Davis Polk
CLIENT MEMORANDUM

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Corporate Governance and Executive Compensation in the New Dodd Bill: Implications for All US Public Companies

The past 18 months have been witness to tremendous legislative and regulatory activity in the area of corporate governance and executive compensation. The 1,336-page Restoring American Financial Stability Act of 2010 ("**2010 Dodd Bill**"), introduced yesterday by Senate Banking Committee Chairman Christopher Dodd, contains meaningful governance and executive compensation mandates that extend beyond financial institutions. The provisions are similar to those in Senator Dodd's prior attempt in November 2009 to overhaul financial regulation ("**2009 Dodd Bill**"),[1] but with some notable changes. In some cases, these changes bring the 2010 Dodd Bill closer to the provisions of the Wall Street Reform and Consumer Protection Act of 2009 passed in the House on December 11, 2009.[2] These governance and compensation sections are a small part of the overall 2010 Dodd Bill, which is expected to undergo significant discussion and debate in Congress.

As with the 2009 Dodd Bill, rather than simply preempting state corporate law, which might have been the more straightforward approach, other than say on pay, the governance and compensation elements of the 2010 Dodd Bill work through the SEC's power to approve the listing standards of national stock exchanges. The 2010 Dodd Bill would authorize the SEC to promulgate rules that would, within one year after the date of enactment, prohibit the listing of any US public companies that fail to adopt the bill's standards. The SEC would 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. The 2010 Dodd Bill would also empower the SEC to provide for transition and cure periods.

Corporate Governance

Significant Changes from the 2009 Dodd Bill

No shareholder vote on staggered boards. The provision that would have prohibited classified boards absent shareholder approval or ratification for public companies under the 2009 Dodd Bill has been eliminated in the 2010 Dodd Bill.

Majority voting. Listing exchanges are 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 tender his or her resignation. The board could determine not to accept the resignation, but if so it must publicly explain, together with a discussion of the analysis used in reaching the conclusion, its decision within 30 days.

This requirement would not be satisfied by "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. According to the Corporate Library, while more than two-thirds of the S&P 500 companies have adopted

[1] See the Davis Polk memorandum *Dodd Bill Would Affect Corporate Governance and Executive Compensation Processes for All US Public Companies* (November 17, 2009) for further information on the 2009 Dodd Bill.

[2] See the Davis Polk memorandum *Summary of the Wall Street Reform and Consumer Protection Act Passed by the House of Representatives, December 11, 2009* (December 15, 2009) for further information on the House bill.

majority voting, 18% of those companies implemented plurality-plus standards. 75% of the companies in the Russell 3000 continue to elect directors by straight plurality voting.

Majority voting is assuming increased significance because withhold and against director campaigns and recommendations are on the rise. According to RiskMetrics Group, 91 directors at 49 US companies in the S&P 500 and Russell 3000 received less than majority support during the 2009 proxy season, nearly three times as much as in 2008. Within the S&P 500 only, 12 directors at six companies received majority dissent. All 49 companies had straight plurality voting, and only two of those companies also had director resignation policies through "plurality-plus" standards. All of the directors remained on their boards.

Proxy access "may" be required. In a shift from the 2009 Dodd Bill, the SEC now "may" prescribe rules permitting shareholders to use issuer proxy solicitation materials to nominate director candidates. The 2009 Dodd Bill required the SEC to issue such rules within 180 days after enactment. As a practical matter, this is not likely to amount to a meaningful change because the SEC continues to indicate its desire to move forward with adopting its proposed proxy access rules.

CEO and Chairman positions. Within 180 days after enactment, the SEC must issue rules requiring companies to disclose in the proxy statement why the same or different persons serve as chairman and CEO. This may already be satisfied by 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.

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).

Executive Compensation

Significant Changes from the 2009 Dodd Bill

No shareholder vote on golden parachute policy. The 2010 Dodd Bill has eliminated a provision that would have applied the "say on pay" concept to require a nonbinding vote to approve policies relating to payments to any principal executive officer as a result of M&A activity.

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. In the 2009 proxy season, over 70 companies received say on pay shareholder proposals, with 22 proposals receiving majority support and a substantial number receiving over 45% support. In 2010, shareholder proposals on say on pay remain active and, at the same time, voluntary adoption of say on pay is on the rise. Approximately 60 non-TARP companies, including Microsoft, Pfizer and Verizon, have either put, or announced plans to put, management say on pay proposals on their ballots.

Compensation committee independence and factors governing adviser independence. Listing exchanges are directed to impose additional independence requirements on the compensation committee, taking into account consulting, advisory and other compensatory fees and affiliate status.

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 taking into account 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.

The 2010 Dodd Bill no longer directs the SEC to undertake a study of the use of compensation consultants and their effects on a company's performance.

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, taking into account any change in the value of stock and dividends and any distributions. This may, but is not required to, include graphic representation.

Clawback (recovery of "erroneously awarded compensation"). The listing exchanges are directed to adopt standards that require the disclosure of policies on incentive-based compensation that is based on publicly reported financial information and the implementation of clawback 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.

Clawback policies are clearly a phenomenon on the rise. According to Equilar, from 2006 to 2009, Fortune 100 companies with publicly disclosed clawback policies increased from 17.6% to 72.9%. Among Fortune 100 companies that disclosed the implementation date, 94.9% adopted their policy in 2006 or later. Adding to the momentum is the current focus on the role of compensation arrangements in fostering risk, the notion being that clawback policies may mitigate the effect of arrangements that could otherwise promote risky behavior.

Disclosure regarding director, in addition to employee, 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.

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.

Unlike the 2009 Dodd Bill, the 2010 Dodd Bill does not expressly authorize bank regulators to impose higher capital charges if an institution has compensation practices that "pose risk of harm."

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The passage of the 2010 Dodd Bill in its current form is uncertain, but its corporate governance and executive compensation provisions indicate continued Congressional interest and focus on these key areas.

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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