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Corporate Governance Proposals in Senator Dodd's Restoring American Financial Stability Act of 2009 Discussion Draft

On November 10, 2009, Sen. Christopher Dodd, chairman of the Senate Committee on Banking, Housing and Urban Affairs, circulated a discussion draft proposing legislation aimed at financial sector reform. The discussion draft, titled the "Restoring American Financial Stability Act of 2009" (the "Dodd Proposal"), sets forth proposed legislation relating to many of the areas originally contemplated in the U.S. Treasury Department's white paper on financial sector regulatory reform that was released in June. The Dodd Proposal covers many areas, including systemic regulation, enhanced resolution authority, the regulation of advisers to hedge funds and other investment vehicles, the insurance industry, the regulation of over-the-counter derivatives, credit rating agencies, consumer protection, corporate governance and executive compensation.

This memorandum focuses on the corporate governance proposals under Title IX, Subtitles E and G of the Dodd Proposal. These provisions, while largely consistent with the proposed Shareholder Bill of Rights Act of 2009 introduced by Senators Charles Schumer and Maria Cantwell in May (the "Schumer Proposal") and subsequently referred to the Senate Committee on Banking, Housing and Urban Affairs, differ from the corresponding provisions in the Schumer Proposal in certain respects. This memorandum compares the corporate governance proposals in the Dodd Proposal with the Schumer Proposal and proposed changes to SEC disclosure rules.

Majority voting in uncontested director elections. Similar to the Schumer Proposal, the Dodd Proposal mandates that directors of all listed companies be elected by a majority of votes cast in uncontested elections. Directors who do not receive the requisite majority of votes cast would be required to tender their resignations. Unlike the Schumer Proposal, in which the resignations must be accepted by the board of directors, the Dodd Proposal provides the board of directors with the option to decline the resignation by unanimous vote, provided the board makes public, within 30 days of the decision or such earlier period as the SEC may establish, the reasons for declining the resignation and why the board believes that its decision is in the best interests of the company and its shareholders.

In contested elections, defined as elections where the number of nominees exceeds the number of directors to be elected, both the Dodd Proposal and the Schumer Proposal provide that directors would continue to be elected by a plurality of the shares represented at a meeting and entitled to vote.

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Under the Dodd Proposal, national securities exchanges would be prohibited from listing the securities of companies that do not provide for compliant majority voting. The Dodd Proposal grants the SEC the authority to exempt any company from this provision depending on its size, market capitalization, the number of shareholders of record, or any other criteria, as the SEC may deem necessary and appropriate in the public interest or for the protection of investors.

Risk committee. The Dodd Proposal requires all systemically important financial companies that are publicly traded to have a risk committee. The proposed Agency for Financial Stability ("AFS") would also promulgate regulations that would require all publicly traded bank holding companies with assets over $10 billion to have a risk committee. The Schumer Proposal, in contrast, requires all public companies to have risk committees.

Under the Dodd Proposal, the risk committees would be required to consist of a number of independent directors as specified by the AFS. The risk committees would also include at least one risk management expert having experience in "identifying, assessing, and managing risk exposures of large, complex firms."

The Schumer Proposal requires risk committees to consist entirely of independent directors. It does not contain any provisions in relation to risk committee experts.

Proxy access. Under the Dodd Proposal (like the Schumer Proposal), the SEC would be required to issue rules permitting the use by shareholders of proxy solicitation materials supplied by a listed company for the purpose of nominating candidates to the board of the issuer. While the Schumer Proposal would require that the nominating shareholder have beneficially owned not less than 1% of the voting securities of the issuer, directly or indirectly, for two or more years, the Dodd Proposal does not contain such parameters. The SEC has, in fact, already issued a proposal that would establish a proxy access regime for U.S. listed companies, including (i) the creation of a new proxy rule that would affirmatively allow shareholder nominations in company proxy materials subject to certain conditions (including a three-tiered share ownership requirement based on the size of the issuer and a less stringent one-year holding period) and (ii) the narrowing of Rule 14a-8(i)(8)'s election exclusion to allow shareholder proposals relating to a shareholder nomination process or related disclosure.

Staggered boards. Under the Dodd Proposal, listed companies would be prohibited from having boards with staggered terms unless shareholders approve or ratify such an arrangement. The percentage of shareholders required to approve or ratify such staggered boards would be the percentage required to amend the constitutive document that provides for the staggered board.

Under the Dodd Proposal, national securities exchanges would be prohibited from listing the securities of companies that are not in compliance with the above requirements in relation to staggered boards. Neither the SEC nor the national securities exchanges have been granted exemptive authority in relation to these provisions. It remains to be seen if these provisions will apply to all listed companies.

