

WSGR ALERT

MARCH 2010

SENATE SET TO DEBATE FINANCIAL REFORM BILL *Corporate Governance and Executive Compensation Update*

On March 15, 2010, U.S. Senator Chris Dodd, chairman of the Senate Banking Committee, released the second version of his comprehensive financial reform bill (the first was released last fall). On March 22, the Banking Committee voted the bill out of committee; it will now be debated and amended by the full Senate. Titled the "Restoring American Financial Stability Act of 2010" (RAFSA), the bill contains sweeping changes to the financial sector. Among the headline items are proposals to:

- 1) make the Federal Reserve responsible for bank holding companies with assets exceeding \$50 billion;
- 2) establish a body within the Federal Reserve to police systemic risk and grant it the power to break up "too big to fail" institutions;
- 3) create a Consumer Financial Protection Bureau to assess financial products;
- 4) require large financial institutions to prepare their own dissolution plans;
- 5) create an agency to regulate rating agencies;
- 6) increase regulation of hedge funds that manage over \$100 million of assets; and

- 7) require more public disclosure of derivatives.

While most of these provisions primarily would affect banking and non-bank financial institutions, the bill's corporate governance, executive compensation, and whistleblower provisions potentially would impact all public companies. This WSGR Alert briefly summarizes those provisions and compares them to the previous version of the bill and other legislation. However, it is critical to note that this bill remains a work in progress, and is currently in the process of being amended, with significant amendments likely to occur in the future. Thus, while it is worthwhile to recognize the scope and importance of this potential legislation, we are not recommending any changes to a company's practices at this time.

I. Corporate Governance

A. Director Elections

Section 971 of RAFSA would add to the Securities Exchange Act of 1934 (the Exchange Act) a Section 14B, which would require—as a listing requirement on the national exchanges rather than as a matter of federal law—that in uncontested elections for a company's board of directors, a director must receive a majority of the votes cast to be elected. A director receiving less than a majority vote in such an election would be required to tender his or her resignation to

the board of directors. The board may then either accept or, by unanimous vote, decline to accept the resignation. If the board declines to accept the resignation, the board must within 30 days make public the specific reasons it chose not to accept the resignation and explain why such decision was in the best interests of the shareholders.

This majority-voting provision would mandate what has been a growing trend, at least with respect to larger public companies, over the last few years. As of July 2009, almost 70 percent of S&P 500 companies already had adopted some form of majority voting for the election of directors, although the trend was much less prominent in small-cap companies, with about three-quarters of the Russell 3000 still having plurality voting in place.¹ Also, since 2007, RiskMetrics Group has adopted a policy of generally recommending in favor of shareholder proposals to adopt majority-voting provisions (with a carve-out for contested elections).² As campaigns against individual directors have become more prevalent in recent years, this provision could make it more difficult to both attract and retain qualified directors, as well as make it more difficult for existing directors to keep their seats.³

It is also worth noting that the governance of director elections historically has been a matter of private ordering (i.e., set forth in the company's articles or bylaws) and regulated by the individual states through state

¹ Georgeson, "SEC Approves Elimination of Broker Discretionary Voting in Uncontested Director Elections," July 14, 2009 (available at http://www.georgeson.com/usa/download/georgeson_report0709.html); The Corporate Library, "Majority Voting for Director Elections – It Is Not Yet Standard Practice," December 2008 (available at <http://www.thecorporatelibrary.com/reports.php?reportid=234&keyword>).

² RiskMetrics Group (formerly Institutional Shareholder Services), "ISS U.S. Corporate Governance Policy 2007 Updates" (2006) (available at http://www.riskmetrics.com/sites/default/files/2007_US_Policy_Update.pdf).

³ Georgeson, "2009 Annual Corporate Governance Review," p. 5 (available at <http://www.georgesonshareholder.com/usa/acgr09.php>).

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corporate law. RAUSA proposes to modify director elections, and yet would do this not by pre-empting state law, but by modifying the listing requirements for the national exchanges.

B. Proxy Access

Section 972 of RAUSA would expand Section 14(a) of the Exchange Act to grant the Securities and Exchange Commission (SEC) the power to prescribe rules and regulations requiring public issuers to include shareholder director nominees in their proxy statements. The SEC would expressly be granted authority to specify the procedure an issuer must follow when responding to requests by shareholders for director nominations.

