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Senate Passes Financial Reform Legislation with Corporate Governance and Executive Compensation Provisions*

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On May 20, 2010, by a vote of 59-39, the Senate passed the Restoring American Financial Stability Act of 2010 (Senate Bill). The Senate Bill includes corporate governance and executive compensation provisions that primarily affect public companies. These provisions are similar to provisions included in the Wall Street Reform and Consumer Protection Act of 2009 (House Bill), passed by the House on December 11, 2009, with some noteworthy differences.

Both the Senate and House Bills address executive compensation and governance practices that could, if enacted, significantly affect the compensation of executive officers and directors. Compensation committees of listed companies will also be affected by provisions in both bills instructing the Securities and Exchange Commission (SEC) to issue rules requiring the national securities exchanges to impose heightened standards of independence on compensation committee members, as well as new requirements related to the use of consultants and other advisers. In addition, both the Senate and House Bills grant new federal rights to shareholders with the intention of increasing accountability and oversight of public companies. Significantly, both bills would:

- give shareholders a "say on pay" by requiring an annual non-binding shareholder advisory vote on the compensation of executives.
- give the SEC authority to adopt proxy access rules.

The Senate Bill is more stringent than the House Bill in several respects. Specifically, the Senate Bill, but not the House Bill:

- requires the SEC to adopt rules directing the national securities exchanges to prohibit the listing of any security of a company that does not:
  — adopt a majority vote standard and resignation policy; or
  — develop and implement a policy to "clawback" excessive compensation from executive officers who received incentive-based compensation (including stock options) during the three years preceding an accounting restatement.
- requires the SEC to adopt rules requiring disclosure in the annual proxy statement of the relationship between executive compensation paid and the company's financial performance.
- directs the SEC to require companies to disclose the ratio of median employee compensation to the compensation of the chief executive officer (CEO).
- requires the SEC to adopt rules requiring companies to disclose in their annual proxy statement any hedging activities by employees and directors with respect to equity compensation.
- requires the SEC to adopt rules, not later than 180 days after enactment, requiring a company to disclose in its annual proxy statement the reason it has chosen the same or different individuals to serve as chairman of the board and CEO.
- requires national securities exchanges to adopt rules prohibiting broker discretionary voting in connection with elections of directors, executive compensation, and any other significant matter, as determined by SEC rule.

The House Bill contains the following additional provisions not included in the Senate Bill:

- provides for a non-binding shareholder vote on "golden parachute" agreements in connection with certain business combinations requiring shareholder approval.
- gives the SEC rulemaking authority to shorten the filing deadline for beneficial ownership reports under Section 13(d) and Section 16 of the Securities Exchange Act of 1934 (Exchange Act).
- exempts smaller issuers that are not accelerated filers from the requirement for independent auditor attestation of internal control over financial reporting under Section 404(b) of the Sarbanes-Oxley Act.

The Senate and House Bills now proceed to a House-Senate conference committee to reconcile differences between the two versions. Although the governance and executive compensation provisions of the two bills are not as contentious as some other areas of financial reform addressed in the bills, there are several differences between the bills that we highlight in this advisory. The White House and Democratic leadership would like to complete the conference and have final legislation ready for President Obama's signature before the July 4, 2010 congressional recess.

Once the legislation is enacted, the SEC will be required to adopt rules implementing the legislation. In some cases there is no deadline set for when the SEC must issue such rules, while in other cases the SEC must adopt rules not later than a certain number of days or months after enactment of the legislation. In addition, several provisions in both bills require the SEC to adopt rules directing the national securities exchanges to adopt listing standards to effectuate the rules. Listed companies that do not comply with the new requirements could be subject to delisting, although in some cases the rules adopted by the SEC must provide issuers with a reasonable opportunity to cure any defects that would be the basis for a delisting.

Below we discuss the executive compensation and governance provisions in the Senate Bill and the House Bill, including key differences in their provisions. We include separate sections discussing the provisions that are included only in the Senate Bill or the House Bill. Finally, a separate section discusses executive compensation and governance provisions that relate solely to financial institutions or "nonbank financial companies" supervised by the Board of Governors of the Federal Reserve System (Federal Reserve).

