

## Corporate Finance and Securities Client Service Group

To: Our Clients and Friends

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## Senate Adopts Corporate Finance and Executive Compensation Provisions in Financial Reform Bill

Yesterday, the Senate released the text of the financial reform bill that was passed last week. The bill, known as the "Restoring American Financial Stability Act of 2010" or the "Act," would result in sweeping reforms to the financial industry. However, it also contains a number of significant provisions that would affect corporate governance and executive compensation at public companies, as well as Regulation D private placements, whistleblowers and beneficial ownership reporting.

The House, which passed the "Wall Street Reform and Consumer Protection Act of 2009" or the "House Bill" last December, and the Senate are now proceeding to the reconciliation process. As a result, it is difficult to predict what changes, if any, will be made to the final legislation.

Some of the more important provisions of the Act are the following:

### Corporate Governance Requirements

**Majority Voting for Directors.** Within one year of enactment, stock exchanges would adopt rules prohibiting the listing of companies that fail to comply with the following voting standards:

- election of directors by a majority of votes cast, in uncontested elections, and by a plurality of shares represented and entitled to vote, in contested elections
- if a director receives less than a majority of votes cast in an uncontested election, the director would tender his or her resignation, and the board would either:
  - accept the resignation, determine when it will take effect and publicly disclose the date, generally within a reasonable period of time, as established by the SEC, or
  - upon a unanimous vote, decline to accept the resignation and, within 30 days (or such shorter period as the SEC may establish), publicly disclose its reasons for the decision and why it was in the best interests of the company and its shareholders.

The SEC would be permitted to exempt companies from these requirements, based on their size, market capitalization, number of record holders or other factors. The House Bill does not contain a comparable provision.

**Authorization of Proxy Access Rules.** The Act would authorize the SEC to adopt rules that would (1) require proxy or consent solicitations to include a director nominee submitted by a shareholder, and (2) require companies to follow certain procedures relating to such a solicitation. Like the House Bill, the Act authorizes, but does not require, the SEC to adopt such rules.

**Disclosures regarding Chairman and CEO.** Within 180 days after enactment, the SEC would issue rules requiring companies to disclose in annual proxy statements the reasons why the company has chosen the same person or different persons to serve as chairman and CEO. (The Act does not appear to acknowledge the recent SEC rules requiring substantially similar disclosures). The House Bill does not contain a comparable provision.

**Risk Committees for Financial Institutions.** The Fed would be directed to require publicly traded nonbank financial holding companies (within one year of a specified notice), as well as publicly traded bank holding companies with total assets of note less than \$10 billion, to establish a risk committee. The Fed would also be permitted to require smaller bank holding companies to establish such a committee. The risk committee would:

- oversee enterprise-wide risk management practices,
- include such number of independent directors as the Fed may determine, based on the nature of operations, size of assets and other factors, and
- include at least one risk management expert with experience in identifying, assessing and managing risk exposures of large, complex firms.

The House Bill does not have a comparable provision.

## **Executive Compensation Provisions**

**Non-Binding Say-on-Pay.** Beginning with annual or special meetings of shareholders occurring six months after enactment, public companies would be required to include a non-binding say-on-pay proposal in their proxy materials. The proposal would relate to the compensation of named executive officers as disclosed pursuant to S-K Item 402, which encompasses CD&A as well as the compensation tables and accompanying narrative.

The proposal would not be construed as overruling any decision by the company or the board; creating or implying any change to or any additional fiduciary duties; or restricting or limiting the ability of shareholders to submit Rule 14a-8 executive compensation proposals.

The House Bill is similar, but would also require, in any shareholder vote on an M&A transaction, a non-binding vote on “golden parachutes,” or compensation arrangements related to the transaction. Additionally, the House Bill only applies to annual meetings and special meetings in lieu thereof. Further, the House Bill would require fund managers subject to Section 13(f) to report annually on any such votes.

**Compensation Committees.** The SEC would be directed, within 360 days of enactment, to require stock exchanges to adopt rules prohibiting the listing of companies that fail to comply with new requirements for the independence of compensation committee members and consultants, independent legal counsel and advisors. The SEC may permit a stock exchange to exempt a category of companies from these requirement if deemed appropriate by such exchange.

***Independence of Committee Members.*** The new SEC rules would require stock exchanges to establish an independence standard that considers:

- the source of compensation of the committee member, including any consulting, advisory, or other compensatory fee paid by the company to such member, and
- whether the member of the committee is affiliated with the company or any of its subsidiaries or affiliates.

SEC rules would permit stock exchanges to exempt particular relationships from these requirements, based on the size of the company and any other relevant factors.

***Independence of Consultants, Legal Counsel and Advisors.*** Compensation committees would only be permitted to utilize a consultant, legal counsel or other advisor after considering factors to be specified by new SEC rules, which would include:

- the provision of other services to the company by the firm that employs the adviser (the "Firm"),
- the amount of fees received from the company by the Firm as a percentage of the total revenue of such Firm,
- the policies and procedures of the Firm that are designed to prevent conflicts of interest,
- any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee, and
- any stock of the issuer owned by the compensation consultant, legal counsel, or other adviser.

***Compensation Committee Authority and Funding.*** Although already addressed by many committee charters, the Act would grant compensation committees authority, in their discretion, to retain or obtain the advice of a consultant, legal counsel or other advisors. Further, the committee would be directly responsible for the appointment, compensation and oversight of the work of any such advisor. The Act expressly provides that committees are not obligated to follow the advice of any such advisor and can exercise their own judgment in fulfilling their duties. Companies would be required to provide appropriate funding, as determined by the committee, to provide reasonable compensation to consultants, independent legal counsel or other advisors.