This provision would blunt any challenge regarding the legality of the SEC's ongoing efforts to promulgate rules regarding proxy access. In June 2009, the SEC proposed certain changes to the federal proxy rules that would require a company, under certain circumstances, to include director nominees proposed by shareholders in its proxy statement, and to include the names of those nominees on the company's proxy card. In addition, the proposed rules would require a company, under certain circumstances, to include in its proxy materials shareholder proposals to amend, or request that the board take action to amend, a company's governing documents regarding nomination procedures or disclosures related to shareholder nominations.⁴ The proposal was published for comment in the Federal Register on June 18, 2009, and the initial comment period closed on August 17, 2009. In December 2009, the SEC reopened the public comment period for its shareholder director-nomination proposal. Despite reopening the comment period, the SEC staff said it continues to expect to make a final recommendation on the proposal to the SEC in 2010.

These proposed rules have come under significant criticism, including questions as to whether the SEC has the statutory authority to promulgate the rules.⁵ If promulgated, these regulations will eliminate the issue as to the SEC's statutory authority, but the remaining issues will continue to be left unresolved.

C. Chairman and CEO Structures

Section 973 of RAUSA would add to the Exchange Act a requirement that a public issuer disclose in its annual proxy statements the reasons why it has chosen the same or different persons to serve as chairman of the board of directors and chief executive officer (or equivalent position). This provision does not alter the status quo. Recent enhancements to proxy disclosure rules by the SEC already require companies to include in their proxy statements a description of the board's leadership structure, including disclosure of whether and why each company has chosen to combine or separate the positions of principal executive officer and board chairman, and why the company believes that such board leadership structure is the most appropriate. Although neither RAUSA nor the SEC's proxy disclosure rules require any particular structure, companies should carefully consider the benefits and disadvantages of their particular leadership structure.

D. No Requirement that Shareholders Approve Staggered Boards; No Aiding and Abetting Liability

Among the changes to the original bill, the removal of two provisions is particularly noteworthy. First, the previous version of the bill would have mandated shareholder approval of staggered boards at all public companies; companies with existing

staggered boards would have been required to seek shareholder approval to maintain that structure.⁶ Second, the previous bill would have made any person that knowingly or recklessly provided substantial assistance to another person who violated the securities laws equally liable for the violation.⁷ Neither of these provisions appears in the current bill.

II. Executive Compensation

A. Say-On-Pay

As with the previous version of RAUSA, Section 951 of the current bill proposes to amend the Exchange Act to require that shareholders of public companies be given a separate non-binding vote on all executive compensation disclosed in the annual proxy statement. This would include all arrangements disclosed in the compensation discussion and analysis (CD&A), the compensation committee report, the compensation tables, and all related materials. The proposal clearly states that the results of the shareholder vote would not be binding on a company or its board of directors and such results may also not be construed as overruling a previous decision of the board, nor to create or imply any additional fiduciary duty owed by the board to company shareholders. Such a say-on-pay requirement is similar to a proposal that was co-sponsored by then-Senator Obama in 2007 and follows other say-on-pay proposals introduced by U.S. Representative Gary Peters and U.S. Senator Charles Schumer in 2009, as well as the proposal made by the U.S. Department of the Treasury (the Treasury) as part of the Investor Protection Act of 2009.

The current version of the bill differs from the previous version in two main regards with respect to say-on-pay. First, the timeframe for the implementation of the say-on-pay vote has been shortened from one year to six

⁴ See our previous WSGR Alerts concerning proxy access: "Update on Important Considerations for Companies Preparing for the 2010 Proxy Season," December 1, 2009; "Recent Developments and Important Considerations for Companies Preparing for the 2010 Proxy Season," September 14, 2009; and "U.S. Senator Schumer Introduces Shareholder Bill of Rights Act of 2009; SEC Votes to Re-propose Proxy Access Rules," May 22, 2009.

⁵ See generally, Grundfest, Joseph A., "The SEC's Proposed Proxy Access Rules: Politics, Economics, and the Law," *The Business Lawyer*, February 2010. The questions about the SEC's statutory authority are raised by the decision in *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990). See *id.*, at 377, n.81.

