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Financial Regulatory Reform: Corporate Governance and Executive Compensation

On June 30, 2010, the U.S. House of Representatives adopted the Dodd-Frank Wall Street Reform and Consumer Protection Act. The finalized bill is expected to be approved by the U.S. Senate after its Fourth of July recess and delivered to President Obama for signature by mid-July. The new law includes a number of important provisions relating to corporate governance and executive compensation affecting companies publicly traded in the United States. We provide a summary of the new changes in these areas:

Proxy Access

- Provides the SEC with express authority to adopt rules and procedures that would allow a shareholder to include alternative director nominees in a company's proxy solicitation materials using the company's proxy card (the SEC has authority to consider minimum ownership thresholds and holding periods and potential exemption for small issuers).
- It is expected that the SEC will adopt final proxy access rules following the enactment of this legislation as the SEC has pending rules relating to proxy access, proposed in June 2009.

Say on Pay

- Requires public companies to include a nonbinding shareholder vote held not less than once every three years to approve the company's executive compensation as disclosed in company's proxy statement.

Related practice areas:
Corporate and Business Law

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- Thereafter, shareholders will be given the option to decide the frequency of the nonbinding vote on executive compensation not less frequently than once every six years.

- Say on pay resolutions will be required in proxy statements filed six months after enactment. At the first meeting after this time, shareholders would be asked for:

  (i) a nonbinding vote on executive compensation; and

  (ii) a vote on whether the vote required above should take place every one, two or three years.

- Public companies receiving Troubled Asset Relief Program ("TARP") funds were already required to include this vote. In addition, a number of public companies not receiving TARP funds also submitted such votes to shareholders. For the most part, shareholders voted in favor of such proposals. Notably, KeyCorp, Motorola and Occidental Petroleum were three companies that failed to receive shareholder approval this year.

- Broker discretionary voting will be prohibited with respect to the say on pay proposal.

- The SEC is not required to issue rules for these provisions to take effect.

Shareholder Approval of Golden Parachute Compensation

- Provides for the following in a company's proxy relating to a merger or acquisition involving the company:

  (i) Additional disclosure regarding compensation arrangements related to the merger or acquisition

  (ii) A nonbinding shareholder vote on such compensation arrangements unless already voted upon at an annual meeting

- The additional disclosure and shareholder vote will be required in proxy statements filed six months after enactment.

- The SEC is not required to issue rules for these provisions to take effect.

Compensation Committees

- Requires the SEC to issue rules, within 360 days of enactment, directing the national security exchanges to mandate fully independent compensation committees based on new heightened standards that exceed current requirements under both NYSE and NASDAQ rules. Relevant factors in determining a member's independence include:

  (i) the source of a board member's compensation, including consulting or advisory fees or other fees; and

  (ii) whether the member is affiliated with the issuer, its subsidiaries or an affiliate of a subsidiary of the issuer.

- Requires that compensation committees have the authority and funding to retain independent compensation consultants, counsel and other advisors. Compensation committee members would be responsible for the selection and oversight of these advisors. Compensation committees must consider the independence of the compensation consultants, outside counsel and other advisors, in rules to be promulgated by the SEC, which will include:

  (i) the provision of other services to the company;

  (ii) the amount of fees as a percentage of the compensation consultant's, counsel's or advisor's total revenues;

  (iii) the compensation consultant's, counsel's or advisor's policies and procedures regarding conflicts of interest;

  (iv) the compensation consultant's, counsel's or advisor's business and personal relationships with the compensation committee; and

  (v) any stock ownership by the compensation consultant, counsel or advisor.

- Requires the company to disclose, in their annual proxy statement:

  (i) whether the compensation committee retained a compensation consultant; and

  (ii) if any conflicts of interests were raised, how those conflicts were addressed.

- The rules approximate those already applicable to the Audit Committee. Companies may need to review membership on the Compensation Committee and the Committee charter.

Executive Compensation Disclosures

- Requires public companies to disclose the relationship between compensation actually paid and a company's financial performance, taking into account any change in the value of shares of stock and dividends of the issuer and any distributions (a graphical representation may be included).

- Requires public companies to disclose in their annual report or proxy statement:

  (i) the median of the annual total compensation of all employees (except the chief executive officer),

  (ii) the chief executive officer's annual compensation, and

  (iii) the ratio between the two.

