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Congressional Watch: House Passes Sweeping Wall Street Reform Bill Including Governance Provisions on "Say-on-Pay," Compensation Committee Independence and S.E.C. Proxy Access Authority

Last Friday, the House passed The Wall Street Reform and Consumer Protection Act of 2009 (the "Wall Street Reform Act")[1] in a 223-202 vote.[2] Among the bill's governance changes are provisions regarding shareholder "say on pay," independent compensation committees and proxy access.[3] Introduced by Representative Barney Frank (D–MA), chairman of the House Financial Services Committee, the Wall Street Reform Act comes on the heels of a string of corporate governance changes proposed by the Obama administration and members of both houses of Congress earlier this year.[4]

The focus now turns to the Senate, where a similar bill introduced on November 10 by Banking Committee Chairman Chris Dodd (D–CT) is reported to be undergoing a significant bipartisan overhaul.[5] While it remains unclear whether, or in what form, final legislation will be passed, senior management and directors at public companies should follow these developments closely. Given the level of Congressional interest, and the current political and economic climate, it is likely that we will see elements of these bills become enacted, with potential for the most significant governance changes since the Sarbanes-Oxley Act of 2002.

Corporate Governance Provisions in the Wall Street Reform Act

Shareholder "Say-on-Pay"

The Wall Street Reform Act will require the SEC to issue final rules applicable to issuers within six months after enactment that provide shareholders with an advisory vote on executive compensation. The provisions are to become effective with respect to shareholder meetings occurring at least six months after the final rules are issued by the SEC:[6]

- Shareholders in public companies will have the right to cast a non-binding vote each year approving or disapproving executive pay packages for the companies' named executive officers as disclosed in the companies' annual proxy materials.[7]
- Shareholders will also have the right to cast a non-binding vote to approve or disapprove "golden parachute compensation" disclosed in proxy materials relating to a merger, acquisition, or other transaction that may involve a change in control of the company.
- Institutional investment managers subject to Section 13(f) of the Exchange Act will be required to report at least annually how they voted on any of the shareholder votes described above.

The draft Dodd bill contains provisions essentially identical to those in the Wall Street Reform Act regarding non-binding shareholder votes on annual compensation and golden parachute payments, but lacks the provision regarding disclosure of institutional investment managers'

votes.[8] The Dodd bill's "say-on-pay" provisions would become effective one year after enactment of the bill.

Compensation Committee Independence

The Wall Street Reform Act will require the SEC to issue rules directing that the national securities exchanges prohibit the listing of any class of equity securities of an issuer that does not satisfy the following requirements:[9]

- Each member of the compensation committee must be independent under a heightened standard requiring that an independent director not accept, other than in the capacity as a director, any consulting, advisory or other compensation fee from the issuer. Note that while this standard is more stringent than the general independence standard provided by current listing standards, it is less stringent than the standard provided for audit committees in Section 301 of the Sarbanes-Oxley Act, which requires, in addition to the foregoing, that an independent director not be affiliated with the issuer or any of its subsidiaries.
- The compensation committee must have authority to retain an independent compensation consultant (and the issuer must disclose in its proxy statement whether the compensation committee has done so), as well as the authority to retain independent counsel and other advisers. The compensation committee is to be directly responsible for the appointment, compensation and oversight of such consultants and advisers, and the issuer is required to provide appropriate funding to the compensation committee for their retention.
- Any compensation consultant or similar adviser to the compensation committee must meet standards for independence to be established by the SEC by regulation. Note that this provision seems to go well beyond the existing audit committee independence requirements and could, for example, be construed to require the compensation committee to retain "independent" counsel to represent it. We would hope to see the intent of this provision clarified in any final legislation and/or related SEC regulations.

The draft Dodd bill contains provisions regarding compensation committee independence that are essentially identical to those in the Wall Street Reform Act, with the exception that the Dodd bill uses the stricter independence standard provided by Sarbanes-Oxley Section 301 for directors serving on the compensation committee.[10] Like the Wall Street Reform Act, the Dodd bill includes a broadly stated independence requirement for compensation committee advisers.

Proxy Access

The Wall Street Reform Act will amend the Exchange Act to give the SEC express authority to issue rules and procedures relating to the inclusion, in an issuer's proxy solicitation materials, of a nominee or nominees submitted by shareholders to serve on an issuer's board of directors.[11]

The draft Dodd bill goes a step further than the Wall Street Reform Act by requiring, rather than simply authorizing, the SEC to issue rules permitting the use by shareholders of proxy solicitation materials supplied by an issuer for the purpose of nominating individuals to the issuer's board of directors.[12]

Beneficial Ownership and Short-Swing Profit Reporting

The Wall Street Reform Act expands the definition of beneficial ownership under Section 13(d) and Section 16 of the Exchange Act to include any person who "becomes or is deemed to become a beneficial owner of any [covered equity security] upon the purchase or sale of a security-based swap or other derivative instrument as the Commission may define by rule."[13] The draft Dodd bill contains an identical provision.[14]

The Wall Street Reform Act also gives the SEC the authority to shorten the time period for filing reports required by Section 13(d) and Section 16 of the Securities Exchange Act.[15] The draft Dodd bill does not contain a comparable provision.

