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Corporate Governance and Executive Compensation Provisions in Dodd Financial Services Reform Bill

The financial services reform bill released in draft form by Senator Christopher Dodd (D-CT) on November 10 contains a number of provisions dealing with executive compensation and corporate governance that would be applicable to all U.S. publicly-traded companies or, in some cases, to those companies listed on a U.S. stock exchange. Many of these provisions expand on provisions included in the Sarbanes-Oxley Act. Although the bill has not yet been formally introduced, and it is too early to tell how it will fare, the draft bill provides a heads-up to areas of potential change.

Say on Pay

The bill would require any proxy for a shareholder meeting to include a separate non-binding vote to approve the compensation of executives "as disclosed pursuant to" Item 402 of SEC Regulation S-K. The bill would also require disclosure of any policy that the company has regarding payment to the CEO upon a merger or other corporate transaction of compensation that was not previously subject to a "say on pay" vote, and would require a separate non-binding shareholder vote with respect to such policy. These provisions would be effective for any shareholder meeting occurring more than one year after enactment of the legislation. The bill expressly provides that these "say on pay" votes would not change the fiduciary duties of the board of directors or limit the rights of shareholders to submit proposals on executive compensation for inclusion in the proxy statement.

Compensation Committee Independence

The SEC would be directed to adopt rules requiring the stock exchanges to adopt listing conditions imposing the following requirements on compensation committees:

- All members of the compensation committee would have to be "independent" as defined by the applicable stock exchange. The definition would need to take into account the source of the director's compensation and whether the director is an affiliate of the issuer, as well as other relevant factors. The stock exchanges would have authority to exempt particular relationships from the independence requirements, based on the size of the issuer and other relevant factors.

  Comment: Since NYSE and Nasdaq already require executive compensation to be determined by a committee of independent directors (subject to a limited exception in the case of Nasdaq), the primary effect of this provision is to change the definition of independence.

- All compensation consultants, legal counsel, and other advisers to the compensation committee would have to be "independent" as defined by the SEC.

- The compensation committee would be given discretion to retain compensation consultants, legal counsel, and other advisers, and would be directly responsible for their appointment, compensation, and oversight. The company would be required to provide funding for this purpose.

  Comment: This would expand to the compensation committee provisions currently applicable to the audit committee and currently applied by NYSE only with respect to compensation consultants.

- Proxy statements for annual meetings would be required to disclose whether the compensation committee has obtained advice from a compensation consultant and whether the work of the consultant raised any conflict of interest (and if so, the nature of the conflict and how it is being

addressed).

- The stock exchanges would be permitted to exempt categories of issuers from the compensation committee requirements.

The SEC would be required to conduct a study of the use of compensation consultants and the effects of such use on company performance.

Additional Executive Compensation Disclosures

The SEC would be required to adopt rules mandating "a clear description" of all compensation required to be disclosed under Item 402 of Regulation S-K, as well as information showing the relationship between executive compensation and the financial performance of the company, specifically including a graphic comparison of such relationship over a five-year period.

Clawback

All publicly-traded companies would be required to implement a clawback policy which would be triggered in the event of an accounting restatement due to the company's "material noncompliance" with any financial reporting requirement. If the policy was triggered, all current and former executive officers of the company would be required to repay to the company all incentive compensation (including stock options) they received in the three years before the date on which the company was required to prepare the restatement, to the extent such amounts exceed what they would have received under the financial statements as restated.

Comment: This is a significant expansion of the clawback provision contained in the Sarbanes-Oxley Act, most notably in that repayment would be required even in the absence of misconduct.

Disclosure of Policy on Employee Hedging

The SEC would be directed to adopt rules requiring proxy statement disclosure of whether the company permits its employees to purchase financial instruments that hedge or offset a decrease in the market value of company equity securities granted as compensation. The types of instruments covered by the disclosure would include prepaid variable forward contracts, equity swaps, collars, and exchange funds.

Majority Election of Directors

The bill would impose a majority vote standard for uncontested elections of directors for companies listed on a stock exchange. (A plurality standard would continue to be permitted in the case of contested elections.) A director who failed to receive a majority of the votes cast in an uncontested election would be required to tender his or her resignation to the company's board. The board would then have the choice to either (i) accept the resignation and disclose the date it would take effect, or (ii) unanimously decline to accept the resignation, in which case it would be required to disclose the reason for not accepting the resignation and why this decision was in the best interests of the company and its shareholders. In what appears to be an effort to avoid direct conflict with state corporation laws, the provision would be implemented by having the SEC adopt rules requiring the stock exchanges to include it as a listing standard. The SEC would have authority to exempt smaller issuers (as defined by the SEC) from these provisions.

Staggered Boards

The bill would prohibit staggered boards of listed companies unless approved by shareholders. The vote required for approval would be the vote required to amend the company's charter, if the provision for a staggered board is contained in the charter, or bylaws, if the staggered board provision is contained in the bylaws. In what appears to be an effort to avoid direct conflict with state corporation laws, the SEC would be directed to adopt rules within one year of enactment requiring the stock exchanges to add this provision as a listing standard. Companies whose shareholders had not previously approved the staggered board by the required vote would need to obtain such approval at the next annual meeting following SEC adoption of the rule (or, if that annual meeting was scheduled to be held within 120 days after the effective date of the SEC rule, at the subsequent annual meeting).

Proxy Access

The bill would require the SEC to adopt rules, within 180 days of enactment, permitting shareholders to have access to the company's proxy soliciting materials for the purpose of nominating directors. The SEC would be authorized to determine the terms and conditions of such access.

Disclosure Regarding Chairman and CEO Positions

The SEC would be required to adopt rules, within 180 days of enactment, requiring disclosure in the annual proxy statement of the reasons the company has chosen to either separate or not separate the positions of chairman of the board and CEO.

Regulation of Compensation Paid by Financial Institutions

The bill contains several provisions that would limit the compensation payable by financial institutions. Some of these would apply to employees generally, not just executive officers.

- The new Financial Institutions Regulatory Authority (FIRA) provided for by the bill would be directed to establish standards prohibiting as an unsafe and unsound practice any compensation plan of a bank holding company that provides an executive officer, employee, director, or principal shareholder with "excessive compensation, fees, or benefits" or that could lead to material financial loss to the bank holding company.

  In establishing these standards, FIRA would be directed to take into consideration the compensation standards currently contained in the FDIC Act (which include the total value of compensation and benefits paid to the individual, the individual's compensation history, the amount of compensation paid to comparable individuals at the particular institution and at comparable institutions, the projected cost of the benefit (for postemployment benefits), and the financial condition of the financial institution).

- Bank regulators would be directed to prohibit payment by a depository institution holding company of executive compensation that is excessive or that could lead to material financial loss to either the depository institution or the holding company.

- Bank regulators would be authorized to impose higher capital standards for an institution whose compensation practices the regulator determines pose a "risk of harm" to the institution.

For more information about the Dodd bill or other proposed corporate governance legislation or about Hughes Hubbard's corporate governance practice, please contact any of the following attorneys:

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