- Total compensation is to be determined in same manner as the Summary Compensation Table.

- The SEC is required to issue rules, although no deadline is specified.

Clawbacks

- Requires listed companies to implement a clawback policy providing:

  (i) for disclosure of the policy of the company on incentive-based compensation that is based on financial information required to be reported under the securities laws, and

  (ii) reimbursement to the company from a current or former executive for any excess previously paid incentive-based compensation (including stock options) paid during a three-year period preceding a restatement of the company's financials. This applies regardless of whether or not the error was a result of the officer's misconduct.

- Provisions extend the Sarbanes-Oxley clawback provision, which only applies to a company's chief executive and chief financial officers.

- The SEC is required to issue rules, although no deadline is specified.

Hedging

- Requires the SEC to issue rules requiring proxy disclosure of whether any employees or directors of the company or their designees are permitted to purchase financial instruments designed to hedge or offset any decrease in the market value of equity securities granted as compensation or otherwise.

- The SEC is required to issue rules, although no deadline is specified.

Broker Discretionary Voting

- Mandates that the SEC issue new rules that will prevent brokers from voting their clients' securities in connection with the election of directors, executive compensation or any other significant matter as determined by the SEC rule, when their clients have not specified how they want to vote.

- As noted above, this will include say on pay and golden parachute votes.

- Requirement already applies to public company proxy voting through NYSE Rule 452.

Chairman and CEO Positions

- Requires companies to disclose the reasons why they have chosen to combine or separate the positions of chief executive officer and chairman of the board in their annual proxy statements. This provision reflects a view that a separation of the roles is favored as "best practice."

- The SEC's recent amendments to its proxy rules already require companies to provide disclosure about board leadership structure, including whether and why the company has chosen to combine or to separate the roles of the principal executive officer and board chairman, so this provision will not affect current disclosure of most companies.

- The SEC is required to issue a rule not later than 180 days after enactment. While the existing SEC rule may be tweaked, significant changes are unlikely.

Exemption for Auditor's Attestation

- The bill amends the Sarbanes-Oxley Act to exempt smaller issuers (public companies with less than $75 million in public float) from requiring an independent auditor attestation of internal control over financial reporting under section 404(b), codifying the SEC's existing exemption.

Definition of Beneficial Ownership

- Expands the definition of beneficial ownership under Section 13 of the Exchange Act to include any person who "becomes or is deemed to become a beneficial owner of any [covered equity security] upon the purchase or sale of a security-based swap that the Commission may define by rule."

Beneficial Ownership and Short-Swing Profit Reporting

- Provides the SEC with authority to shorten time periods for filing beneficial ownership reports under Section 13(d) and section 16 of the Exchange Act.

For Financial Institutions Only

Risk Committees

- Requires the following to establish "risk committees" to be responsible for the oversight of enterprise-wide risk management practices in conformity with rules to be promulgated by the Federal Reserve Board of Governors:

  (i) Publicly traded systemically important nonbank financial companies supervised by the Board of Governors of the Federal Reserve System

  (ii) Publicly traded bank holding companies with total consolidated assets of $10 billion or more

- The "risk committees" must consist of:

  (i) at least one risk management "expert" with experience in identifying, assessing and managing risk concerns of large and complex companies; and

  (ii) a number of independent directors, such number to be determined by the Board of Governors.

Restrictions on Compensation Relating to Financial Institutions

- Requires the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Board of Directors of the Federal Deposit Insurance Corporation, the Director of the Office of Thrift Supervision, the National Credit Union Administration Board, the SEC and the Federal Housing Finance Agency (together, "Federal Regulators") to issue rules prohibiting depository institutions, depository institution holding companies, registered broker-dealers, credit unions, investment advisors, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and any other financial institution the Federal Regulators deem appropriate from providing:

    (i) executive officers, employees, directors or principal shareholders with excessive compensation, fees, or benefits; or

    (ii) compensation that could lead to a material financial loss to the covered financial institution.

- Financial institutions with assets of less than $1 billion are exempt from this requirement.
- New rules are required no later than nine months after enactment.
- The Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation issued "guidance" on June 21, 2010, relating to excessive risk in incentive compensation. Presumably this rule will change that guidance.

Investment Manager Vote Reporting

- Requires investment managers to disclose at least every year how they voted regarding executive compensation and golden parachute compensation.

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