SUTHERLAND

LEGAL ALERT

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Capitol Hill Takes on Executive Compensation and Corporate Governance

The current global financial crisis, government bailouts and the ensuing contraction of the credit markets have led to calls for increased regulation and government oversight of Wall Street. The U.S. Senate weighed in on the debate when, on May 20, 2010, it passed the Restoring American Financial Stability Act of 2010 (the RAFSA).[1] The RAFSA follows the December 2009 passage of the U.S. House of Representatives' Wall Street Reform and Consumer Protection Act (the House bill).[2] The process of reconciling the RAFSA and the House bill began on June 11, and the conferees expect to present legislation for President Obama's signature before the July recess. Negotiations between House and Senate conferees over corporate governance provisions began on June 16. While the House bill contained far fewer corporate governance-related provisions, the base text of the bill used in legislative conference contains the same governance provisions provided for in the RAFSA.

Bill Provision	S. 3217	H.R. 4173	Conference Negotiation
Proxy Access	X	X	More detail proposed
Majority Vote in Uncontested Elections	X		Proposal rejected
Say on Pay	X	X	Proposal accepted to require large institutional investors to disclose vote
Compensation Committee Independence	X		
Mandatory "Clawbacks"	X		
Hedging Disclosure	X		
Broker Non-Voting	X		
Executive Compensation Issues	X		
Non-Binding Vote on "Golden Parachutes"		X	Proposal rejected

This Legal Alert will summarize the RAFSA's corporate governance and executive compensation provisions in anticipation of the release of the reconciled bill from conference, particularly in light of the negotiations already taking place on the provisions in conference. For example, the conferees appear to be eliminating provisions for mandatory majority voting for directors and appear to have rejected a proposal to mandate a non-binding shareholder vote on "golden parachute" packages. The analysis of the RAFSA corporate governance and executive compensation provisions in this Legal Alert will be described in the context of the broader movement for financial regulatory reform, including new and pending Securities and Exchange Commission (SEC) rules covering proxy disclosure and proxy access.

Proxy Access for Shareholder Nominees

Section 972 of the RAFSA would give the SEC explicit authority to make rules requiring an issuer to include shareholder nominees in its proxy solicitation materials. Notably, however, the RAFSA would not require the SEC to issue such rules.

[1] S. 3217, 111th Cong. (2010). The bill was returned to the Senate Calendar on May 25, 2010.

[2] H.R. 4173, 111th Cong. (2009). The House bill, which incorporated the corporate governance provisions of the Corporate and Financial Institution Compensation Fairness Act, includes "Say on Pay" for all public companies, an independent compensation committee requirement for public companies, incentive-based compensation standards, and disclosure requirements applicable to financial institutions with $1 billion or more in assets.

The SEC has already proposed similar proxy access rules that would permit shareholders meeting certain thresholds to place their own nominees alongside a company's nominees in the company's proxy materials.[3] At a June 9 meeting of the Business Roundtable in Washington, SEC Chairman Mary Schapiro reiterated that proxy access rulemaking would be done in a time frame which would allow nominees for the 2011 annual meeting season. She also noted that a Concept Release on proxy access would be issued soon.

On June 16, the Senate conferees appeared to have accepted a House provision to impose a 5% ownership standard and a two-year holding period on shareholders who wish to nominate directors.[4] During negotiations on June 17, the Senate representatives votes 8 to 4 against a motion to remove those limits.[5] Under the RAFSA, as well as in the base text used in conference, the setting of any standards would have been left to the SEC.

Discretionary Broker Voting

Section 957 of the RAFSA would, in certain circumstances, prohibit brokers that are not beneficial owners of shares from exercising their discretion to vote those shares by proxy. Brokers would be prohibited from voting on director elections, executive compensation or any other "significant matter" (to be defined in future SEC rules) without specific voting instructions from the beneficial owner of the shares.

This provision follows the July 1, 2009 approval by the SEC of an amendment to New York Stock Exchange Rule 452 (NYSE Rule 452), applicable to all companies listed on the NYSE, which prohibits brokers from voting unrestricted shares in uncontested director elections without receiving specific voting instructions from beneficial owners.[6]

Majority Voting for Directors in Uncontested Elections

Section 971 of the RAFSA would mandate that directors be elected by a majority (in uncontested elections) or a plurality (in contested elections) of votes cast. In an uncontested election, the RAFSA would require a director who receives less than a majority of votes cast to tender his or her resignation. The board must accept the director's resignation unless it unanimously votes to reject it. If the board votes to reject the resignation, it must fully explain, within 30 days, why doing so is in the best interests of the issuer and its shareholders.