Sarbanes-Oxley Section 404(b) Exemption for Non-Accelerated Filers

The Wall Street Reform Act provides that the Sarbanes-Oxley Act shall be amended to provide an exemption from Section 404(b) of the Act (requiring independent auditor attestation of internal control over financial reporting) for companies that are non-accelerated filers pursuant to Rule 12b-2.[16] The draft Dodd bill does not contain a comparable exemption.

Legislative Outlook

To move forward with the legislative reforms in the Wall Street Reform Act requires passage of a comparable bill by the Senate. The Senate is not expected to act on its version of a financial and governance reform bill until the early part of next year. The Dodd bill, which incorporates elements of the Shareholders Bill of Rights Act that was introduced by Senators Charles Schumer (D–NY) and Maria Cantwell (D–WA) in May of this year,[17] is the likely focus of the Senate's activity.

Similarities of the Dodd bill to the Wall Street Reform Act already passed in the House have been described above. In addition, the Dodd bill contains a number of provisions not addressed by the Wall Street Reform Act. The Dodd bill would instruct the SEC to adopt rules requiring:

- *Executive Compensation Disclosures.* Issuers would be required to disclose in their annual proxy statements a clear description of compensation for named executive officers, including (i) information that shows the relationship between executive compensation and financial performance of the issuer and (ii) a graphic or pictorial comparison of executive compensation and the financial performance or return to investors of the issuer during a five-year period or such other period determined by the SEC.[18]
- *Clawbacks of Unearned Performance-Based Pay.* In the event an issuer is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement, the issuer would be required to recover from any current or former executive officer any excess incentive-based compensation received by such officer in the three-year period preceding the restatement as a result of the erroneous data.[19] This provision is broader than the existing incentive compensation clawback provided by Section 304 of the Sarbanes-Oxley Act,[20] which (i) applies only to an issuer's chief executive officer and chief financial officer, (ii) extends to compensation received during the 12-month period prior to an accounting restatement and (iii) requires that the restatement result from misconduct (though not necessarily by the chief executive officer or chief financial officer).[21]

- *Disclosure Regarding Employee Hedging.* Issuers would be required to disclose in their annual proxy statement whether their employees are permitted to purchase financial instruments designed to hedge or offset any decrease in the market value of equity securities granted to employees by the issuer as part of employee compensation.[22]
- *Majority Voting in Uncontested Director Elections.* To maintain listing on a national securities exchange, an issuer would be required to provide that a director who fails to receive a majority of votes cast in an uncontested election must tender his or her resignation. The board would not be required to accept the resignation, but if the board elected not to accept the resignation, it would be required to make public the reasons that it chose not to do so and why the decision is in the best interests of the issuer and its shareholders.[23]
- *Disclosure Regarding Chairman and CEO Structure.* Issuers would be required to disclose in their annual proxy statements the reasons why the issuer has chosen to combine or separate, as applicable, the positions of chairman of the board and chief executive officer.[24]
- *Shareholder Approval Required for Staggered Boards.* To maintain listing on a national securities exchange, issuers would be required to obtain express shareholder approval in order to maintain a staggered board of directors. Issuers already having a staggered board not previously approved by shareholders would be required to seek shareholder ratification within a specified time period after enactment of the requirement.[25]

Given the public and media focus on the provisions of the Wall Street Reform Act related to regulation of financial institutions and new consumer protection initiatives, we have not yet seen robust debate of the corporate governance changes proposed in these measures. Nevertheless, management and directors of public companies should pay close attention to this legislation as it evolves, because it is likely to result in significant changes to the corporate governance landscape.

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If you have any questions on these matters, please do not hesitate to speak to your regular contact at Weil, Gotshal & Manges LLP or to any member of the Firm's Public Company Advisory Group:

Howard B. Dicker	howard.dicker@weil.com	212-310-8858
Catherine T. Dixon	cathy.dixon@weil.com	202-682-7147
Holly J. Gregory	holly.gregory@weil.com	212-310-8038
P.J. Himelfarb	pj.himelfarb@weil.com	202-682-7197
Robert L. Messineo	robert.messineo@weil.com	212-310-8835
Ellen J. Odoner	ellen.odoner@weil.com	212-310-8438

ENDNOTES

[1] H.R. 4173, 111th Cong. (1st Sess. 2009).

