

ClientAlert

Capital Markets | Executive Compensation, Benefits, Employment and Labor

November 2009

Proposed Restoring American Financial Stability Act of 2009

On November 10, 2009, Senator Christopher Dodd published a 1,136 page discussion draft of the Restoring American Financial Stability Act of 2009 (the **"Dodd Bill"**). The Dodd Bill is directed primarily at regulating financial institutions and their products, however it contains a number of corporate governance and executive compensation provisions that would apply to all public companies. Even though some of these provisions contain marginal improvements over the Shareholder Bill of Rights Act (the **"Schumer Bill"**) proposed by Senator Charles Schumer earlier this year,¹ the Dodd Bill still represents a radical federal encroachment into areas that are better left to state regulation. It is hoped that the general governance and executive compensation provisions that have found their way into the Dodd Bill will be subject to further scrutiny and revision despite the overwhelming pressure to enact legislation to reform the financial system.

Proposed Corporate Governance Provisions

Mandatory Proxy Access

The Dodd Bill would authorize the Securities and Exchange Commission (the **"SEC"**) to adopt rules requiring companies that are subject to the SEC's proxy rules to include shareholder nominees for the board in the company's proxy statement and to follow related procedures designated by the SEC. The Dodd Bill requires the SEC to promulgate rules to permit proxy access within 180 days after its enactment.

Commentary

Similar to the Schumer Bill, this provision's primary purpose is to insulate the SEC's proxy access rules² from constitutional attacks based on the fact that director nomination procedures fall into a category of activities that are quintessentially state-law governed. Nevertheless, the Dodd Bill goes beyond this by actually requiring the SEC to promulgate rules implementing mandatory proxy access rather than merely permitting private ordering. It is unfortunate that a one-size-fits-all approach, based on the assumption that all shareholders of all companies desire proxy access, appears to have prevailed. Nevertheless, the Dodd Bill improves marginally on the Schumer Bill by leaving open the ownership threshold for proxy access rather than specifying a one percent threshold.



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¹ For a detailed discussion, please see "Proposed US Shareholder Rights Bill of Rights Act of 2009," May 2009 at http://www.whitecase.com/alert_05262009_1/.

² For a detailed discussion, please see "SEC Proposes Rules on Shareholder Proxy Access: Analysis and Commentary," June 2009 at http://www.whitecase.com/alert_06302009_1/.

Majority Voting

Securities exchanges would be prohibited from listing the securities of any company that does not adopt a majority voting standard in uncontested elections. Plurality voting would be permitted in contested elections where the number of nominees exceeds the number of directors being elected. A director not receiving a majority of votes cast in an uncontested election would be required to tender his or her resignation to the board, which resignation would take effect within a reasonable period to be determined by the SEC and could only be rejected by a unanimous vote of the board (although, presumably, not including that director). In that case, the company would be required to disclose the board's reasons for rejecting the director's resignation and why it was in the best interests of the company and its shareholders.

Commentary

A federal majority voting requirement seems unnecessary since over 60 percent of Fortune 500 companies have already adopted a majority voting standard based purely on market forces. If federal standards are adopted for director elections, this could be precedent for federal standards in other areas where there are perceived to be board-favorable provisions. For example, it could be argued that the federal government should prohibit the adoption of state antitakeover provisions, such as Section 203 of the Delaware General Corporation Law, without a shareholder vote. We view this as a slippery slope.

Prohibition on Staggered Boards

Securities exchanges would be prohibited from listing a company with a staggered board unless shareholders have approved the staggered board. The vote required for approval would be the same as that required for an amendment to the company's certificate of incorporation (if the provision regarding the staggered board is located there) or bylaws (if located there). The requirement would apply to currently-listed companies as well as those conducting IPOs (although for companies conducting an IPO, there is nothing explicit in the Dodd Bill preventing shareholders approving the staggered board in advance).

Commentary

Federal legislation seems unnecessary to address classified boards when investors are fully aware of their existence before making an investment. In addition, companies have other means of entrenching their boards of directors without resorting to a staggered board. For example, approximately six percent of listed companies have dual-class stock, including some of the most well known companies in the United States (e.g., Google, Ford, Comcast, The New York Times, etc.). Furthermore, as a practical matter, controlled companies do not give public shareholders a means of obtaining board representation in director elections, yet the Dodd Bill does not propose cumulative voting.