PROVISIONS IN BOTH THE SENATE BILL AND THE HOUSE BILL

Say on Pay

The Senate Bill mandates that any proxy or consent or authorization for an annual or other shareholder meeting occurring more than six months after enactment, for which SEC proxy rules require compensation disclosure, include a separate resolution for a non-binding shareholder advisory vote on the compensation of executives. The shareholder vote does not overrule any decision made by the company or the board and does not create or imply any additional fiduciary duty of the board. (§ 951)

The House Bill includes a similar non-binding "say on pay" provision; however, a vote is only required at annual meetings of shareholders to elect directors or a special meeting in lieu of the annual meeting. (The Senate Bill is broader, requiring an advisory shareholder vote at any meeting for which proxy rules require compensation disclosure, such as for certain business combinations.) Under the House Bill, proxy statements that relate to meetings occurring on or after six months after final rules are issued by the SEC (rather than six months after enactment of the legislation, as in the Senate Bill) must include such a resolution. The SEC is required to issue final rules under the House Bill not later than six months after enactment. (§ 2002)

Proxy Access

The Senate Bill gives the SEC authority to issue rules permitting shareholders to nominate directors in a company's proxy solicitation materials on terms determined by the SEC, but does not mandate that proxy access rules be adopted. (§ 972) The House Bill contains a similar provision. (§ 7222)[1]

Compensation Committees

Both § 952 of the Senate Bill and § 2003 of the House Bill establish new requirements for listed companies relating to compensation committee independence, the independence of compensation consultants and other advisers to the compensation committee, disclosure of the compensation committee's use of compensation consultants, and the authority of compensation committees to retain and fund compensation consultants and other advisers.

Under the Senate Bill, the SEC must issue rules not later than 360 days after enactment directing the national securities exchanges to prohibit the listing of securities of an issuer that does not comply with the requirements of § 952. The rules of the SEC must provide for appropriate procedures for an issuer to cure any defect that would be the basis for a listing prohibition. The SEC rules must permit a national securities exchange to exempt a category of issuers. In determining appropriate exemptions, the exchanges must take into account the potential impact of the requirements on smaller reporting issuers.

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[1] The SEC issued proposed proxy access rules in June 2009, which are the subject of much controversy. Some commenters questioned the SEC's authority to adopt proxy access. The Senate Bill addresses this issue by giving the SEC authority to adopt proxy access. For additional information about the SEC's proposed proxy rules, see "Proxy Access, Take Three: SEC Proposal Would Fundamentally Change Director Elections," available at: http://www.arnoldporter.com/public_document.cfm?id=14505&key=1F1.

Under the House Bill, the SEC must issue rules not later than nine months after enactment directing the national securities exchanges to prohibit the listing of securities of an issuer that does not comply with the requirements of § 2003. The rules of the SEC must provide for appropriate procedures for an issuer to cure any defect that would be the basis for a listing prohibition. The SEC may exempt certain categories of issuers from these requirements, taking into account, among other considerations, the potential impact on smaller reporting issuers.

The provisions in the Senate Bill and House Bill relating to compensation committees of listed companies and their use of consultants and advisers are discussed below.

- ***Compensation Committee Independence***. Under the Senate Bill, compensation committee members of listed companies must satisfy heightened independence standards to be established by the national securities exchanges. (§ 952)

The House Bill includes a similar provision, but in determining independence, the exchanges would consider more narrowly defined criteria. (The broader requirement in the Senate Bill is consistent with the standard of independence that is required of audit committee members under Rule 10A-3 of the Exchange Act). (§ 2003)

- ***Independence of Compensation Committee Consultants and Advisers***. Under the Senate Bill, a listed company's compensation committee must consider specific factors that the SEC identifies as affecting the independence of a compensation consultant, counsel or other adviser before selecting such consultant, counsel, or adviser.[2] (§ 952)

Under the House Bill, compensation consultants and other advisers to the compensation committee of a listed company must meet SEC-established standards of independence. (§ 2003)

