Dodd-Frank affects private companies too: practice points to note

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The Dodd-Frank Act – signed by President Barack Obama more than three years ago, and since then advanced with a host of rules and regulations – has been widely viewed as a law that addresses systemic risk in the financial system and enhances the corporate responsibility of public companies to shareholders.

Although the substantial majority of the corporate governance, executive compensation and disclosure provisions of the Dodd-Frank Act designed to enhance corporate responsibility apply to public companies, some private companies too are implementing similar controls in their governance structures. Certain private companies are opting to do this, and others are doing it because their investors demand it.

For private companies concerned about reviewing their governance structures in a post Dodd-Frank world, here is a capsule review of the relevant provisions of the Dodd-Frank Act that were crafted to enhance corporate responsibility, plus information on how they may affect private company governance structures. In addition, we take a look at the way the new derivatives regulations affect private companies.

Dodd-Frank's corporate responsibility provisions

Among the provisions included in the Dodd-Frank Act by Congress as a means to enhance corporate responsibility to shareholders are the following:

***Say on pay and say on golden parachutes*.** Section 951 of the Dodd-Frank Act requires public companies to provide their shareholders with a periodic non-binding "advisory" vote to approve the compensation of its executives. Public companies must also provide their shareholders with an advisory vote to approve payments made to certain executive officers in connection with a merger or acquisition within a certain amount of time following such transaction. In January 2011, the Securities and Exchange Commission adopted final rules covering these requirements, and such rules are now effective.

Independence for compensation committees and for compensation consultants or advisors. Section 952 requires the SEC to direct the stock exchanges to adopt independence standards for public companies' compensation committees considering certain factors established by the SEC. The SEC is also required to direct the stock exchanges and associations to require compensation committees to consider the independence of any compensation consultant or advisor selected. Section 952 also requires that public companies make disclosure about the role of, and potential conflicts involving, compensation consultants. The SEC adopted final rules implementing these provisions in June 2012 and, earlier this year, approved NYSE and Nasdaq rules that implement Section 952. Public companies needed to comply with certain of these exchange rules by July 1, 2013, while others go into effect in 2014.

***Pay-for-performance and pay equity disclosures*.** Section 953 requires public companies to make disclosures regarding the relationship between a company's executive compensation and its financial performance. Public companies must also disclose the ratio between a company's CEO's total compensation and the median total compensation for all other company employees. In September 2013, the SEC proposed rules to implement the pay equity disclosures mandated by the Dodd-Frank Act, but such rules have yet to be adopted. Rules regarding the relationship between executive compensation and performance have yet to be proposed.

Clawback of compensation. Section 954 requires the SEC to direct the stock exchanges to require listed companies to develop and implement compensation claw-back policies enabling the recovery of incentive-based compensation from current or former executive officers following a restatement of financial results. This section also requires the exchanges to require listed companies to disclose incentive-based compensation that is based on publicly-reported financial results. The SEC has yet to propose rules covering these requirements.

Hedging disclosure. The SEC is required to issue rules requiring public companies to disclose whether employees and directors are permitted to hedge against any decrease in the value of the a public company's stock.The SEC has yet to propose rules covering these requirements.

Proxy access. The SEC is authorized to issue rules permitting public company shareholders to nominate directors using the company's proxy solicitation materials. In August 2010, the SEC adopted final rules implementing the proxy access provisions, but those final rules were later rejected by the courts.

Whistleblowers. Section 922 created a significant financial incentive for whistleblowers that voluntarily provide "original information" to the SEC that leads to the recovery of more than US$1 million in monetary sanctions from the violation of the federal securities laws. The provision impacts both public and private companies as there are a number of ways in which a private company can violate the federal securities laws (e.g., seeking investors). In addition to the financial incentives for whistleblowers, Section 922 creates a private right of action for whistleblowers who suffer retaliation which prohibits employers from discharging, demoting, suspending, threatening, harassing or otherwise discriminating against a whistleblower because of any lawful act or report by the whistleblower. In May 2011, the SEC adopted rules to establish a whistleblower program, and such rules are now effective.