The Schumer Proposal does not provide for shareholder approval or ratification of boards with staggered terms. It completely eliminates staggered boards and requires U.S. listed companies to elect all directors annually.

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Disclosures relating to leadership structure. The Dodd Proposal calls on the SEC to issue rules to require domestic companies to disclose in their annual proxy statement why the same or different persons have been chosen to serve as chairman and CEO.

The proposal mirrors disclosure requirements proposed by the SEC in July, which would require that domestic listed companies discuss whether and why they have chosen to combine or separate the principal executive officer and board chair positions. The Schumer Proposal, in contrast, requires all public companies to have independent chairmen.

Say-on-pay and golden parachutes. Similar to the Schumer Proposal, the Dodd Proposal would require domestic companies to have a nonbinding, advisory shareholder vote on the "compensation of executives" whenever any proxy statement for a shareholder meeting is required by the SEC's proxy rules to include compensation disclosure. Also similar to the Schumer Proposal, the Dodd Proposal would require any person soliciting proxies in connection with a business combination transaction to disclose in its solicitation materials any agreements or understandings that such person has with any principal executive officers of the target or the acquiror concerning any type of compensation (present, deferred or contingent) that is related to the business combination and to require a separate shareholder vote to approve such arrangements, unless already approved as part of a broader say-on-pay vote.

Compensation committees. The Dodd Proposal would require that compensation committees at all listed companies consist solely of independent directors. Director independence would depend on the source of director compensation and affiliations with the company.

Under the Dodd Proposal, national securities exchanges would be prohibited from listing the securities of companies that are not in compliance with the compensation committee independence requirements. The Dodd Proposal grants the authority to the SEC to permit national securities exchanges to exempt particular relationships from the above requirements depending on the size of the company and any other relevant factors.

The Schumer Proposal does not contain any provisions relating to compensation committee independence.

Under the Dodd Proposal, all consultants, legal counsel or other advisers engaged by the compensation committee must also be independent, as defined by the SEC, and the company must provide appropriate funding for such advisers. The compensation committee would also be directly responsible for the appointment, compensation and oversight of the work of the compensation consultant. A company would be required to disclose in its proxy or consent solicitation material for annual shareholder meetings (or special meetings in lieu of annual meetings) whether (a) the compensation committee engaged or obtained the advice of a compensation consultant and (b) the work of the compensation committee has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.

The provisions in the Dodd Proposal in relation to say-on-pay, golden parachutes and compensation committee independence broadly reflect the provisions of the Corporate and Financial Institution Compensation Fairness Act of 2009 approved by the House of Representatives in July.

Other executive compensation proposals. The Dodd Proposal also includes the following proposals relating to executive compensation:

- disclosure of the relationship between a company's executive compensation and financial performance and a graphic or pictorial comparison of the amount of executive compensation and the financial performance of the company or return to investors of the company during a five-year period, or such other period, as determined by the SEC;
- adoption by companies of clawback policies for current and former executive officers, triggered based on material non-compliance by the company with financial reporting requirements that led to accounting restatements, during the three-year period preceding the date on which the company is required to prepare the accounting restatement;
- disclosure by companies of whether employees are allowed to hedge the value of equity grants;
- amendments to the Bank Holding Company Act making it an unsafe and unsound practice for bank holding companies to provide their executive officers, directors, employees or principal shareholders with compensation that is excessive or could lead to material financial loss, and directing the applicable banking regulator to prohibit such practices; and
- giving the applicable banking regulator the right to impose higher capital charges if an institution's compensation practices "pose a risk of harm" to itself.

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Next steps. The Dodd Proposal will have to be approved by the Senate Committee on Banking, Housing and Urban Affairs before passing to the full Senate for a vote. Upon securing the vote of the Senate, elements of the proposal will have to be merged with the corresponding elements in proposals being prepared in the House of Representatives, including the "Financial Stability Improvement Act of 2009" and the "Shareholder Empowerment Act of 2009" being prepared by the House Financial Services Committee. While the Financial Stability Improvement Act of 2009 does not contain proposals related to corporate governance, the Shareholder Empowerment Act of 2009 does contain certain corporate governance proposals that are broadly similar to the Dodd Proposal, including majority voting in uncontested elections, proxy access and say-on-pay. However, it does not contain proposals in relation to risk committees or compensation committee independence, and mirrors the Schumer Proposal in requiring all public companies to have independent chairmen.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Any questions concerning the issues addressed in this memorandum may be directed to Mark S. Bergman (44-20-7367-1601), Raphael M. Russo (212-373-3309) or Frances F. Mi (212-373-3185).