- ***Disclosure Regarding Use of Compensation Consultants***. Under the Senate Bill, a listed company must disclose in the proxy material for an annual meeting occurring one year or more after enactment of the Senate Bill whether (1) the compensation committee retained or obtained the advice of a compensation consultant; and (2) any conflicts of interest arise from the consultant's work and, if so, the nature of the conflict and how it is being addressed. (§ 952)

Under the House Bill, a listed company must disclose in the proxy material for an annual meeting occurring one year or more after enactment of the House Bill whether the compensation committee retained and obtained the advice of a compensation consultant meeting SEC-established independence standards. (§ 2003) The House Bill does not require disclosure of conflicts of interest of compensation consultants, but existing SEC rules adopted in December 2009 include disclosure requirements regarding compensation consultants, including potential conflicts of interest.[3]

- ***Authority to Engage and Oversee Independent Compensation Consultants, Counsel and Other Advisers***. Under the Senate Bill, the compensation committee of a listed company must be granted authority, in its sole discretion, to retain or obtain the advice of a compensation consultant, independent legal counsel, and other advisers and to be directly responsible for their oversight. These requirements may not be construed to require a compensation committee to implement or act consistently with the advice or recommendations of a compensation consultant, legal counsel, or other advisers or affect the ability or obligation of a compensation committee to exercise its own judgment in fulfillment of its duties. (§ 952)

The House Bill contains similar provisions. (§ 2003)

- ***Funding of Compensation Consultants and Other Advisers***. Under the Senate Bill, listed companies must provide for appropriate funding, as determined by the compensation committee, for payment of "reasonable compensation" to compensation consultants, independent legal counsel, or other advisers to the committee. (§ 952)

Under the House Bill, listed companies must provide appropriate funding, as determined by the compensation committee, for payment of compensation to any compensation consultant who meets the standards for independence established by the SEC, and any independent counsel or other advisers to the compensation committee. (§ 2003)

Section 13 Beneficial Ownership Reporting Upon the Purchase or Sale of Security-Based Swaps

The Senate Bill amends Section 13(d)(1) of the Exchange Act so that it applies to any person who "otherwise 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 SEC may define

[2] The SEC is required to issue rules identifying the factors that affect the independence of a compensation consultant, legal counsel, or other adviser to a compensation committee of the issuer, including "(A) the provision of other services to the issuer by the person that employs the compensation consultant, legal counsel, or other adviser; (B) the amount of fees received from the issuer by the person that employs the compensation consultant, legal counsel, or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel, or other adviser; (C) the policies and procedures of the person that employs the compensation consultant, legal counsel, or other adviser that are designed to prevent conflicts of interest; (D) any business or personal relationship of the compensation consultant, legal counsel, or other adviser with a member of the compensation committee; and (E) any stock of the issuer owned by the compensation consultant, legal counsel, or other adviser."

[3] For additional information, see "SEC Approves Enhanced Proxy Disclosures-What To Do In Advance of Your 2010 Annual Meeting" available at: http://www.arnoldporter.com/public_document.cfm?id=15041&key=27B1.

by rule. Corollary changes are made to Section 13(g)(1) of the Exchange Act. (§ 766) The House Bill contains similar language, but refers to the purchase or sale of a "security-based swap or other derivative instrument" that the SEC may define by rule. No deadline is specified for SEC rulemaking. (§ 3205)

The Senate Bill also amends Section 13 to add a new subsection (o) that states that for purposes of Section 13 and Section 16, a person will be deemed to acquire beneficial ownership of an equity security based on the purchase or sale of a security-based swap, only to the extent that the SEC, by rule, determines that the purchase or sale of the security-based swap provides incidents of ownership comparable to direct ownership of the equity security, and that it is necessary to achieve the purposes of the section that the purchase or sale of the security-based swap be deemed the acquisition of beneficial ownership of the equity security. No deadline is specified for SEC rulemaking. (§ 766) The House Bill contains similar language, but refers to the purchase or sale of a "security-based swap or other derivative instrument." (§ 3205)

