securities law violations and apply for financial awards under the whistleblower program rules (www.sec.gov/about/offices/owb/owb-tips.shtml).

The whistleblower rules are probably the most controversial provisions of the Dodd-Frank Act. Opponents argue that these rules undermine the internal control systems of companies because the rules allow whistleblowers to go to the SEC directly. While the final rule includes a provision that allows whistleblowers to first report the violation internally and establishes a 120-day lookback "grace period" to then report it to the SEC, opponents have argued that this grace period may not be sufficient for companies to fully investigate and resolve such matters internally.

Sean McKessy, first SEC chief of the Office of the Whistleblower, recently addressed these concerns. He argued that the whistleblower program will actually bolster, not hamper, the internal compliance systems of companies and will ensure that efforts to address any misconduct are sped up. Furthermore, the final rules recognize that, in most cases, attorneys, compliance personnel, and external auditors are not allowed to become whistleblowers.

The whistleblower rule of the Dodd-Frank Act impacts the corporate governance and the internal control compliance programs of publicly held companies. The following is a list of measures that public companies' compliance programs may want to consider in light of this provision of the Dodd-Frank Act:

- Reinforce to all employees the importance of reporting any concerns regarding the compliance programs at all levels of the organization.
- Emphasize the company's commitment in dealing with any compliance violations.
- Fully understand the provisions of the Dodd-Frank Act and the SEC's promulgations on this matter.
- Develop a plan for dealing with reported compliance violations.
- Be prepared for dealing with the SEC if the company gets contacted with regard to any compliance violations.
- Have a plan for contacting the audit committee, outside counsel, and independent public accountants in the case of a reported violation.
- Be prepared for any potential security litigation due to a compliance violation.

Disclosure Requirements for Executive Compensation

On December 16, 2009, the SEC issued its final guidance (effective February 28, 2010) requiring companies to disclose the following information in their proxy statements: 1) whether the roles of the chairman of the board of directors and the CEO are separate or combined, and 2) why they believe the selected structure is appropriate. This guidance is not directly related to the Dodd-Frank Act, but it is related to its enactment. On January 25, 2011, in response to section 951 of the Dodd-Frank Act, the SEC issued another piece of guidance on executive compensation, including shareholder advisory votes, frequency of votes on executive compensation, and shareholder advisory votes on golden parachutes (commonly known as "say on pay," "say on frequency," and "say on golden parachutes," respectively). Although shareholders' votes are advisory and nonbinding, the SEC has acknowledged the importance of the Dodd-Frank Act's objective to engage shareholders in discussions about executive compensation.

The "say on pay" and "say on frequency" rules will become effective January 21, 2013, for smaller reporting companies; they became effective January 21, 2011, for all other companies. The "say on golden parachutes" rules became effective April 25, 2011.

The Dodd-Frank Act also calls for certain nonbank public financial companies and certain public bank holding companies to form a separate committee that will be responsible for risk oversight. The act also requires the SEC to issue rules on the independence of compensation committees and advisors, and it calls for substantive requirements to ensure that incentive-based compensation programs of certain financial service companies do not encourage excessive risk-taking.

On July 22, 2011, the U.S. Court of Appeals vacated the proxy access rule (*Business Roundtable and Chamber of Commerce of the United States of America v. SEC*, D.C. Cir., July 22, 2011). The court concluded that the SEC did not adequately assess the economic effects of complying with the new rule on companies. The SEC's proxy access rule was championed by shareholder rights advocates and required a company to include in its proxy statement shareholders' director nominees that meet certain requirements. In September 2010, the U.S. Chamber of Commerce and Business Roundtable filed a legal petition challenging the rule. This rule was never implemented, because the SEC delayed the process until the U.S. Court of Appeals decided the case.

The proposed "clawback" rule (i.e., the recovery of executive incentive compensation) was on the SEC's agenda in the fourth quarter of 2011. The clawback provision of the Dodd-Frank Act is different from the SOX 404 provision and has broader scope and implications. The *Exhibit* features a comparison of the clawback provision in the two acts.

