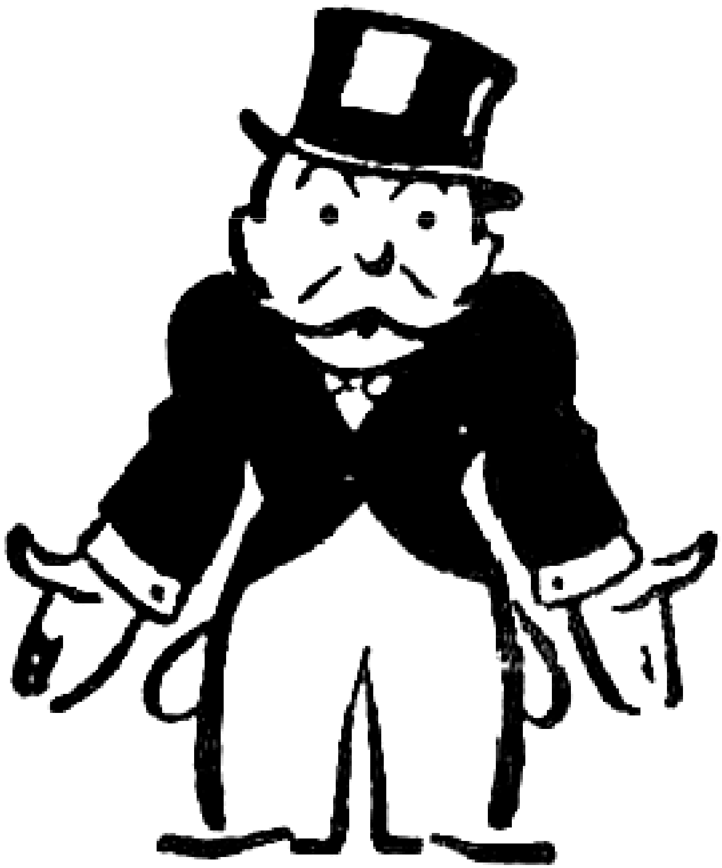
REFORMING WALL STREET:
What Will Congress Do About Corporate Governance?



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Introduction

1. In the wake of the worst financial crisis in over seventy five years, Congress is pursuing financial reform. H.R. 4173 passed the House of Representatives in December, and the "Restoring American Financial Stability Act of 2010" (the "Dodd Bill") was approved by the Senate Banking Committee on March 15, 2010 (on a party-line vote).
2. The odds are increasing that "financial reform" legislation will pass this year, although there are broad differences between the House and Senate bills and further compromises are likely in the Senate.
3. Much of this legislation addresses the issue of systemic risk and the "too big to fail" phenomenon. Detailed provisions address: (1) the powers and jurisdiction of the Federal Reserve, the FDIC, the SEC, the OTS (which will be abolished); (2) "resolution authority" to permit the early liquidation of an insolvent, but systemically significant firm; (3) the credit rating agencies; (4) hedge fund registration; (5) asset-backed securitization; (6) over-the-counter derivatives; and (7) a consumer protection agency.
4. Today, I will address none of these; instead, I intend to focus on what has received less attention: the corporate governance/executive compensation provisions in this legislation.

PROXY ACCESS

1. Probably the most controversial change in corporate governance proposed by the current financial reform is that set forth in Section 972 (“Proxy Access”) of the Dodd Bill, which authorizes the SEC to adopt rules (1) enabling shareholders to submit one or more nominees for inclusion in the corporation’s own proxy statement for election by the shareholders to the board of directors, and (2) specifying procedures for proxy access.

2. There was a small shift in the latest draft of the Dodd Bill, as it no longer mandates, but instead only authorizes, the SEC to “issue rules permitting the use by shareholders of proxy solicitation materials supplied by an issuer of securities for the purpose of nominating individuals to membership on the board of directors of the issuer, under such terms and conditions as the Commission determines are in the interest of shareholders and for the protection of investors.”

3. Although this language is unqualified, the SEC is currently considering only whether to authorize a minority slate of 1,2 or 3 directors (depending upon the size of the board) if a requisite threshold percentage of shareholders (between 1% and 5% depending on the size of the issuer) joined in the nomination.

4. This reform is intensely controversial within the business community. Although the SEC is divided, it is still likely to approve some form of proxy access by a 3-2 party-line vote.