Nevertheless, the Dodd Bill is an improvement over the outright prohibition on staggered boards contained in the Schumer Bill. However, we believe it will still be unworkable for many companies. First, many certificates of incorporation or bylaws require different majorities to amend different provisions. It is not clear which one would apply, although one assumes that the drafters intend to apply the majority necessary to amend the staggered board provision. Second, some bylaws cannot be amended by a shareholder vote so it is unclear what majority would apply. Third, staggered board provisions for many companies are contained in their certificate of incorporation, which in most cases can only be amended by a supermajority vote. A company that fails to achieve the required supermajority vote to ratify the staggered board would be unlikely to achieve the supermajority vote necessary to amend the staggered board. Those companies will face delisting. Finally, even if the proposal could be made to work mechanically, staggered boards have declined markedly in recent years due to shareholder activism. It was reported in September 2009 that among the S&P 500 companies, 162 had a staggered board compared with 302 in 2002. It is unclear why federal intervention is necessary in this instance.

Separation of the Offices of Chairman and CEO

Companies will be required to disclose in their annual proxy statements the reasons why they chose to separate or not to separate the Chairman and CEO roles.

Commentary

This is an improvement over the Schumer Bill which would mandate separation of the Chairman and CEO roles.

Proposed Executive Compensation Provisions³

Mandatory Say-on-Pay Votes for Annual Compensation and Golden Parachutes

The Dodd Bill requires an annual, non-binding shareholder vote on executive compensation for any company that is subject to the SEC's proxy rules. Such companies would also be required to disclose their policies on compensation payable to any "principal executive officer" (not defined in the Dodd Bill) upon an acquisition or other change of control (generally referred to as a "golden parachute") unless that compensation was previously approved as part of the annual vote.

Commentary

The say-on-pay provisions largely mirror those in the Schumer Bill. As we have noted previously, say-on-pay has been implemented to date by only a small number of US companies. Microsoft recently announced that it would implement a say-on-pay vote once every three years. There seem to be strong arguments in favor of that approach, particularly for companies that have majority voting standards which give shareholders a meaningful opportunity to voice dissent annually. It would be unfortunate to impose a single federal solution on all companies at a time when there is momentum for a tailored, market-based solution. Nevertheless, of all of the proposals in the Dodd Bill, say-on-pay seems one that is most likely to garner support.

Independence of Compensation Committee Members

Securities exchanges would be prohibited from listing the securities of any company that does not have an independent compensation committee. The definition of "independence" used by the exchanges should take into account relevant factors, including (1) the sources of a director's compensation and (2) whether a director is affiliated with the company or a subsidiary of the company.

Commentary

The Dodd Bill's proposed independence standards contain a radical new restriction on compensation committee membership. By requiring consideration of affiliate status, a large shareholder presumptively cannot be represented on the compensation committee. Consider, for example, an activist hedge fund that acquires 20 percent of the shares of a company due to perceived mismanagement or a private equity fund that holds 20 percent of the shares of a company following its IPO. There is no justification for excluding representatives of such entities, many of whom have significant experience with executive compensation and whose interests are almost always aligned with public stockholders on matters of executive compensation.

³ The Dodd Bill also proposes a number of provisions related to executive compensation that only apply to banks. We do not address those provisions in this client alert.

Independence of Compensation Committee Consultants

The compensation committee would be authorized to retain a compensation consultant and independent legal counsel or other advisors, and would be solely responsible for the appointment, compensation and oversight of any such consultant, counsel or advisors. Companies will be required to disclose in their annual proxy statement whether they have engaged a compensation consultant and whether its work raises any conflicts of interest. Any compensation consultant must be independent and the SEC is required to promulgate rules defining independence for this purpose. Securities exchanges would be prohibited from listing any company that does not comply with these provisions.