⁶ See Reforming American Financial Stability Act of 2009 § 974.

⁷ See *id.* § 984.

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months following the enactment of the bill. Second, the requirement for say-on-pay for golden parachutes—which was part of the proposal made by the Treasury in 2009—has been removed.

B. Compensation Committee Independence

Section 952 of the current bill includes similar proposals—styled as listing requirements—as were included in the previous version with respect to the independence of compensation committees and their consultants at public companies. These also have been included in other proposed legislation, such as the Treasury's proposal in the Investor Protection Act of 2009. More specifically, Section 952 would require amendments to the Exchange Act and mandate that the SEC adopt rules and regulations to address the following:

- Members of the compensation committee will be required to be independent, with the factors considered for determination of independence to include both the source of compensation (including any fees paid by the company) to the committee member and whether the committee member is affiliated with the company or any subsidiary or affiliate of the company.
- Compensation committees may only select a consultant, legal counsel, or other advisor after taking into consideration factors identified by the SEC, which will include: (1) the total services provided to the company by such consultant, legal counsel, or other advisor; (2) the amount of fees paid by the company to the entity that employs the consultant as a percentage of total revenue of such entity; (3) the policies and procedures adopted by the entity employing the consultant, legal counsel, or other advisor that are designed to prevent conflicts of interest; (4) any business or personal relationships that such consultant, legal counsel, or other advisor has with a member of the compensation committee; and (5) any

stock of the company that the consultant, legal counsel, or other advisor owns.

- If a compensation committee retains a consultant, legal counsel, or other advisor, the committee will be solely responsible for the appointment, compensation, and oversight of such advisor.
- Beginning one year after the enactment of the bill, disclosure will be required in the annual proxy statement indicating whether the compensation committee retained or obtained the advice of a consultant, as well as whether retaining such consultant has raised any conflict of interest. Notably, these disclosure requirements will not apply to legal counsel retained by the compensation committee.

C. Disclosure of Executive Pay in Relation to Company Performance

In addition to the proxy disclosure requirement noted above for consultants retained by a compensation committee, Section 953 of RAUSA also would require the SEC to adopt rules that require a public company to disclose in its annual proxy statement the relationship between the compensation actually paid to an executive and the company's financial performance, taking into account any change in the value of the company's stock, dividends, and other distributions. This proposal is different than the proposal contained in the previous bill, particularly because it does not require a graphic or pictorial comparison of the amount of executive compensation and the financial performance of the company or return to the company's investors during a five-year period (or such other period as may have been determined by the SEC).

D. Clawback Policy

Both the previous bill and Section 954 of the current bill would require the SEC to adopt rules prohibiting the listing on any national

securities exchanges of companies that do not adopt a clawback policy for incentive-based compensation paid to executives (including stock options) in the event the company is required to prepare an accounting restatement based on material noncompliance with financial reporting requirements. Pursuant to such a policy, the company would be required to recover from any current or former executive officer incentive-based compensation earned during the three-year period preceding the accounting restatement that is in excess of the incentive-based compensation that would have been paid under the accounting restatement. By comparison, such clawback policy requirement would have far greater implications and reach than the current provisions of the Sarbanes-Oxley Act of 2002, which covers only a company's chief executive officer and chief financial officer, and the recovery of compensation only if the accounting restatement results from misconduct.

E. Disclosure of Hedging

Section 955 of RAUSA would require disclosure in a company's annual proxy statement as to whether any employee or member of the company's board of directors is permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities that are (1) granted to such person by the company as part of compensation paid to such person or (2) held, directly or indirectly, by such person. This section of the bill has been revised from the previous version to now include the requirement with respect to members of a company's board of directors, rather than just the company's employees, as it was originally drafted.

III. Whistleblower Provisions

As with the previous version of the bill, Section 922 of RAUSA would allow the SEC the discretion to award whistleblowers who provide the SEC with original information leading to the successful enforcement of a judicial or administrative action between 10 and 30 percent of any monetary sanctions

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imposed and collected in such action. RAFSA further proposes to protect whistleblowers from retaliation in the terms and conditions of employment due to cooperation with the SEC or assistance in judicial or administrative actions. Under RAFSA, if a whistleblower prevails in an unlawful discharge or discrimination action, he or she would be entitled to reinstatement at the same status, to compensation of twice the amount of back pay owed with interest, and to reimbursement for litigation costs, including expert and attorneys' fees.

