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Securities and Corporate Governance Provisions of the "Restoring American Financial Stability Act of 2010"

Earlier this month Senator Chris Dodd (D–Conn.) introduced a revised version of his Bill entitled the "Restoring American Financial Stability Act of 2010" (S.3217). Although primarily aimed at reforming the U.S. banking system, the Bill includes securities and corporate governance provisions that would impact smaller companies.

Returning Oversight of Rule 506 Offerings to the States

Section 926 of the Bill would remove most securities currently offered in private placements pursuant to Rule 506 under the Securities Act of 1933 (Securities Act) from the definition of "covered securities" under Section 18 of the Securities Act. Currently, covered securities, including securities sold pursuant to the Rule 506 exemption from Securities Act registration, are not subject to state securities laws' registration and qualification requirements, though issuers generally must file a Form D with the states in which the offering is conducted and remain subject to the anti-fraud provisions of state securities laws. Section 926 empowers the Securities and Exchange Commission (SEC) to designate certain securities as not "covered securities because the offering of such securities is not of sufficient size or scope" and directs the SEC to conduct a rulemaking with respect to such designations. Furthermore, any securities that still qualified for covered security status would lose such status if the SEC did not review the Form D with respect to the offering of such securities within 120 days of filing.

We believe there are several technical problems with Section 926, including the fact that the SEC lacks the resources to review the thousands of annual Form D filings. More importantly, the "size and scope" language of Section 926 makes it likely that the Rule 506 offerings that small companies often rely on to raise capital would no longer qualify for federal preemption of state securities laws, although based on the Form D SEC review requirement few if any offerings would qualify for federal preemption of state securities laws under this section. If this happens, companies would be forced to return to the pre-1996 (the year the National Securities Markets Improvement Act, which implemented Section 18 of the Securities Act, was enacted) framework requiring compliance with a patchwork of different state registration, qualification and/or exemption requirements, which would increase the cost and complexity of conducting Rule 506 exempt offerings. Many groups have objected to Section 926, however, and we are hopeful that the final Bill will not include, or will make substantial improvements to, this section.

Corporate Governance Provisions of the Bill

The Bill also includes several corporate governance provisions that would affect all SEC reporting companies. Some public companies, though generally larger ones, have started to adopt many of the corporate governance provisions of the Bill. If these provisions are included in any final legislation, and we expect that most if not all of them will be, smaller companies, especially those listed on a national securities exchange, will have to modify certain aspects of their corporate governance. Even non-reporting companies will need to consider these corporate governance practices which will, to the extent they are not already, quickly become considered "best practices."

First, the Bill would implement say-on-pay for all reporting companies. In other words, each company would have to provide for an annual non-binding stockholder vote to approve the compensation of its executives as disclosed in its proxy statement. Smaller companies, which are not required to include a Compensation Discussion and Analysis section in their proxy statements, may have to consider providing additional explanatory information about their executive compensation programs in connection with this vote. Reporting companies would also be required to provide in their annual proxy statements information showing "the relationship between executive compensation actually paid and financial performance of the [company]," as well as the amount, and ratio, of the median annual total

compensation of all its employees and the annual total compensation of its chief executive officer. They would also have to disclose whether any employees or directors are permitted to hedge or offset decreases in the market value of company securities they hold or have been granted as compensation.

Listed companies would be subject to heightened compensation committee requirements that are similar to current audit committee requirements. Listed companies would be required to maintain a compensation committee comprised solely of independent directors that meet a heightened independence standard, which committee would have to be authorized to retain or obtain the advice of compensation consultants, legal counsel and other advisors, all of whom must be independent, and be directly responsible for the appointment, compensation and oversight of such consultants or advisors. Listed companies would also be required to adopt and disclose "clawback policies" that provide for recovery of incentive compensation paid to current and former executive officers in connection with an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws – no misconduct required.

The Bill would also require majority voting in any uncontested election of directors of a listed company, confirm the SEC's authority to promulgate rules providing stockholders access to the company's proxy materials, proxy and ballot in director elections (which it has already proposed) and require the SEC to promulgate rules requiring reporting companies to discuss the reasons the company has chosen to have the same or different persons serve as Chairman and CEO (which it has already done).

Finally, the Bill requires the Federal Reserve, in consultation with the Office of the Comptroller of the Currency and FDIC, to establish standards prohibiting as an unsafe or unsound practice excessive compensation of executive officers, employees, directors or principal stockholders of bank holding companies or any compensation plan that "could lead to material financial loss to the bank holding company."

About Me. I am a former SEC attorney who also has prior "big firm" experience. I assist public as well as private companies with compliance with federal and state securities laws, including assisting public companies with their reporting obligations under the Securities Exchange Act of 1934, and general corporate matters, at competitive billing rates. Please contact me if you would like more information about my practice or to discuss how I can be of assistance to you.

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