The RAFSA would direct the SEC, within one year of enactment, to issue rules requiring the national exchanges to prohibit listing any security of an issuer that does not comply with these requirements.

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[3] Proposed Rule Facilitating Shareholder Director Nominations, Securities Act Release No. 9,046, Exchange Act Release No. 60,089, Investment Company Act Release No. 28,765 (proposed June 10, 2009), *available at* http://www.sec.gov/rules/proposed/2009/33-9046.pdf.

[4] See Ted Allen, *Senate Seeks to Drop Majority Voting From Reform Bill and Weaken Proxy Access*, available at http://blog.riskmetrics.com/gov/2010/06/senate-seeks-to-drop-majority-voting-from-reform-bill-and-weaken-proxy-access.html.

[5] See Ted Allen, *Senate Conferees Vote to Restrict Proxy Access*, available at http://blog.riskmetrics.com/gov/2010/06/senate-conferees-vote-to-restrict-proxy-access.html.

[6] The amendment to NYSE Rule 452 took effect for shareholder meetings held on or after January 1, 2010. *See* Order Approving Proposed Rule Change, as modified by Amendment No. 4, to Amend NYSE Rule 452, Exchange Act Release No. 60,215 (approved July 1, 2009), available at http://www.sec.gov/rules/sro/nyse/2009/34-60215.pdf.

However, issuers will have an opportunity to cure any related defects. Further, the SEC Commissioner would have the authority to exempt issuers from this requirement.

The advent of both amended NYSE Rule 452 and RAFSA Section 957 may make the failure of majority support for director candidates a more common occurrence. An issuer concerned about discretionary broker voting and the utilization of a majority voting standard may consider additional shareholder communication efforts to get sufficient votes for the company's proposed directors.

During conference negotiations, Senator Christopher Dodd, the lead Senate negotiator, stated that Senate conferees had agreed to drop the majority voting provision. Senator Dodd did not express why he was eliminating this provision, which was not present in the House bill, from the Senate conferees' recommendations.

Separation of Chairman and CEO

Section 973 of the RAFSA would direct the SEC, within 180 days of enactment, to adopt rules requiring issuers to disclose in their annual proxy statements the reasons why they have chosen the same person, or different people, to serve as chair of the board and as chief executive officer (or the equivalent position).

This provision mirrors a parallel provision in the proxy disclosure rules adopted by the SEC in December 2009 (the 2009 proxy rules).[7] If a company has combined the role of board chair and CEO and has also appointed a lead independent director, the 2009 proxy rules also require disclosure related to that decision and the specific role of the lead independent director.[8] In adopting the 2009 proxy rules, the SEC made clear that it would not express a preference for a particular leadership structure.[9]

Shareholder Vote on Executive Compensation (Say on Pay)

Section 951 of the RAFSA would require issuers of securities covered by the SEC's proxy solicitation rules to institute a non-binding Say on Pay vote. Effective six months after the RAFSA's enactment, issuers would be required to place a separate resolution to approve compensation of named executives on their annual meeting proxy forms, subject to an up or down shareholder vote. The vote would be non-binding and would not be meant to alter or overrule any specific action or decision by the issuer.

Say on Pay votes are already mandatory for recipients of Troubled Asset Relief Program (TARP) funds and have been a focus of U.S. financial regulatory reform efforts since 2007.[10] The growing movement

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[7] Proxy Disclosure Enhancements, Securities Act Release No. 9,089, Exchange Act Release No. 61,175, Investment Company Act Release No. 29,092 (adopted December 16, 2009), *available at* http://www.sec.gov/rules/final/2009/33-9089.pdf. In contrast to the RAFSA, however, the 2009 proxy rules set forth specific monetary thresholds that determine the disclosure of aggregate fees paid to compensation consultants, as well as disclosure related to the circumstances under which the decision to hire a consultant was made.

[8] *Id.* at 43.

[9] *Id.* at 42.

[10] For more information on the history of Say on Pay initiatives, please see our October 5, 2009, Legal Alert, "Say on Pay: It's Coming, Are You Ready?", *available at* http://www.sutherland.com/files/News/b41d1bd9-a974-48a5-a9e1-0339bcffc4ed/Presentation/NewsAttachment/85bebe0d-f7b1-4970-9bb9-181b98555321/CORP%20Alert%2010.5.09.pdf.

for Say on Pay has culminated this year in the failure of three companies to receive majority support for their compensation plans.[11]

During conference negotiations on June 16, the Senate conferees appeared to have accepted a proposal from House conferees to require large institutional investment managers to disclose their Say on Pay votes. Further, a proposal was issued during conference to alter Say on Pay to allow companies to hold these votes on a biannual or triennial basis. The outcome of this proposal has not yet been determined.

