Senate Bill Passed: Corporate Governance and Executive Compensation Changes Would Affect All US Public Companies

Last night the Senate passed the Restoring American Financial Stability Act of 2010 . As discussed in a prior memorandum, the Senate Bill would federalize significant governance and executive compensation matters that have historically been a matter of state law. The bill would affect all US public companies and would especially be felt by midcap and smaller companies that have until now generally not been the target of governance activists.

We expect that next month Congress will begin reconciling the Senate Bill with the Wall Street Reform and Consumer Protection Act of 2009, which passed the House on December 11, 2009. We expect that the law that emerges will closely follow the Senate Bill.

This brief memorandum highlights the key corporate governance and disclosure provisions of the Senate Bill. We will shortly publish a detailed memorandum that will address the heart of the Senate Bill: the overhaul of financial institution regulation.

The Senate Bill resembles the March version from the Senate Banking Committee. An amendment by Senator Carper (D-Del) that would have eliminated the majority voting and proxy access sections was never voted on. The Senate Bill authorizes the SEC to promulgate rules that would, within one year after the date of enactment (six months in the case of say on pay), prohibit the listing of any US public companies that fail to adopt the standards. The SEC would continue to have the authority to exempt companies from any of the requirements based on size, market capitalization, number of shareholders or other criteria that the SEC deems appropriate, along with the ability to provide for transition and cure periods.

Major Changes

Majority voting. Listing exchanges would be required to impose a majority vote standard in uncontested director elections for all listed companies, reverting to the plurality standard in contested elections. Any director who receives less than a majority of the votes cast must offer to resign. The board could determine not to accept the resignation, but if so it must publicly disclose its decision and the analysis behind it within 30 days. The procedures would presumably be embodied in a company's charter or bylaws, and would result in proxy cards offering an up-or-down For or Against choice for each director. Existing "plurality-plus" majority voting policies, under which directors are elected by plurality voting but must offer to resign if a majority of shareholders withhold their votes, would not satisfy the requirements of the Senate Bill.

The House Bill, by contrast, does not require majority voting.

During the 2009 proxy season only 91 directors at 49 US companies failed to receive majority support at uncontested annual meetings. Almost none of these companies had majority voting policies. All but one of those directors remained on their boards.

This season has been fairly quiet in terms of active withhold campaigns, other than the notable campaign at Massey Energy where dissent for certain directors ranged from 48% to 49.5%. If the Senate Bill becomes law, the incidence of these campaigns, and the pressure on boards to accept resignations, are likely to increase.

Proxy access. The Senate Bill would authorize but not require the SEC to prescribe rules permitting shareholders to include their own director nominations in issuer proxy solicitation materials. The House Bill requires the SEC to adopt proxy access. The SEC has been biding its time since proposing proxy access almost a year ago, but it can be expected to move promptly once its statutory authority is clarified.

Annual "say on pay" vote. Within six months after enactment, any proxy statement that requires compensation disclosure must include an annual nonbinding vote to approve executive compensation as disclosed under Item 402 of Regulation S-K. The House Bill contains a similar requirement.

Say on pay is still a relatively new concept and, while mandated for TARP companies, only about 70 companies have "voluntarily" (some under extreme pressure) adopted it. The big news this season has been the failures at Motorola and Occidental Petroleum to receive shareholder approval of their executive compensation programs. Reported concerns in those cases included compensation levels, criticism of poor disclosure of award decisions and modification of tax gross-up provisions.

Say on pay votes are advisory rather than binding, but they are far from meaningless. Shareholders who disapprove compensation programs are expecting change, and may be expected to react badly if change is not forthcoming. The combination of say on pay and majority voting means that boards that fail to respond to shareholder disapproval of compensation programs may well find their own tenure under pressure the following year.

Clawback (recovery of "erroneously awarded compensation"). The Senate Bill directs listing exchanges to adopt standards requiring listed companies to have policies enabling the recovery of incentive-based compensation (including stock options awarded as compensation) from current or former executive officers following a restatement. The trigger would be based on material noncompliance with any financial reporting requirements that led to the restatement, during the three-year period preceding the date on which a company is required to prepare the restatement. The amount to be clawed back is the amount in excess of what would have been paid under the restated results.

Compensation committee independence and factors governing adviser independence. Listing exchanges would also be directed to impose additional independence requirements on the compensation committee, taking into account consulting, advisory and other compensatory fees and affiliate status. The House Bill contains a similar requirement.

With respect to compensation consultants, legal counsel and other committee advisers:

- The SEC will identify factors affecting the independence of advisers that the compensation committee must consider when selecting its advisers, including factors such as the provision of other services to the company and fees received from the company.
- Compensation committees would be directly responsible for the appointment, compensation and oversight of the work of compensation consultants, legal counsel or other advisers engaged by the committee.
- Companies would be required to disclose whether the compensation committee retained a consultant and whether the work raised any conflict of interest and how it was addressed.

Broker discretionary voting. In a provision added at the last moment to the manager's amendment of the Senate Bill, the listing exchanges must prohibit broker discretionary voting in connection with the election of directors, executive compensation or any other significant matter, as determined by the SEC. Currently brokers may not vote without specific client instructions on election of directors, the adoption of equity plans or shareholder proposals. This new requirement would likely eliminate brokers from being able to vote on other types of management proposals, such as management say on pay proposals.

Risk Committee. All publicly traded nonbank financial companies that are supervised by the Board of Governors of the Federal Reserve System must have a risk committee, and all publicly traded bank holding companies with assets over $10 billion would be required to have a risk committee. In addition, the Board of Governors may require publicly traded bank holding companies with assets of less than $10 billion to have a risk committee. The Board of Governors will determine the number of independent directors required on the committee, and the committee must include one risk management expert having experience in risk management at large complex firms.

Nonbank financial companies supervised by the Board of Governors are those companies that have been designated by the Financial Stability Oversight Council as systemically important and that are substantially engaged in activities in the US that are financial in nature (other than bank holding companies or their subsidiaries).

Disclosure Requirements

The Senate Bill contains the following disclosure requirements, most of which are not in the House Bill:

Link between compensation and performance**.** The SEC must amend Item 402 of Regulation S-K to require companies to disclose the relationship between executive compensation and financial performance.

Internal pay disparity. Another requirement added in the manager's amendment mandates that the SEC issue rules requiring disclosure of: (1) the median annual total compensation of all employees, except the CEO; (2) the annual total compensation of the CEO; and (3) the ratio of the median employee annual total compensation to that of the CEO.

Employee and director hedging. The SEC must require companies to disclose whether directors and employees are allowed to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds) designed to hedge the value of equity securities.

CEO and chairman positions. Within 180 days after enactment, the SEC must issue rules requiring companies to disclose in the proxy statement why they have separated, or combined, the positions of chairman and CEO. In light of recent changes to the proxy rules requiring companies to disclose their leadership structures and why they believe that their structure is best for their company, most companies will already be making these disclosures.

For financial institutions only**.** The Board of Governors must establish standards making it an unsafe and unsound practice for the holding companies of depository institutions to provide an employee, director or principal shareholder with compensation that is excessive or could lead to material financial loss to the bank holding company and directing the appropriate bank regulator to prohibit such unsafe and unsound practices.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact

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