2014-2015 YEAR-END TOOL KIT

DODD-FRANK COMPENSATION DISCLOSURE AND CONFLICT MINERALS UPDATE

December 2014

Update on Pending Compensation Rulemaking Under the Dodd-Frank Act

Speed read: The status of the four compensation-related SEC rulemaking mandates remains unclear. The SEC has proposed (but not adopted) rules for pay ratio disclosure, and has yet to propose rules for CEO pay for performance, clawbacks and hedging. In late November 2014, an informal, non-binding regulatory agenda published by the SEC indicated that the SEC had established October 2015 as the target date for adoption of final CEO pay ratio disclosure rules and proposal of the pay for performance, clawbacks and hedging disclosure rules. These rules are the subject of ongoing political controversy, and it is possible that the new Congress will act to amend or repeal the sections of the Dodd-Frank Act that required the SEC to adopt these rules. Companies should continue to monitor the status of these rules.

The Dodd-Frank Wall Street Reform and Consumer Protection Act required the SEC to adopt rules relating to CEO pay ratio disclosure, stock exchange listing standards requiring clawbacks of incentive compensation in certain circumstances, hedging policy disclosure and pay for performance disclosure. As of mid-December 2014, the SEC had taken no action since September 2013 on these rulemaking mandates. The CEO pay ratio disclosure rules remain in the form proposed by the SEC in September 2013, and the SEC had not yet proposed rules for clawbacks of incentive compensation under stock exchange rules, hedging policy disclosure or pay for performance disclosure.

Proposed CEO Pay Ratio Disclosure Rules. The SEC proposed CEO pay ratio disclosure rules pursuant to a Dodd-Frank mandate on September 18, 2013. As proposed, the CEO pay ratio rules provided a transition period under which disclosure would not have been required for calendar year 2014 compensation (to be disclosed in 2015 proxy statements). As noted above, an internal SEC agenda indicates that the SEC may not adopt final rules until October 2015. Based on the phase-in provided in the original proposal, it is possible that if the SEC adopts final CEO pay ratio rules in late 2015, CEO pay ratio disclosure would not be required for calendar-year companies until 2016 (for disclosure in 2017 proxy statements).

Under the CEO pay ratio proposal, public companies would have to disclose the median of annual total compensation for all employees of the company other than the chief executive officer for the last completed fiscal year; the annual total compensation of the chief executive officer for the last completed fiscal year; and the ratio of these two amounts. The disclosure of the pay ratio may be presented as a fraction (*e.g.*, “1 to [the appropriate multiple]”), or in narrative form (*e.g.*, “the CEO’s annual total compensation is X times that of the median of the total annual compensation of all employees”). The proposed rules contained exemptions for smaller reporting companies, emerging growth companies and foreign private issuers.

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The proposed CEO pay ratio disclosure would cover all employees of the company and any subsidiary of the company (defined as an affiliate controlled by the company directly or indirectly through one or more intermediaries), including all full-time, part-time, temporary, seasonal and non-U.S. employees who were employed as of the last day of the company's prior fiscal year. Workers who are not employed by the company or its subsidiaries, including independent contractors, "leased" employees or other temporary workers employed by a third party, would be omitted.

Under the proposed rules, companies could annualize the total compensation of permanent employees who were employed for less than the full fiscal year. Companies could not, however, make full-time equivalent adjustments for part-time employees, annualize compensation for temporary or seasonal workers, or make cost-of-living adjustments for non-U.S. employees.

The proposed rules would allow companies to select a reasonable method to identify the median employee and to use reasonable estimates to determine any element of total compensation for the median employee and the annual total compensation for the median employee. The proposed rules would require companies to disclose briefly the methodology used to identify the median employee, including the compensation measure used and any material assumptions, adjustments or estimates. The narrative disclosure is intended to be a brief overview, and disclosure of technical analyses or formulas is not required. If a company estimates total annual compensation, the resulting disclosure would need to be clearly identified as an estimated amount and include a brief description of the estimates used by the company. If a company changes its methodology from a prior period and the effects of such change are material, the company must briefly describe the change, the reasons for the change and the expected impact on the median and the ratio.

For additional information about the SEC's proposed pay ratio rules, see our Client Alert "SEC Issues Proposed "Pay Ratio" Disclosure Rules" (October 2, 2013).

Clawbacks. The Dodd-Frank Act requires the SEC to adopt rules directing stock exchanges to prohibit the listing of securities if the company has not developed and implemented a policy for the recovery of incentive-based compensation in certain circumstances. Unlike the comparable clawback requirements of the Sarbanes-Oxley Act clawback provision, the Dodd-Frank Act clawback policy must cover both current and former executive officers, rather than just the chief executive officer and the chief financial officer, and applies to any accounting restatement resulting from material non-compliance, without regard to whether the executive officer is responsible for misconduct that led to the restatement. Companies would be required to disclose their clawback policies.