Compensation Committee Independence

Section 952 of the RAFSA would require each member of a board's compensation committee to meet independence requirements to be established by the national exchanges. Any compensation consultants or other advisers retained by the compensation committee would also need to meet independence standards to be identified by the SEC.

Echoing the 2009 proxy rules, an issuer would be required to disclose in its annual proxy statement whether the compensation committee hired a compensation consultant, whether the consultant's work raised any conflicts of interest, and, if so, the nature of the conflict and how it is being addressed.

The RAFSA would provide the compensation committee with the authority to appoint, oversee and determine the compensation for independent legal counsel and other advisers. The compensation committee would be under no obligation to implement the adviser's recommendations nor would the committee be relieved of any of its existing obligations. This provision mirrors Title III of the Sarbanes-Oxley Act of 2002, which specifically empowered a company's audit committee to engage outside experts at company expense. Courts have also recognized the need for directors to look to competent outside consultants and legal advisers.[12]

The RAFSA also would direct the SEC, within one year of enactment, to issue rules requiring national exchanges and securities associations to prohibit the listing of any securities of issuers that are not in compliance with these requirements. A non-compliant issuer would have an opportunity to cure any related defects.

Executive Compensation Disclosures

Section 953 of the RAFSA would direct the SEC to adopt enhanced rules relating to disclosure of executive compensation. Each issuer would be required to include in its annual proxy statement a clear description of compensation paid to its executives and how the compensation relates to the issuer's financial performance.

The RAFSA would further require that issuers disclose the median total annual compensation of all employees other than the CEO, the annual total compensation of the CEO, and the ratio of these two amounts. Shareholder advocacy groups point to extreme disparities between CEO compensation and

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[11] In May, a majority of shareholders of Motorola, Occidental Petroleum Corp., and KeyCorp (a TARP recipient) each failed to vote to approve the respective company's compensation plan.

[12] For example, the Delaware Supreme Court in the *Disney* case focused on the alleged failure of the compensation committee to seek expert advice in advance of important compensation decisions. *In re The Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 59–61 (Del. 2006).

other executive compensation as a red flag that could induce shareholders to withhold approval in any Say on Pay vote.[13]

Recovery of Erroneously Awarded Compensation (Clawback)

Section 954 of the RAFSA would require issuers to adopt "clawback" policies on excessive incentive-based compensation. These policies would apply if the issuer is required to prepare an accounting restatement based on material noncompliance with financial reporting requirements under federal securities laws. Issuers would have to recover from current and former executive officers any incentive-based compensation (including stock options) awarded in excess of what would have been awarded under the restated accounting numbers. The recovery would apply to a three-year "look-back" period preceding the date that the restatement was required.

The RAFSA would further require issuers to disclose their policies on incentive-based compensation that is based on financial information reported under federal securities laws. It would also mandate that national exchanges and securities associations prohibit the listing of any class of equity security of issuers that do not comply with these requirements.

Employee and Director Hedging

Section 955 of the RAFSA would require the SEC to adopt rules requiring issuers to disclose in their proxy statements whether employees or directors may purchase financial instruments designed to hedge or offset decreases in the value of equity securities. This disclosure includes not only equity securities granted to employees or directors as part of employee compensation, but also equity securities held directly or indirectly by the employee or director.

Conclusion

In sum, the RAFSA builds on the SEC's recent efforts to increase perceived transparency and accountability on the part of publicly traded companies. Should the bill become law as it currently stands, corporate boards will have heightened disclosure requirements, may find it more difficult to elect or re-elect their nominees, and will need to prepare to respond to possible shareholder disapproval of executive compensation plans. As the conference process progresses, the bill is likely to continue to change in response to negotiations on the part of the House and Senate conferees with respect to its corporate governance and executive compensation provisions.

[13] For example, The Corporate Library lists CEO compensation that is "more than three to five times the average [compensation] of the other named executive officers" as one of its 10 most important factors for shareholders to consider in deciding how to cast a "Say on Pay" vote. Paul Hodgson, *A 10-Point Test: When We Have Say on Pay, How Will I Decide Whether to Vote Yes or No?*, The Corporate Library, *available at* http://info.thecorporatelibrary.com/say-on-pay-how-to-vote-yes-or-no/?utm_campaign=Say-on-Pay&utm_source=TCL-homepage.

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