Among these provisions, the percent-of-recovery and double-back-pay award would be significant new additions. Under Section 806 of the Sarbanes-Oxley Act (SOX), retaliated-against whistleblowers already are entitled to reinstatement, back pay with interest, and reimbursement of legal costs, including expert and attorneys' fees. However, under SOX, a whistleblower must act within 90 days of any alleged retaliation by filing a complaint with the Department of Labor; either party then may appeal an adverse ruling to the Court of Appeals for the Federal Circuit. In contrast, under RAFSA, the whistleblower would have until six years from the date of the retaliation, or three years from the time the whistleblower discovered the retaliation, to bring a complaint directly in federal district court.

IV. Broker Discretionary Voting

On March 22, the Senate Banking Committee voted 13-10, strictly along party lines, to move the bill to the Senate floor. In connection with that vote, a series of amendments—known as the Manager's Amendment—also was offered. One of these amendments would amend the Exchange Act to ban broker discretionary voting on director elections, executive compensation proposals, and "any other significant matter, as determined by the Commission, by rule." Although similar to NYSE Rule 452, which recently was modified to disallow

discretionary broker voting in uncontested director elections, the changes proposed by RAFSA would significantly broaden the types of proposals for which brokers would lack discretionary voting authority.⁸ Further, by turning a rule into a statute, the SEC would be prevented from later modifying its position should there be unintended consequences of the ban.

V. Regulation D Filings

Of interest to private companies is Section 926 of RAFSA, which would modify the current system of exempting securities offerings from state regulation, including exemptions under Regulation D. Regulation D exempts from the registration requirements of the Securities Act of 1933 certain issuances of securities from private companies to accredited investors, including angel investors, venture capitalists, and private equity funds. Under the bill, the SEC would be required to review—and presumably approve, though the bill does not specify—the filings within 120 days. If the SEC fails to review the filings within 120 days, the securities will not be considered "covered securities" exempt from state regulation unless the SEC separately finds that the issuer has made a good-faith and reasonable attempt to comply with applicable rules and regulations related to the filing, and any failure to comply therewith is immaterial to the offering as a whole.⁹ Additionally, the proposal would authorize the SEC to designate a class of securities as not covered by the exemptions because the offering is not of sufficient size or scope.

This proposal would increase the burden on private companies seeking to raise capital in private financings by requiring them to either obtain pre-clearance from the SEC or comply with state securities laws. The former could significantly delay the private offerings, while the latter could increase costs by way of reporting and filing requirements, potentially in multiple jurisdictions.

Conclusion

Multiple bills addressing executive compensation, say-on-pay advisory votes, corporate governance standards, disclosure requirements, and other related governance issues still are pending in the U.S. Senate and House of Representatives. All of these bills, including RAFSA, are expected to be sharply debated. Given the intense lobbying expected, multiple competing legislative initiatives, and recently enacted and proposed SEC rules, it is unclear what form any legislation, if signed into law, would take. Wilson Sonsini Goodrich & Rosati will continue to monitor these developments in the coming weeks.

For any questions or more information on these or any related matters, please contact David Berger, Katie Martin, Ralph Barry, Todd Cleary, Mike Ringler, Ignacio Salceda, or any member of your Wilson Sonsini Goodrich & Rosati team.



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⁸ See our previous WSGR Alert concerning NYSE Rule 452, "SEC Eliminates Discretionary Broker Voting for Uncontested Director Elections," July 15, 2009.

⁹ RAFSA provides that if the SEC fails to review the filings within 120 days, the securities will not be considered exempt, unless a *State securities commission (or equivalent state officer)* determines that there has been a good-faith effort to comply with applicable rules and regulations, and any failure thereto is immaterial to the offering as a whole. The Manager's Amendment proposes to replace "State securities commissioner (or equivalent state officer)" with "the Commission" (i.e., the SEC).