ALERTS AND UPDATES

U.S. Financial Reform: Corporate Governance and Executive Compensation Provisions for Public Companies

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The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("the Act") begins sweeping reform for the U.S. financial system. It requires new and existing regulatory agencies to undertake more than 50 studies of the financial system and more than 250 instances of rulemaking. Duane Morris has issued further Alerts *on many of the broad topics addressed by the Act, accessible at* www.duanemorris.com/FinancialReform.

The corporate governance provisions discussed in this *Alert* require shareholder proxy access, expand compensation disclosure, institute say-on-pay votes, prohibit brokers from voting street-name shares on say-on-pay and other significant matters, mandate membership and operation of compensation committees, strengthen proxy disclosure, and amend securities transaction reporting under sections 13 and 16 of the Securities Exchange Act of 1934. The Act also vests broad rulemaking discretion in the SEC, which may make it difficult to foresee the full impact of the Act at this time.

Overview of Corporate Governance Provisions

Among many sweeping governance provisions, the Act contains several that may reshape the topography for U.S. public companies. Governance areas addressed in the Act in Title IX – designated the "Investor Protection and Securities Reform Act of 2010" – include:

- granting authority to the SEC to adopt regulations providing shareholder access to the company's proxy process to nominate directors;
- requiring non-binding mandatory shareholder votes on executive compensation and "golden parachute" payments, as to which matters brokers may not vote undirected shares;
- granting authority to and directing national securities exchanges to mandate compensation "clawback" if executive compensation is based on inaccurate financial statements;
- granting authority to and directing national securities exchanges to require independence of compensation committee members, and to grant committee authority to hire independent compensation consultants;
- directing the SEC to issue rules requiring proxy disclosure regarding (1) compensation, including requirements that companies provide charts comparing executive compensation to stock performance over a five-year period; (2) hedging by employees and directors of the company's equity securities; and (3) whether or not the company has divided the CEO and board chairman roles; and
- altering certain technical provisions of the reporting requirements under sections 13 and 16 of the Exchange Act.

Shareholder Proxy Access

Shareholder access to a public company's proxy process has long been a favored battleground, including in Delaware courts, between shareholder activists and management.

Historically, the SEC permitted exclusion from proxy solicitation materials of any shareholder nominations and proposals that related to bylaw amendments, offering a procedure for outside shareholders to initiate proxy contests. It is unlikely to come as a surprise that the historical exclusion of election proposals has led to litigation, the course of which is likely to be affected by the proxy access rights granted in section 971 under Title IX, Subtitle G of the Act.

Section 971 authorizes the SEC to issue rules permitting shareholder nominations to a public company's board, under such terms and conditions as the SEC determines are in the interests of shareholders and for the protection of investors. The SEC is given the discretionary authority under the Act to exempt a public company or a class of public companies from these shareholder proxy access rights, a discretion that may protect smaller issuers from the expense of repeated shareholder initiatives.

The SEC is likely to promptly exercise its new authority, having already unveiled shareholder proxy access proposals in 2009, and having undertaken two separate, heated public comment periods during which many observers in the business and legal community expressed disapproval of expanded shareholder rights. The SEC had proposed amendments to Rule 14a-11 that would have granted mandatory proxy access to shareholders who own at least a 1-percent to 5-percent ownership stake (depending on the size of the company) held for at least one year, and amendments to Rule 14a-8 that would have permitted shareholders to place on the corporate agenda bylaw amendments to permit proxy access for director nominations.

It remains to be seen how the SEC will proceed, given the commentary by business groups and counsel that were more receptive to the Rule 14a-8 amendments that contended that such an approach respected the individual profile of each company, rather than imposing a mandatory one-size-fits-all provision. If the SEC adopts only the Rule 14a-8 approach, it also would be acting more consistently with Delaware lawmakers, who in 2009 provided a statutory framework that allows each Delaware-incorporated public company to craft for itself bylaws for shareholder proxy access pursuant to its own individually delineated standards, including standards relating to minimum number of shares owned, length of ownership, submission of specific information regarding the stock ownership of the nominator and the nominee, and reimbursement of reasonable expenses incurred by shareholders who achieve a defined level of success in a proxy contest.

It is possible that the SEC rules eventually enacted based on section 971 could supersede Delaware law only in part by mandating certain aspects of proxy access that could not be made more company-friendly, while leaving other aspects up to state law and a company's governing documents. In the alternative, the SEC could establish an exclusive federal proxy access regime and oust, virtually in their entirety, state corporate laws and customized proxy access by companies and their shareholders.

Executive Compensation

Shareholder "Say on Pay"

In recent years, poor financial performance exacerbated by highly publicized corporate scandals have resulted in increasing shareholder activism seeking greater corporate accountability, notably regarding "say on pay" – a non-binding shareholder vote on executive compensation. Say-on-pay votes have grown increasingly popular in the last few years. Banks receiving funds under the federal government's TARP program are required to offer say-on-pay votes, and many major companies (notably Aflac, Blockbuster, Colgate-Palmolive, Ingersoll Rand, Microsoft, Motorola and Verizon) have adopted say-on-pay votes.

Section 951 of the Act gives shareholders the right to a non-binding vote on executive compensation not less frequently than once every three years. In addition, not less frequently than once every six years, shareholders would have the right to decide whether the shareholder vote on executive compensation would occur every one, two or three years. Additionally, public companies also will be required to provide detailed disclosures, and a non-binding shareholder vote, regarding "golden parachute" payments in connection with an acquisition, merger or sale transaction.