PROVISIONS IN THE SENATE BILL BUT NOT THE HOUSE BILL

Majority Vote Mandated in Uncontested Director Elections

Not later than one year after enactment, the SEC is required to adopt rules directing the national securities exchanges to prohibit the listing of any security of a company that does not adopt a majority vote standard and resignation policy. If a director receives less than a majority of the votes cast in an uncontested election, the director must tender his or her resignation. The board is required to accept the resignation unless the board unanimously votes that it is in the best interests of the company and its shareholders for the director to continue to serve. If the board unanimously declines the director's resignation, the company must publicly disclose within 30 days its analysis in declining the director's resignation. The rules established by the SEC must allow an issuer to have an opportunity to cure any defect that would be the basis for prohibiting a listing. The SEC has authority to exempt a company from any or all of these requirements. (§ 971)

Disclosure of Relationship between Pay and Performance

The SEC is required to adopt rules requiring each company to disclose in the annual proxy statement a clear description of any compensation required to be disclosed under Item 402 of Regulation S-K, including information showing the relationship between executive compensation paid and the company's financial performance, taking into account any change in the value of stock and dividends and distributions. Companies may include a graphic representation of the information required to be disclosed. No deadline is specified for adoption of SEC rules under this section. (§ 953)

Disclosure of Median Employee Compensation and Ratio of CEO to Employee Compensation

The SEC is required to amend Item 402 of Regulation S-K to require companies to disclose: (1) the median of the annual total compensation of all employees of the company, except the CEO; (2) the annual total compensation of the CEO; and (3) the ratio of the compensation of employees determined under (1) to the compensation of the CEO determined under (2). The annual total compensation of an employee is determined in accordance with Item 402 of Regulation S-K. No deadline is specified for adoption of SEC rules under this section. (§ 953)

Clawback of Incentive-Based Compensation

The SEC is required to adopt rules directing national securities exchanges to prohibit the listing of any security of a company that does not develop and implement a policy providing:

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

(2) that, if the company is required to restate its financial statements due to material noncompliance with any financial reporting requirement, the company will recover compensation from any current or former executive officer who received incentive-based compensation (including stock options) during the three-year period preceding the accounting restatement, in excess of what would have been paid under the restatement. (§ 954)

This provision is broader than the current clawback provision that was adopted under the Sarbanes-Oxley Act. No deadline for SEC rulemaking is specified. The House Bill does not contain a similar provision.

Disclosure of Employee and Director Hedging Activities

The SEC is required to adopt rules requiring companies to disclose in their annual proxy statement whether any employee or director is permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) that are designed to hedge or offset a decline in the market value of equity securities granted as part of the employee's or director's compensation or held, directly or indirectly, by the employee or director. No deadline for SEC rulemaking is specified. (§ 955)

Disclosure Regarding Chairman and CEO Structure

The SEC is required to adopt rules, not later than 180 days after enactment, requiring a company to disclose in its annual proxy statement the reasons it has chosen the same person to serve as chairman of the board and CEO or different individuals to serve in these positions. (§ 973) Similar disclosure is already required under

SEC proxy disclosure rules adopted on December 16, 2009.[4]

Discretionary Voting by Brokers

The Senate Bill amends Section 6(b) of the Exchange Act to require national securities exchanges to adopt rules prohibiting brokers who are not beneficial owners of a security from granting a proxy to vote the security in connection with a shareholder vote for the election of directors, executive compensation, and any other significant matter as determined by the SEC by rule, unless the beneficial owner has provided voting instructions to the broker. No time period for adoption of these rules is specified. (§ 957) This requirement codifies current New York Stock Exchange Rule 452.

PROVISIONS IN THE HOUSE BILL BUT NOT THE SENATE BILL

Say on Golden Parachutes

The House Bill provides for a non-binding shareholder vote on "golden parachute" agreements in connection with certain business combinations requiring shareholder approval. The SEC is required to issue final rules to implement this requirement not later than six months after enactment.[5] (§ 2002)

SEC Authority to Shorten Filing Deadline for Section 13 and 16 Reports

The SEC is granted rulemaking authority to shorten the due date for filing beneficial ownership reports under Section 13(d) and Section 16 of the Exchange Act. (§ 7105)