Effective Date: The SEC Must Issue Rules Within 180 Days of Enactment.

Impact of Proxy Access

Why is Proxy Access so controversial? The SEC has several times proposed granting shareholders a right to nominate directors on the issuer's proxy statement (most recently in 2009), but has backed off, probably because of legal questions involving its authority.

Answers:

1. It will greatly reduce the costs of undertaking a proxy contest and make such an effort attractive to some institutional investors (large public pension funds in particular).
2. Arguably, it may "fragment" the board between the majority and a small camp of one or two directors who were not chosen by the nominating committee.
3. Opponents claim it will increase pressures on the board to pursue short-term gains at the expense of long-term planning and to increase leverage and risk.
4. Opponents point to an alternative procedures recently adopted under Delaware law (and also incorporated into the ABA's Model Business Corporation Act) under which shareholders or boards may adopt bylaws implementing proxy access in a more tailored, firm-specific fashion. (This Delaware statutory change might have legally undercut the SEC's proposed rule, but for the pending Congressional legislation, which clarifies the SEC's authority).

Remaining Issues

Assuming passage, the SEC must address a number of issues:

1. Threshold: In 2009, the SEC proposed tiered thresholds for nomination ranging between 1% and 5% depending on the corporation's size.

2. "Long-Term" Shareholders: In 2009, the SEC proposed that only shareholders who had held for a minimum period of one year could join the nominating group in order to minimize pressure from "short term" shareholders. The debate continues on this issue, and in the past the SEC preferred a three year holding period.

3. Default Rules: Can an issuer set higher thresholds and how may it do so: i.e., by a board-passed bylaw? Or only by a shareholder-adopted bylaw?.

4. Multiple Nominations: Which nomination takes precedence: (1) that of the first-to-file (with the requisite minimum percentage), or (2) that of the largest nominating group. To date, the SEC has favored the former approach as simpler, but management could possibly use that approach to stack the deck.

Majority Vote in Uncontested Elections

1. Section 971 of the Dodd Bill requires the Commission to direct the NYSE, Nasdaq and other securities exchanges to prohibit the listing of any issuer that does not adopt a majority voting rule for uncontested elections.
2. In a contested election when the number of nominees exceeds the number of directors to be elected, a plurality vote will elect the board.
3. In an uncontested election, if a director receives less than a majority of the votes cast in the election, then
   - (i) the director must tender his resignation to the board; and
   - (ii) the board of directors must either:
     - (a) accept the resignation;
     - (b) determine a date on which the resignation will take effect (within time limits specified by the SEC); or
     - (c) based upon a unanimous vote of the board, decline to accept the resignation and within 30 days disclose the specific reasons for its decision and the analysis it was based upon.

Effective Date: The Exchanges Must Adopt Listing Rules Not Later Than One Year From Enactment

Impact

1. Majority voting is already widespread. The Corporate Library reports that more than two-thirds of S&P 500 companies have adopted it.

2. But the Dodd Bill requires a unanimous board vote to decline a resignation and mandates that the board provide a detailed justification within 30 days.

3. Practices will also change at smaller public companies, as 75% of the Russell 3000 still elect directors by simple plurality voting.

4. During 2009, the RiskMetrics Group reports that some 91 directors at 49 U.S. companies (in the S&P 500 and Russell 3,000) received less than a majority vote (up 3 times from the 2008 proxy season). Within the S&P 500, only 12 directors at 6 companies failed to obtain majority support. Of these 49 companies, only two had director resignation policies requiring the tender of a resignation and in all cases the directors remained on the board.

EXECUTIVE COMPENSATION

1. "SAY ON PAY" (Advisory Shareholder Vote on Executive Compensation

Section 951 of the Dodd Bill requires that the corporation's annual proxy statement "shall include a separate resolution subject to shareholder vote to approve the compensation of executives as disclosed" in the proxy statement.

This vote is non-binding and advisory (but boards may be reluctant to disregard a shareholder vote).

Effective Date: Six months after enactment of the legislation (Hence: proxy statements in 2011 may have to comply).

Impact: The U.K. has had this system for years, and boards negotiate compensation with major institutional investors to assure a favorable vote.

Note: The 2010 Dodd Bill deleted a prior provision requiring a separate shareholder vote on "golden parachutes" as a result of M&A activity.