What matters in this for private companies

With the exception of the whistleblower provisions, the corporate governance and executive compensation provisions of Dodd-Frank Act directly apply only to public companies. However, some private companies may choose to implement similar measures in their governance structures.
With respect to those whistleblower provisions that do directly apply, private companies should consider the following:

- Private companies should consider educating employees regarding **what constitutes a "reportable event"** under the new whistleblower provisions.
- Depending on its size, a private company may consider **instituting a process for the anonymous reporting of tips** about possible malfeasance to management, a compliance officer or the company's outside counsel.
- Private companies of sufficient size should have **a well-organized system in place to assess, investigate and respond** to such reports or complaints.
- Private companies might also consider drafting and distributing **policy manuals** covering these topics. Some larger private companies have begun requiring employees to sign an annual acknowledgement that they have reported any potential issues about which they have information.

Although the executive compensation provisions of the Dodd-Frank Act directly apply only to public companies, best practices may increasingly dictate that some of these provisions be applied to certain private companies, especially those with institutional investors. For example, the boards of private companies should consider reviewing the independence of their compensation committees and/or compensation consultants to make sure their practices in this area are consistent with their fiduciary duties.

Derivatives regulations also may apply to non-financial private companies

Pursuant to the regulatory framework established by the Dodd-Frank Act covering the "over-the-counter" derivatives market, the Commodity Futures Trading Commission now has regulatory authority over "swaps" and the SEC has regulatory authority over security-based swaps. The term "swap" is broadly defined to cover numerous classes of transactions in which one or more payment obligations are based on the price or value of underlying instruments, indexes, commodities, currencies or financial or other contingencies, and includes transactions such as interest rate swaps, credit default swaps, commodity swaps, cross-currency swaps, non-deliverable currency forwards, and puts, calls, caps and other options on each of the foregoing. For example, **if a private company enters into a floating-rate credit facility and concurrently enters into an interest rate cap in connection with such facility, the interest rate cap likely is a "swap" and, therefore, regulated under the Dodd-Frank Act**.

While the majority of the requirements applicable to swaps under the Dodd-Frank Act apply directly to regulated financial entities such as swap dealers and major swap participants, **certain of the requirements also apply, directly or indirectly, to end-users in swaps, including private companies**. Some of the requirements that may apply, directly or indirectly, to non-financial companies include the following:

- ***Clearing.*** The Dodd-Frank Act and the rules promulgated thereunder require the **mandatory clearing and exchange trading of all swaps** so designated by the CFTC, subject to certain limited exceptions. An exception from these requirements exists for certain non-financial end-users of swaps that use swaps to hedge or mitigate commercial risk.
- ***Business conduct standards and swap documentation.*** As required by the Dodd-Frank Act, the CFTC has promulgated rules covering, among other things, external business conduct standards and swap documentation requirements applicable to swap dealers. Compliance with these rules **requires swap dealers to collect additional information from their counterparties and to amend their existing swap documentation or create compliant swap documentation with such counterparties**. The amendment of existing swap documentation or the creation of compliant swap documentation could occur through bilateral means by amending or creating the relevant ISDA Master Agreements or other trading documentation and/or by adhering to protocols developed by the International Swaps and Derivatives Association, Inc.
- ***Obtaining an LEI/CICI.*** Under the Dodd-Frank Act, **every counterparty to a swap** must obtain a unique legal entity identifier known as an LEI/CICI.
- ***Recordkeeping.*** The rules promulgated under the Dodd-Frank Act **require all unregistered swap counterparties (e.g., non-financial private companies)** to maintain "full, complete, and systematic records, including all pertinent data and memoranda, with respect to each swap in which [it is] a counterparty."

For more information regarding the effects of the Dodd-Frank Act on private companies, or for assistance in developing policies or practices in this area, please contact your DLA Piper lawyer or:

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