Some companies have adopted clawback policies in advance of the final rules, in some cases because adoption and disclosure of a clawback policy may affect corporate governance ratings by proxy advisory firms. Because the SEC's current internal agenda indicates that the Dodd-Frank clawback rules may not be proposed until October 2015, and implementation of these rules will require rulemaking proposals and adoption by the SEC and then by the stock exchanges, the Dodd-Frank clawback rules are not likely to affect companies until at least the 2016 proxy season.

Hedging. The Dodd-Frank Act also requires the SEC to adopt rules requiring companies to disclose whether employees and directors are permitted, directly or indirectly, to hedge the market value of compensatory securities grants and awards. This disclosure is in addition to existing SEC requirements that companies disclose any policies regarding hedging the economic risk of owning company securities by

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the company's named executive officers in proxy statements. Like the clawback rules, the SEC's internal agenda for its rulemaking proposal indicates that it is unlikely that the hedging policy disclosure requirements will apply until at least the 2016 proxy season.

Pay for Performance. The third compensation-related Dodd-Frank Act rulemaking mandate that remains unproposed at this time is the requirement that the SEC to adopt pay for performance disclosure rules. These rules would require companies to disclose material 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 company's stock and the dividends paid by the company. Like the clawback and hedging rules, the SEC's internal agenda for its rulemaking proposal indicates that it is unlikely that the hedging policy disclosure requirements will apply until at least the 2016 proxy season. Companies should monitor SEC rulemaking in this area, however, because the proposed rules may provide insights concerning final SEC rules that compensation committees may wish to consider when they adopt compensation programs and make compensation decisions.

Update on Conflict Minerals

Speed read: The final status of the SEC's conflict minerals rules remains uncertain. There has been no substantive change from the legal position when 2013 reports were filed in late May and early June 2014. Litigation still pending before the D.C. Court of Appeals could strike the current limited order that prevents public companies from being required to state whether their products are "DRC conflict free." That would ultimately result in companies becoming obligated to comply with the conflict minerals rules as originally adopted by the SEC, after all appeals had been dealt with. Meanwhile, it is also possible that legislation that would amend the Dodd-Frank Act to eliminate the conflict minerals rule could be adopted by the House of Representatives and the Senate in 2015. Until these uncertainties are resolved, companies should continue to monitor developments, and should be prepared to file reports in 2015 on the same basis that they did in 2014.

Section 1502 of the Dodd-Frank Act required the SEC to adopt rules requiring public companies to disclose their use of coltan, cassiterite, gold and wolframite if those minerals (i) originated in the Democratic Republic of the Congo (the "DRC") or an adjoining country and (ii) are necessary to the functionality or production of their products. As a required by the Dodd-Frank Act, the SEC adopted Rule 13p-1 in August 2012, which requires companies to prepare and file annually a Form SD and, in some circumstances, a Conflict Minerals Report.

After the U.S. District Court for the District of Columbia ruled against a challenge to the SEC's conflict minerals rule, the U.S. Court of Appeals for the D.C. Circuit issued an opinion in April 2014 upholding the lower court's decision in all respects other than on First Amendment grounds. The Court of Appeals held that the relevant section of the Dodd-Frank Act and the SEC's conflict minerals rule violated the First Amendment by unconstitutionally compelling speech to the extent they require issuers to report to the SEC and state on their website that any of their products have "not been found to be 'DRC conflict free.'"

To deal with the resulting uncertainties about how companies should comply with the conflict minerals rule in light of the litigation, the SEC Division of Corporation Finance issued a statement in April 2014 indicating that companies were required to comply with the conflict minerals rule and to file a Form SD by the June 2, 2014 deadline, but were not required to describe their products as being "DRC conflict free," having "not

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been found to be 'DRC conflict free,'" or "DRC conflict undeterminable." Pending further action, companies would also not be required to obtain an independent private sector audit unless they voluntarily described their products as "DRC conflict free." The April 2014 SEC statement can be found here.

Following up on the April SEC statement, the SEC issued an order in May 2014 staying the effective date for compliance with the portions of the conflict minerals rule and Form SD that had been found invalid by the courts. The SEC's May 2014 press release discussing the order can be found here, and the order itself can be found here.

As of mid-December 2014, the conflict minerals litigation remains unresolved. On August 1, 2014, the full U.S. Court of Appeals for the District of Columbia Circuit issued an opinion in the appeal of *American Meat Institute v. US Department of Agriculture* that upheld a Department of Agriculture "country-of-origin" labeling requirement that had been challenged on First Amendment grounds that were similar to the grounds on which the SEC conflicts minerals rules had been declared in part unconstitutional. On November 18, 2014, the three-judge panel of the D.C. Circuit Court of Appeals that had issued the decision finding the SEC conflict minerals rule invalid in part on First Amendment grounds issued an order requiring the parties to submit briefs relating to the impact of the *American Meat Institute* decision on its earlier conflict minerals ruling and deferring action on pending motions for *en banc* rehearing of an appeal in the conflict minerals rule litigation.

It is possible that the conflict minerals provisions of the Dodd-Frank Act will be among those that the new Congress will consider amending in 2015. For these reasons, companies required to file Form SD should monitor developments in the coming months to determine if any disclosure changes are needed and whether the Congress modifies or eliminates the conflict minerals mandate.

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