This section clarifies that these non-binding shareholder votes do not change the fiduciary responsibilities of the company's directors or restrict the ability of shareholders to submit other proposals regarding executive compensation for inclusion in proxy materials. Therefore, whether or not a shareholder say-on-pay proposal passes, the board can continue to determine executive compensation.

Finally, pursuant to SEC rulemaking, institutional investment managers must report at least annually on how they voted on say-on-pay and "golden parachute" resolutions.

These say-on-pay provisions apply to the first annual or other meeting of shareholders occurring after six months from enactment. The SEC has the discretionary authority to exempt a public company or a class of public companies from the shareholder say-on-pay rights.

Decreased Broker Discretion

Under current NYSE Rule 452, brokers may vote uninstructed street-name shares on all "routine" matters, although such votes are not permitted in several areas, including in uncontested director elections or with respect to merger votes, significant changes in the rights of classes of securities, and share-based compensation plans. Section 957 compels the SEC to require national securities exchanges to prohibit voting customer shares without instruction on the following additional matters: all director elections (except uncontested elections at registered investment companies), any executive compensation (including say on pay, but also even cash plans) and any other "significant matter."

The SEC must define "significant matter" by rule, with awareness not to make the category so broad as to leave no routine matters such as auditor ratification on the agenda. (In the event of a complete absence of routine matters, broker uninstructed shares would not even count toward a quorum.)

Registrants with significant retail investors should consider the need for increased shareholder outreach and abandonment of "notice-only" e-proxy solicitation in order to achieve sufficient votes at upcoming shareholder meetings.

Compensation "Clawback"

Section 954 of the Act, titled "Recovery of Erroneously Awarded Compensation," directs the SEC to issue rules for national securities exchanges to adopt listing standards, requiring that listed companies "claw back" or rescind incentive compensation for "executive officers" if such compensation proves to be based on inaccurate financial statements. This requirement would apply to executive officers who received incentive-based compensation, including stock option awards, during the three-year period preceding the date of the restated financial statements, so that any current or former executive officer affected would have to return to the company any excess compensation received as a result of the inaccuracy. Such restatement must be the result of a material noncompliance with any financial reporting requirement, a trigger that would be met almost automatically if in fact a restatement has been effected. This expands section 304 of the Sarbanes-Oxley Act of

2002 (SOX), which requires rescission of bonuses and incentive-based compensation only for the CEO and CFO received during the 12-month period following the date of first public filing of an inaccurate financial statement, and recapture of any profits received from the sale of company securities during such period. A significant aspect of section 954 (as well as with SOX 304) is that Congress purposefully does not require in section 954 a showing of any wrongdoing on the part of the executive.

Independent Compensation Committees

Section 952 of the Act directs the SEC to issue rules for national securities exchanges to adopt listing standards requiring that compensation committees include only independent directors (already required by NYSE and NASDAQ) and have the authority to hire independent compensation consultants. Section 952 sets forth the guidelines for independence, and also requires companies to disclose whether or not the compensation committee retained the services of a compensation consultant, whether the advice of such consultant raised any issue of conflict of interest and how any such conflict was resolved. The SEC has the discretionary authority to exempt a public company or a class of public companies from these compensation committee standards. "Controlled companies" (more than 50-percent controlled by an individual, a group or another issuer) also will be exempt from the requirements of section 952.

Enhanced Proxy Disclosure

Section 953 of the Act directs the SEC to clarify proxy disclosures regarding compensation, including requiring companies to provide charts that compare executive compensation with stock performance over a five-year period. Section 955 directs the SEC to clarify proxy disclosures regarding hedging arrangements of equity securities of the company entered into by employees and directors, while section 972 requires proxy disclosure of the reasons that a company either has or has not designated the same individual as both CEO and board chair. The SEC instituted such a section 972 requirement in December 2009, for proxies solicited after February 28, 2010, as part of its new disclosures aimed at eliciting reasons that the company believes that its board-leadership structure is most appropriate at the time of filing.

Excluded Provision

The final version of the Act omits a previously included provision requiring uncontested director candidates to receive a majority of the votes cast, a standard that many companies already have adopted. The SEC, in any event, could adopt such a rule, after reviewing investor concerns, through its recently created Investor Advisory Committee.

Reporting Certain Transactions

Section 929 of the Act amends technical aspects of reports required under sections 13 and 16 of the Exchange Act.

Section 13 of the Exchange Act mandates a filing whenever a person or group achieves more than five-percent ownership of a registered securities class. The Act authorizes the SEC to adopt a rule shortening the reporting time period to less than the present statutory 10 days, and deletes filing requirements with the issuer and the exchange, relying solely on a filing with the SEC.

Section 16 of the Exchange Act mandates that officers, directors and holders of more than 10 percent of any registered class of security file statements of securities ownership. The Act authorizes the SEC to adopt a rule shortening the initial filing date to less than the present statutory 10 days, and eliminates notice to any exchange, relying only upon notice to the SEC.

About Duane Morris

Duane Morris has an online **Financial Services Reform Center** – www.duanemorris.com/FinancialReform – which includes videos and the firm's comprehensive series of *Alerts* analyzing the provisions of the Act and emerging policies, as well as links to relevant government websites. Duane Morris' attorneys will be monitoring the rules and regulations released under the Act, as well as the regulatory agencies' interpretive guidance. For subsequent *Alerts* on these and other topics, please revisit www.duanemorris.com and www.duanemorris.com/FinancialReform.

For Further Information

If you have any questions about the Act or any of the topics described in this *Alert*, including how they may affect your company or its executives, please contact Stephen M. Honig, Mehrin Masud-Elias, any member of the Corporate Practice Group or the attorney in the firm with whom you are most regularly in contact.

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