There are a couple of additional rule-making proposals on the SEC's agenda: disclosures of pay-to-performance and CEO pay ratios, as well as hedging activities on company stock by employees and directors. The SEC expects that rules regarding executive compensation be proposed and adopted during the first half of 2012. These rules will not be effective for the upcoming 2012 proxy season. The disclosures covered by the rules will include executive pay-to-performance relationships, pay ratios of chief executive officers to other employees, and executive compensation clawbacks.

Proxy disclosures have not been traditionally found within the scope of ICFR and SOX section 404; nevertheless, the compliance programs of publicly held companies should establish frameworks for the proper implementation and disclosures of executive compensation rules.

Use of Conflict Minerals

The intent of section 1502 of the Dodd-Frank Act is to try to curb the violence and exploitation in the Democratic Republic of the Congo and neighboring countries by requiring companies to disclose their use of any minerals derived from this region.

Public entities that use conflict minerals must disclose whether the origin of these minerals was the Democratic Republic of the Congo or an adjoining country. To comply with these requirements, affected companies must furnish a separate report describing the measures that they have taken to exercise due diligence on the source and chain of custody of the conflict minerals. These due diligence measures would include, but would not be limited to, an independent private sector audit of the issuer's report.

The proposed rule would require certain disclosures in a registrant's Form 10-K or 20-F and might require registrants to furnish the following as exhibits to their annual reports: their report on the use of conflict minerals, and the report of an independent private-sector auditor on management's report.

A company will be impacted by this rule if it files reports with the SEC under the Securities Exchange Act of 1934, and if conflict minerals are "necessary to the functionality or production" of its manufactured products. The metals and ores currently classified as conflict minerals are tin, tantalum, tungsten, and gold; these metals are also collectively referred to as "3TG." This requirement affects most electronics, aerospace, communication, automotive, jewelry, healthcare devices, and industrial machinery. Even some nonregistrants may be affected if they are part of the supply chain for these metals to registrants.

The SEC has estimated that as many as 6,000 public companies could be affected, primarily because conflict minerals have the potential to be used in various industries, and the SEC has proposed to include within the rule's scope both manufacturers and the companies that contract to manufacture their products, including retailers with private-label products.

The SEC hosted a public roundtable in October 2011 to discuss the requirements under section 1502 of the Dodd-Frank Act, which relates to reporting requirements regarding conflict minerals originating in the Democratic Republic of the Congo and adjoining countries. The event provided a forum for various stakeholders to exchange views and express opinions. The panel discussions focused on key regulatory issues, such as appropriate reporting approaches for the final rule, challenges in tracking conflict minerals through the supply chain, and workable due diligence and other requirements related to the rule making. It is expected that the SEC will issue the final rule on this matter during the first half of 2012.

The Dodd-Frank Act's conflict minerals provision may create some of the most challenging compliance tasks for publicly held companies. SEC registrants must track and document the origin of the materials that they use in their products and provide disclosures in their annual reports.

Expanded Regulation and Compliance

To mitigate any adverse impact of the Dodd-Frank Act's requirements and the SEC's related promulgations, registrants should assess and proactively expand and improve their compliance programs. Boards of directors and audit committees can mitigate the risks associated with the new rules by actively monitoring current modifications to their internal reporting processes as well as critically evaluating the effectiveness and completeness of these programs going forward.

On December 27, 2011, the *Washington Post* reported: "A year and a half has gone by since the Dodd-Frank financial reform act was signed into law, but barely a quarter of the rules in the legislation have been finalized, though federal regulators are rolling out key components of the bill." This analysis reflects the complexity of the Dodd-Frank Act and the fact that many of its provisions are yet to come. ❑

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EXHIBIT
Comparison of Clawback Provisions

	Sarbanes-Oxley Act Section 404	**Dodd-Frank Act**
Scope	Accounting restatement due to material noncompliance with securities laws as a result of misconduct	Accounting restatement due to material noncompliance with any financial reporting requirements under securities laws
Recovery	Amount received as incentive-based compensation and profits realized from stock sales	Erroneously awarded incentive-based compensation (including stock options) in excess of the amount that would have been paid under the accounting restatement
Applicability	CEOs and CFOs	All current and former executive officers
Period Covered	12 months	3 years