[2] The legislative history of H.R. 4173 and links to the full text of the bill and its amendments are available at http://thomas.loc.gov/cgi-bin/bdquery/z?d111:h.r.04173:.

[3] In addition to the relatively small number of corporate governance provisions that are the focus of this article, the 1300-page bill would also create a new Consumer Financial Protection Agency with a mandate to protect consumers from harmful lending practices, and would institute significant new regulations with respect to financial institutions, credit rating agencies, hedge fund advisers, mortgage lenders, and dealers of swaps and other derivative securities.

[4] For a detailed discussion of corporate governance legislation proposed in the first half of 2009, see our Weil Briefing "Congressional Watch: Corporate Governance Initiatives Emphasize Concerns Regarding Executive Compensation" (June 19, 2009) available at http://www.weil.com/news/pubdetail.aspx?pub=9503.

[5] Discussion Draft of the "Restoring American Financial Stability Act of 2009," introduced by Senator Chris Dodd on November 10, 2009 (hereinafter, "Dodd Discussion Draft"). The full text of the document is available at http://banking.senate.gov/public/_files/AYO09D44_xml.pdf.

[6] H.R. 4173, 111th Cong. (1st Sess. 2009), § 2002.

[7] The text of the bill states that these shareholder advisory votes on executive compensation shall not be binding on the board of directors and shall not be construed "as overruling a decision by such board, nor to create or imply any additional fiduciary duty by such board, nor shall such vote be construed to restrict or limit the ability of shareholders to make proposals for inclusion in such proxy materials related to executive compensation." H.R. 4173, 111th Cong. (1st Sess. 2009), § 2002.

[8] Dodd Discussion Draft, §§ 951-952.

[9] H.R. 4173, 111th Cong. (1st Sess. 2009), § 2003.

[10] Dodd Discussion Draft, § 953.

[11] H.R. 4173, 111th Cong. (1st Sess. 2009), § 7222.

[12] Dodd Discussion Draft, § 972. On May 20, 2009 the SEC voted in favor of adopting a new proxy rule that would provide shareholders meeting certain eligibility standards with access to corporate proxy materials to nominate their own directors where otherwise not prohibited by applicable state law and/or the company's governing documents. For a detailed discussion of the SEC's proposed rules see our Weil Briefing "SEC Proposes New Rule Mandating Proxy Access" (May 21, 2009) available at http://www.weil.com/news/pubdetail.aspx?pub=9483. The SEC released its proposed proxy access rules on June 10, 2009 (available at http://www.sec.gov/rules/proposed/2009/33-9046.pdf). The proposed rules were published in the Federal Register on June 18, 2009 (74 Fed. Reg. 116).

[13] H.R. 4173, 111th Cong. (1st Sess. 2009), § 3206.

[14] Dodd Discussion Draft, § 755.

[15] H.R. 4173, 111th Cong. (1st Sess. 2009), § 7105.

[16] H.R. 4173, 111th Cong. (1st Sess. 2009), § 7606.

[17] S. 1074, 111th Cong. (1st Sess. 2009).

[18] Dodd Discussion Draft, § 954. The SEC recently proposed proxy disclosure and solicitation rules that would expand the Compensation Discussion & Analysis ("CD&A") to include a new section providing

information about how a company's overall compensation policies create incentives that can affect the company's risk and management of that risk. Securities and Exchange Commission Release No. 33-9052 (July 10, 2009), available at http://www.sec.gov/rules/proposed/2009/33-9052.pdf. The proposed rules are scheduled to be voted upon later this week. It remains to be seen whether, and how, the Senate will revise its legislation based on the final CD&A rules adopted by the SEC.

[19] Dodd Discussion Draft, § 955.

[20] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 15 U.S.C. § 7243 (2002).

[21] The Commission recently sought disgorgement under Sarbanes-Oxley Section 304 of incentive-based compensation paid to the former Chairman and CEO of CSK Auto Corporation based on accounting restatements that resulted from misconduct by *other* executives at CSK. *See Securities and Exchange Commission v. Maynard L. Jenkins*, Case No. 2:09-cv-01510-JWS (D. Ariz., entered July 22, 2009). This was the first time that the Commission sought disgorgement under Section 304 from a CEO or CFO who was not alleged to have been involved in the misconduct.

[22] Dodd Discussion Draft, § 956.

[23] Dodd Discussion Draft, § 971.

[24] Dodd Discussion Draft, § 973. The proxy disclosure and solicitation rules proposed by the SEC earlier this year and scheduled to be voted upon this week would also require a company to explain why it has chosen to either separate or combine its principal executive officer and board chair positions. See Securities and Exchange Commission Release No. 33-9052, *supra* note 18.

[25] Dodd Discussion Draft, § 974.