Commentary

The Dodd Bill states that retention of a compensation consultant and/or separate legal counsel is not required. However, if enacted, the provision is likely to accelerate the trend of large companies having separate counsel for their compensation committees. This is often appropriate because that counsel is generally not beholden to management in the same way as a company's regular corporate counsel might be. Finally, the reference to securities exchanges being prohibited from listing companies that do not comply with this provision seems unnecessary since there is no clear way to evidence compliance.

Enhanced Executive Compensation Disclosure

The Dodd Bill directs the SEC to amend Item 402 of Regulation S-K to require companies to disclose (1) the relationship between its executive compensation practices and financial performance and (2) a graphic or pictorial comparison of the amount of executive compensation and financial performance or return to investors over a five-year period or other time period as determined by the SEC.

Commentary

The relationship between compensation and performance should already be addressed in a company's CD&A. It is nearly impossible to provide a meaningful graphic representation of compensation vs. financial performance/return since so many factors particular to a company and its industry impact compensation and performance. Ultimately, the best measure of performance is against peer companies. For example, RiskMetrics looks at total shareholder returns over one- and three-year periods compared to each company's industry group in order to determine whether directors should be subject to a withhold vote. Institutional investors are also well placed to assess comparative returns. The disclosure proposed to be required from issuers in the Dodd Bill appears to be incomplete and potentially misleading.

No Fault Clawbacks

The Dodd Bill would require each Exchange Act reporting company—whether an issuer of debt or equity, and whether or not listed—to adopt a policy that permits the company to recover from current and former executive officers any excess incentive-based compensation in the event the company is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirements under the securities laws. The amendment would cover all executive officers, both current and former, and would apply to compensation paid during the three-year period preceding the date on which the company is required to prepare an accounting restatement.

Commentary

This provision is a significant departure from Section 304 of the Sarbanes-Oxley Act. First, it does not require misconduct—whether on the part of the executive officer or anyone else in the company—for a clawback to take effect. Second, it provides a means for companies, and not just the SEC, to recover compensation that would not have been paid but for misstated financial statements. Third, Section 304 only applies to compensation events for one year after the misstatement. Fourth, Section 304 only applies to the CEO and CFO. As drafted, there is some ambiguity over when a company is “required” to prepare an accounting restatement. This could be the date of the misstatement rather than its discovery, thereby resulting in a long tail to the potential obligation to return incentive compensation. Finally, it is worth noting that a growing number of companies have been including clawback provisions in employment contracts with senior executives. The terms vary, including whether misconduct is required. In light of this trend, it would be preferable for the Dodd Bill to give companies wider discretion to tailor the terms of any clawback arrangement than is currently envisaged.

Hedging Disclosures

The Dodd Bill would require companies to disclose whether their employees are permitted to engage in hedging arrangements relating to the company’s equity securities that were granted as compensation.

Commentary

Insider trading policies prohibit many forms of hedging by employees absent consent from the company. (Note that short selling is prohibited for directors and officers by law and is generally prohibited for all other employees as a matter of company policy.) The proposed disclosure requirement will likely cause companies to focus more closely on hedging provisions in their insider trading policies and adopt clearer standards. That said, there is nothing to prevent employees from selling vested stock. It seems more meaningful to affirmatively require disclosure of stock ownership policies for directors and executive officers⁴ and limit the discussion of hedging policies to those directors and executive officers in order to indicate whether the stock ownership policy is meaningful.

Conclusion

The Dodd Bill is directed primarily towards the supervision of banks, hedge funds and the derivatives markets, and the protection of consumers. It remains to be seen whether the general corporate governance and executive compensation provisions that have found their way into the Dodd Bill, and will apply to thousands of companies, will be subject to further scrutiny and revision. Public companies and their boards should follow developments closely and make their views known through professional organizations and direct communications with legislators.

⁴ Current disclosure requirements require a discussion explaining all material elements of a company’s compensation of the named executive officers. Item 402(b)(2)(xiii) of Regulation S-K suggests that while the material information to be disclosed in the Compensation Discussion and Analysis will vary, an example of such information may include the reporting company’s equity or other security ownership requirements or guidelines (including applicable amounts and forms of ownership), and any company policies regarding hedging the economic risk of such ownership.

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