Exemption from Section 404(b) of Sarbanes-Oxley for Non-accelerated Filers; SEC Study

Section 404 of the Sarbanes-Oxley Act is amended to exempt smaller issuers that are not accelerated filers under Rule 12b-2 from the Section 404(b) requirement for independent auditor attestation of internal control over financial reporting. The SEC is required to conduct a study to determine how the SEC could reduce the burden of complying with Section 404(b) for companies whose market capitalization is between US$75 million and US$250 million for the relevant reporting period and to deliver a report to Congress not later than nine months after enactment. (§ 7606)

[4] For additional information on the SEC's enhanced proxy disclosures, see "SEC Approves Enhanced Proxy Disclosures-What To Do In Advance of Your 2010 Annual Meeting," available at: http://www.arnoldporter.com/public_document.cfm?id=15041&key=27B1.

[5] Under the House Bill, institutional investment managers who are subject to Section 13(f) of the Exchange Act must report at least annually how they voted with regard to a shareholder vote on executive compensation or "golden parachute" compensation unless such vote is otherwise reported publicly under SEC rules. The SEC is required to issue final rules to implement this requirement not later than six months after enactment.

PROVISIONS AFFECTING FINANCIAL INSTITUTIONS AND "NONBANK FINANCIAL COMPANIES" SUPERVISED BY THE FEDERAL RESERVE

Risk Committee Required for Nonbank Financial Companies Supervised by the Federal Reserve (Senate Bill)

Under the Senate Bill, the Federal Reserve must require each "nonbank financial company" supervised by the Federal Reserve that is a publicly traded company to establish a risk committee not later than one year after the date of receipt of a notice of final determination with respect to such nonbank financial company supervised by the Federal Reserve. (The term "nonbank financial company" includes companies that are "predominantly engaged in financial activities" (as defined in the bill). The Financial Stability Oversight Council can subject certain nonbank financial companies that it determines would pose a threat to US financial stability in the event of their material financial distress to the supervision of the Federal Reserve. Such companies can be subject to stricter standards, such as the risk committee requirement.) The risk committee is responsible for the oversight of enterprise-wide risk management practices and must include such number of independent directors as the Federal Reserve may determine appropriate, and at least one risk management expert with experience in identifying, assessing and managing risk exposures of large, complex firms. (§ 165) The House Bill does not contain a similar requirement[6]

Prohibition on the Payment of "Excessive Compensation" By Bank Holding Companies (Senate Bill) or by Covered Financial Institutions (House Bill)

Section 5 of the Bank Holding Company Act is amended to require the Federal Reserve Board to establish standards, by rule, prohibiting as an unsafe and unsound practice any compensation plan of a bank holding company that (1) provides an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits, or (2) could lead to material financial loss to the bank holding company. This provision applies regulatory authority that is currently applicable to banks to their holding companies. (§ 956)

[6] The SEC adopted new rules in December 2009 requiring public companies to disclose the extent of the board's role in risk oversight, such as how the board administers its oversight function, and the effect that this has on the board's leadership structure. The final rules give companies the flexibility to describe how the board administers its risk oversight function, such as through the whole board, or through a separate risk committee or the audit committee. For additional information, see "SEC Approves Enhanced Proxy Disclosures-What To Do In Advance of Your 2010 Annual Meeting," available at: http://www.arnoldporter.com/public_document.cfm?id=15041&key=27B1.

Under the House Bill, Federal regulators must jointly prescribe regulations to require "covered financial institutions" to disclose to the appropriate Federal regulator the structures of all incentive-based compensation arrangements. "Covered financial institutions" include banks and savings associations and their respective holding companies, registered broker-dealers, credit unions, investment advisers, Fannie Mae, Freddie Mac, and any other financial institution that the appropriate Federal regulators jointly determine should be treated as a covered financial institution. Federal regulators must jointly prescribe rules that prohibit any incentive-based payment arrangement that the regulators determine encourage "inappropriate risks" by covered financial institutions that could threaten their safety and soundness or have serious adverse effects on economic conditions or financial stability. These requirements do not apply to covered financial institutions with assets of less than US$1 billion. (§ 2004)

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