November 17, 2009

Dodd Bill Would Affect Corporate Governance and Executive Compensation Processes for All US Public Companies

The project of federalizing major elements of our corporate governance and executive compensation processes continues apace. The 1,136-page Restoring American Financial Stability Act of 2009, introduced last week by Senate Banking Committee Chairman Christopher Dodd, has principally attracted attention for its proposed radical overhaul of the regulation of financial institutions. But the Dodd bill also contains corporate governance and executive compensation provisions that would be applicable to all US public companies. The governance elements function as a somewhat more modest Version 2.0 of the universal governance mandates that had earlier been proposed in Senator Charles Schumer's Shareholder Bill of Rights. The compensation elements are to a great extent lifted from legislation already passed by the House of Representatives this summer under the Corporate and Financial Institution Compensation Fairness Act of 2009.

Corporate Governance

Rather than simply preempting state corporate law, which might have been the more straightforward approach, these elements of the Dodd bill work through the SEC's power to approve the listing standards of national stock exchanges. The bill would authorize the SEC to promulgate rules that would, within one year after 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. The bill would also empower the SEC to provide for transition and cure periods.

Majority voting. The bill would impose a majority vote rule in uncontested elections, 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 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 the holders of a majority of shares withhold their votes. A recent Corporate Library study indicated that while more than two-thirds of the S&P 500 companies have adopted majority voting, 18% of those companies had implemented plurality-plus standards.

Large companies have shifted to majority voting in recent years as a result of increased pressure from shareholder proposals submitted by activists and supported by institutional investors. Mid- and small-cap companies that do not traditionally receive this type of attention have not been as quick to make the switch, as 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 this past 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.

Staggered boards. The Dodd bill would prohibit classified boards absent shareholder approval or ratification. The percentage of shareholders needed to approve or ratify a classified board would be the same necessary to amend a company's charter or bylaws: normally at least a majority of the outstanding shares or votes cast, and in some cases higher. This opt-out mechanism, which was not contained in the Schumer bill, adds a veneer of reasonableness but in practice would be unlikely to have much of an impact, given that shareholders routinely vote strongly in favor of annual election of directors.

Although most larger companies have declassified their boards in recent years, about half of the S&P 1500 still have staggered boards.

CEO and Chairman positions. Unlike the Schumer bill, which mandated separation of the CEO and chairman roles, the Dodd bill adopts a disclosure approach similar to that contained in the SEC's rules proposed this summer as described in this memo. Companies must explain why the same or different persons serve as chairman and CEO.

The 2009 Spencer Stuart Board Index reported that 37% of the S&P 500 companies have separate CEO and chair positions, and 81 of those 184 companies had independent chairs (translating into about 16% of the S&P 500). 46% of the large-cap companies have appointed lead directors.

The demand for independent board chairs is nonetheless likely to continue in the upcoming proxy season. Four shareholder proposals on this topic received majority support in 2009, including the binding proposal at Bank of America that cost Ken Lewis his chairmanship.

Proxy access. The Dodd bill would require the SEC to issue rules permitting shareholders to use company proxy solicitation materials to nominate director candidates. This statutory authority would moot or at least blunt any potential challenge to the proxy access rules that we expect the SEC will adopt sometime early in 2010.

Risk Committee. The Dodd bill narrows substantially the Schumer bill's requirement for board-level risk committees. Under the Dodd bill, such committees would be mandated only for institutions that are "systemically important" and for bank holding companies with assets over $10 billion. Regulators could extend the requirement to smaller bank holding companies. These risk committee must have independent directors, including one risk management expert having experience in risk management at large complex firms.

Executive Compensation

Annual "say on pay" vote. The Dodd bill would require an annual nonbinding vote to approve executive compensation. In the 2009 proxy season over 70 proposals to require say on pay were voted on. Average support was over 45%, with 22 companies receiving majority support. Given that legislation making say on pay mandatory no longer appears imminent, proponents have already declared that they intend to submit more say on pay shareholder proposals this season.

Say on pay has been in the news recently with a few high-profile adoptions by major companies, including a triennial version at Microsoft and biennial votes at Prudential Financial and Pfizer. While this may foreshadow a trend, fewer than 30 non-TARP companies have announced plans to put management say on pay proposals on their ballots.

Shareholder vote on golden parachute policy. The Dodd bill would extend 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.

Compensation committee independence. Each member of the compensation committee would be required to be independent, to be defined by the SEC, taking into account the source of director compensation and affiliations with the company.

With respect to compensation consultants and other advisers:

- Compensation committees would have the authority to engage compensation consultants, legal counsel or other advisers. All such advisers must be independent, to be defined by the SEC.
- Compensation committees would be directly responsible for the appointment, compensation and oversight of the work of the compensation consultant and any other advisers.
- 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 Dodd bill would also direct the SEC to undertake a three to five year study of the use of compensation consultants and their effects on a company's performance.

Additional executive compensation disclosures. Companies would be required to disclose the relationship between executive compensation and financial performance, and provide graphic or pictorial comparisons of the amount of executive compensation and financial performance or return to investors during a five-year period.

Clawback. The Dodd bill would mandate that companies implement clawback policies enabling the recovery of incentive-based compensation from current or former executives 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. Corporate Library's June 2008 data stated that 34% of the S&P 500 have announced such policies. Adding to the momentum is the current focus on the role of compensation schemes in fostering risk, the notion being that clawback policies may mitigate the effect of arrangements that could otherwise promote risky behavior.

Disclosure regarding employee hedging. The Dodd bill would require companies to disclose whether 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 grants.

For financial institutions only. The bill contains additional compensation provisions that only apply to financial institutions, including:

- 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.
- Giving the applicable bank regulator the authority to impose higher capital charges if an institution has compensation practices that "pose risk of harm".

The passage of the Dodd bill is highly uncertain, particularly in light of the sweeping impact of the balance of the bill. But the chances appear to be increasing that, in one form or another, Congress will act to strengthen the hand of the SEC and to convert a number of recent governance and compensation trends into permanent features of the landscape.

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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