Compensation Committee Independence

1. Section 952 of the Dodd Bill requires that all members of the Compensation Committee be "independent" (as defined). This provision further requires the NYSE and Nasdaq to promulgate a definition of independence that takes account of:

   (1) total compensation, including advisory and consulting fees paid by the issuer;

   (2) any affiliation with the issuer, a subsidiary, or an affiliate.

   Potentially, outside directors could simply be paid too much by their company to be deemed independent.

2. The Compensation Committee is authorized "in its sole discretion" to retain, or obtain the advice of, its own counsel and compensation consultant, but may only select a compensation consultant, legal counsel, or other adviser that meets independence criteria.

3. Each issuer shall provide for appropriate funding, as determined by the Compensation Committee, for payment of reasonable compensation to the consultants and counsel chosen by the committee. This overrides Delaware law, but the board is not obligated to follow the committee's recommendations.

Effective Date: Not later than 360 days after date of enactment.

“Pay for Performance”

1. Section 953 of the Dodd Bill instructs the SEC to require each issuer to disclose in its proxy statement the “relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer.”

2. This section contemplates a five-year chart or graph showing how the shareholders have done in relation to changes in executive compensation. (If the lines cross, the picture may look bad).

COMPENSATION CLAWBACKS

1. Section 954 of the Dodd Bill mandates a recovery (or "clawback") of incentive compensation paid based on inflated earnings that are later restated. Specifically, it provides that:

   > In the event of "an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the federal securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date . . . (of the restatement) . . . in excess of what would have been paid to the executive officer under the accounting restatement."

2. This language seems to contemplate that if the accounting restatement reduces reported earnings from, say, $10 per share to say $6 per share, the corporation shall recover all stock options and other incentive compensation that was attributable to the $4 difference that was eliminated.

3. This language raises many interpretive questions (for example, how do we know how much incentive compensation was attributable to the foregoing $4 difference). But this provision is far broader than a similar provision in Sarbanes-Oxley because it covers all executive officers (not just the CEO and CFO), looks to the 3-year period before the restatement, and requires no finding of "misconduct."

4. According to Equilar, in 2009, 72.9% of Fortune 100 companies had publicly disclosed "clawback" policies (nearly all of these were adopted since 2006).

Separation of Chairman and CEO

1. Beginning not later than 180 days from enactment, the SEC must require disclosure in the annual proxy statement of “the reasons why the issuer has chosen the same person to serve as chairman of the board of directors and chief executive officer” or “different individuals to serve. . . .”

2. In short, reasons must be disclosed in either case.

Miscellany

1. Hedging Disclosure: Section 955 requires disclosure of the ability of executives to purchase short options, equity swaps, collars, or prepaid variable forward contracts. Effectively, this is intended to encourage a corporate policy against hedging by executives.

2. Excessive or Unsafe Compensation. In the case of bank holding companies, Section 956 instructs the Federal Reserve's Board of Governors to prohibit by rule "excessive" compensation or compensation plans that "could lead to a material financial loss."

3. Whistleblower Bounties. Section 922 provides for the SEC to establish a whistleblower fund that would reward whistleblowers who "voluntarily provided original information to the Commission that led to the successful enforcement" of a covered action in an aggregate amount between 10% and 30% of the "monetary sanctions" imposed in the action. The term "monetary sanction" includes disgorgement.

   Consequence: The economic incentive to "blow the whistle" in a securities fraud case will be greatly increased.

4. Risk Committee: All publicly traded nonbank financial companies that are supervised by the Federal Reserve must adopt a risk committee (as must all publicly traded bank holding companies with assets over $10 billion). The Board of Governors may also require smaller bank holding companies to have a risk committee.

Assessment

1. Some provisions have been dropped from the 2010 Dodd Bill, including a requirement that shareholders approve staggered boards.

2. Of the corporate governance provisions that remain, proxy access will have the greatest impact, and a lobbying battle will begin over how the SEC should implement it. But the SEC will probably stick closely to its 2009 proposals.

3. Many of the Dodd Bill’s corporate governance provisions are implemented by requiring the stock exchanges to adopt listing rules requiring adoption of the Bill’s governance provisions as a condition of listing eligibility. This will raise complex problems if a company arguably has not complied, and direct shareholder enforcement may not be possible. The extent to which the exchanges will monitor and enforce is open to question.