CORPORATE GOVERNANCE

Anticipating Financial Regulatory Reform

With the health care bill signed into law, Washington has now turned its attention to financial regulatory reform. The Senate Banking Committee recently approved a bill that would fundamentally alter the landscape of financial regulation in the United States. Many of the proposals are targeted at financial institutions, but others, including significant corporate governance reforms, would apply to all public companies. Given the strong possibility of new legislation this year, companies should begin anticipating the impact of these governance proposals.

On the executive compensation front, here are some of the proposals currently being considered:

• **Say-on-pay.** Every public company would be required to include in its annual proxy statement a nonbinding shareholder resolution to approve the company's executive compensation. Mandatory say-on-pay would bring a heightened level of scrutiny to compensation decisions, but may not ultimately have a significant impact on compensation levels, other than in egregious cases.

• **Compensation committees.** Listed companies would be required to have fully independent compensation committees, based on new independence standards. Compensation committees would be explicitly charged with hiring and overseeing compensation consultants and would be required to consider certain independence factors when doing so. If they have not already done so, boards should reexamine their compensation committee charters and consultant arrangements in anticipation of these reforms.

• **Executive compensation disclosures.** The SEC would require public companies to disclose (i) the relationship between executive compensation actually paid and a company's historical financial performance and (ii) the relationship between CEO compensation and the median annual total compensation of all employees. Companies should begin considering the impact of these disclosures, but unless otherwise material, need not attempt to provide this disclosure until the SEC adopts final rules.

• **Clawbacks.** Every listed company would have to implement a clawback policy requiring executive officers to reimburse the company for previously-paid incentive-based compensation following a restatement, whether or not the restatement was caused by the officers' misconduct. This would extend the clawback provision contained in the Sarbanes-Oxley Act, which applies only to compensation received by the CEO and CFO.

• **Hedging disclosure.** Public companies would be required to disclose whether they permit officers and directors to purchase financial instruments designed to hedge against decreases in the value of company stock they hold. If a company does not already have a formal hedging policy, the board should consider adopting one.

The legislation being considered also includes the following additional corporate governance measures:

• **Majority voting for director elections.** Stock exchanges would be directed to impose new listing standards requiring a majority vote in uncontested director elections (the plurality standard would remain for contested elections). Companies would have to require the resignation of any director who receives less than a majority vote in an uncontested election, unless the board unanimously declines to accept the director's resignation. Majority voting, together with proxy access (described below), will bring a heightened focus on director nominations and director elections generally.

• **Proxy access.** The SEC would be given explicit authority to promulgate rules requiring companies to include nominees submitted by shareholders in proxy solicitation materials. Proxy access has been the subject of fierce debate for some time and it appears likely that the SEC will finally adopt rules this year. For most public companies, this will mean greater focus on board/shareholder relations and require better communications between the company and its shareholders to ensure that the board's various business and corporate governance strategies have broad support.

• **Limits on broker discretionary voting.** Broker discretionary voting would not be permitted in connection with director elections, say-on-pay votes, or other significant matters. This principle, which has already been implemented by the SEC in respect of directors' elections, will take on heightened importance when coupled with majority voting.

• **Chairman and CEO disclosures.** The SEC would be directed to promulgate rules requiring public companies to disclose in their proxy statements the reason the same person was chosen to serve as both chairman of the board and chief executive officer, or why different individuals were selected to serve in each of these roles. The legislation being considered stops short of requiring an independent chairman of the board.

The final outcome of these proposed measures is still anybody's guess—and many of the proposals would require further rulemaking by the SEC or the stock exchanges before they take effect. Still, the momentum for financial regulatory reform remains strong. Public companies and their boards would be well advised to get ahead of the curve and begin considering the potential impact of these measures on their governance policies.

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David S. Huntington

David S. Huntington is a partner with Paul, Weiss, Rifkind, Wharton & Garrison LLP. Prior to joining the firm, he served as counsel to successive chairmen at the U.S. Securities and Exchange Commission, where he was responsible for providing legal and policy advice on a variety of regulatory and enforcement matters.

CORPORATE BOARD MEMBER MAGAZINE | As seen in *Corporate Board Member* magazine 2nd Quarter 2010