Public Company Impact of Financial Reform Measures

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On May 20, 2010, the United States Senate passed the Restoring American Financial Stability Act of 2010, sponsored by Senator Christopher Dodd (the "Dodd Bill"), one of the most comprehensive and broad-sweeping pieces of financial reform legislation since the Great Depression. While much of the Dodd Bill focuses on the financial sector, there are significant measures which impact publicly-traded companies. The new requirements primarily affect the areas of corporate governance and executive compensation, with companies facing additional proxy disclosure obligations and restrictions on shareholder voting.

Proxy Disclosure

The Dodd Bill is another example of the ongoing trend toward requiring increased disclosure by publicly-traded companies in their annual proxy statements.

- *Executive Compensation Disclosure*. The Dodd Bill focuses on executive compensation levels in the context of the company as a whole, instead of the specifics of each executive's compensation package. Under the Dodd Bill, the Securities and Exchange Commission (the "SEC") would create rules requiring a "clear description" of compensation paid to executive officers and its relationship relative to the financial performance of the company, taking into account dividends and changes in the price of shares. The Dodd Bill suggests that this be accomplished using "graphical" means, suggesting a chart comparing the levels of executive compensation with the company's stock price. In addition, the SEC would adopt rules requiring companies to disclose the median of the annual total compensation paid to all employees (other than the chief executive officer), along with the ratio of the chief executive officer's annual total compensation to that median figure. The SEC would also adopt rules requiring companies to disclose whether employees or directors are allowed to hedge against decreases in the market value of equity they hold in the company.

- *Board Leadership Structure*. The SEC would adopt rules requiring companies to disclose whether they have separate chief executive officer and chairperson positions along with their reasons for having that particular leadership structure. The SEC already requires public companies to disclose their board leadership structure along with justifications for their selected structure as part of enhanced disclosure requirements adopted in December 2009. There has been no indication of how the requirement in the Dodd Bill might differ from or supplement the current disclosure requirements.

Shareholder Voting

The Dodd Bill's greatest influence on public companies may come in the form of additional requirements for shareholder voting at annual meetings.

- *Greater Shareholder Influence*. The Dodd Bill would require companies that provide compensation disclosure in their proxy statements to give shareholders a non-binding vote on executive compensation, or "say on pay."[1] The SEC would also be required to direct the national stock exchanges to prohibit the listing of any company that does not employ "majority voting" in uncontested director elections. This "majority voting" standard would necessitate that any director who failed to receive a majority of the shareholder vote in an uncontested election tender the director's resignation. The company's board of directors could refuse to accept the resignation by

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a unanimous vote, making a public statement of the specific reasons they chose not to accept the resignation and explaining why their refusal was in the best interests of the shareholders and the company. The "say on pay" and "majority voting" measures would be strengthened by new SEC rules that would prevent broker discretionary voting in elections for directors, executive compensation proposals or any other matters that the SEC would deem significant.[2]

- *Proxy Access*. The issue of "proxy access" for shareholders is also addressed in the Dodd Bill, but will ultimately be left to the discretion of the SEC. The Dodd Bill provides the SEC with the authority to issue rules which would allow certain shareholders to include their director nominees as candidates in the company's proxy statement; however, the SEC would not be required to adopt such rules. Even though this provision only creates authority instead of mandating new rules, it represents a significant measure, as the rights of shareholders to nominate directors has traditionally been left to state law.

Executive Compensation

The Dodd Bill also includes requirements regarding the maintenance of independent compensation committees, and the "clawback" of erroneously paid incentive compensation.

- *Compensation Committees and Consultants*. Under the Dodd Bill, national stock exchanges would be required by the SEC to ban from listing any companies that did not maintain compensation committees composed entirely of independent directors.[3] Compensation committees would have sole discretion in selecting, compensating and overseeing compensation consultants, independent legal counsel and other advisors. The company would have to disclose the retention of any such compensation consultant, legal counsel or other advisor in its annual proxy statement, and the work undertaken by such consultant, counsel or advisor.[4]

- *Clawback Provisions*. Listed companies would also be required to have "clawback" procedures that would allow a company to recover incentive-based compensation paid to executives based on financial information that was in material non-compliance with any financial reporting requirements under the securities laws, as long as the non-compliance was discovered within a three-year look-back window. The company would also be required to disclose the details of their "clawback" program.

Although the Dodd Bill has been passed by the Senate, the details regarding the actual implementation of the bill's provisions and its true scope will not be known until the reconciliation of the Dodd Bill with the Wall Street Reform and Consumer Protection Act of 2009 (the "House Bill") and subsequent rulemaking by the SEC and stock exchanges. Once the Dodd Bill and the House Bill are reconciled and the resulting legislation is signed into law, the rulemaking process will require additional time to complete, with certain provisions containing specified deadlines for rules to be enacted. Despite significant protest and debate, new financial reform will soon become law in a form likely to contain provisions substantially similar to those in the Dodd Bill. The impact on the executive compensation and corporate governance practices of publicly-traded companies will be significant.

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[1] The Dodd Bill would not require the companies to take any action in response to the vote. Financial institutions that received money under the Troubled Asset Relief Program ("TARP") have already addressed similar agenda items in their annual meetings as a condition of the receipt of TARP funds.

[2] The national stock exchanges currently have rules that restrict broker discretionary voting on certain matters, including uncontested director elections. Under the new rules, the exchanges would still be able to allow brokers to vote on matters such as the ratification of auditors.

[3] The SEC or the exchanges may heighten existing requirements to be considered an independent director, focusing primarily on directors who receive consulting or advisory fees or other amounts from the company outside of their role as director.

[4] These measures closely track requirements for audit committees under the SEC and stock exchange listing rules.

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