***Disclosure in Proxy Statements.*** Beginning with annual meetings of shareholders (or special meetings in lieu thereof) occurring one year after enactment, public companies would be required to disclose in their proxy materials (1) whether the committee retained or obtained advice from a consultant; and (2) any conflict of interest raised by the work of the consultant and its nature and how it was addressed. This requirement does not appear to apply to independent legal counsel or other advisors.

The House Bill contains comparable provisions, except that (1) the effective date would be not later than nine months instead of 360 days of enactment, and (2) compensation consultants or advisors to compensation committees would be required to meet independence standards established by SEC rule.

**Clawback of Executive Compensation.** The SEC would direct stock exchanges to prohibit the listing of companies that fail to adopt “clawback” policies. Listed companies would be required to adopt, disclose and implement policies that provide, in the event of an accounting restatement due to material noncompliance with any financial reporting requirement under securities laws, that the company will recover from any current or former executive officer who received incentive-based compensation (including stock options) during the preceding three-year period, based on erroneous data, in excess of what would have been paid under the restatement.

This provision would expand the existing clawback provision under Section 304 of Sarbanes-Oxley, which only applies to the CEO and CFO, looks-back only 12 months, and requires misconduct. The House Bill does not contain a comparable provision.

**Pay versus Performance.** The SEC would adopt rules requiring proxy statement disclosure showing the relationship between executive compensation actually paid and the financial performance of the company, taking into account any change in the value of stock and dividends of the company and any distributions. The disclosure may include a graphical representation. The House Bill does not contain a comparable provision.

**Relative Pay Ratio.** The SEC would amend S-K Item 402 to require disclosure of:

- the median of annual total compensation of all employees, excluding the CEO,
- the annual total compensation of the CEO, and
- the ratio of the amounts in the two bullet points.

“Total compensation” would be determined in accordance with rules governing the Summary Compensation Table. The House Bill does not contain a comparable provision.

**Employee and Director Hedging Policy.** The SEC would adopt rules requiring companies to disclose in annual proxy materials 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 any decrease in market value of equity securities (1) granted by the company as part of his or her compensation or (2) held directly or indirectly by such individual. The House Bill does not contain a comparable provision.

**Excessive Compensation by Bank Holding Companies.** Within 180 days after the first anniversary of enactment, the Fed, in consultation with banking regulators, would be required to adopt 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

- could lead to “material financial loss” to the bank holding company.

### **Discretionary Voting by Brokers**

Stock exchanges would be required to prohibit the exercise of discretionary voting authority by brokers with respect to the election of directors, executive compensation or “any other significant matters, as determined by the SEC.” Notably, this prohibition would apply to the mandatory say-on-pay proposals discussed above. The House Bill does not contain a comparable provision.

### **Additional Whistleblower Protections**

**Awards.** The Act would create an investor protection fund for payments to whistleblowers. Subject to certain exceptions, the SEC would be required to pay a bounty to individuals who voluntarily provide “original information” leading to a successful enforcement action by the SEC or certain related matters. The whistleblower would be entitled to receive an amount between 10% and 30% of any monetary sanctions exceeding \$1 million, as determined by the SEC. The Act disqualifies certain categories of individuals who would not be eligible to receive a payment.

**Private Right of Action.** Whistleblowers would have a private right of action against employers who discharge, demote, suspend, threaten, harass or discriminate against them because of any lawful act in providing information to or assisting the SEC in an enforcement action. The statute of limitations would be six years from the violation or three years from when material facts became known or reasonably should have been known

Remedies under the private of action would include (1) reinstatement, (2) two times the amount of back pay, with interest, and (3) reimbursement for litigation costs and fees, including reasonable attorneys’ fees.

**Employees of Subsidiaries.** The anti-retaliation provisions of Sarbanes-Oxley would be amended to clarify that employees of subsidiaries and affiliates of public companies are protected, not just parent company employees.

The House Bill contains comparable provisions, but does not provide for a minimum bounty.

### **Regulation D**

**New Bad Boy Disqualification.** The SEC would be directed to adopt regulations within one year that would disqualify certain offers and sales of securities from eligibility to utilize Regulation 506, the exemption under Regulation D available for private placements in any amount. The disqualifications:

- would include criteria substantially similar to Rule 262 under Regulation A, and
- would cover any offer or sale “by any person” who (1) is subject to a final order by state securities commissions or certain financial regulatory authorities that
  - bar the person from (i) association with certain regulated entities, (ii) engaging in the business of securities, insurance or banking, or (iii) engaging in savings association or credit union activities, or

- o constitutes a final order relating to certain anti-fraud prohibitions within the past ten years, or

(2) has been convicted of a felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the SEC.

**Changes to Accredited Investor Standard.** The SEC would be directed to adjust the net worth standard for “accredited investor” status, so that the individual net worth of any natural person, or joint net worth with his or her spouse, exceeds \$1 million (as periodically adjusted by SEC rule beginning four years after enactment) - excluding the value of their primary residence. The SEC would be directed to review the standard to determine whether adjustments are needed for the protection of investors, in the public interest and in light of the economy, within four years after enactment, and not less frequently than every four years thereafter.

### **Beneficial Ownership Through Swaps**

The Act would amend Section 13 of the Securities Exchange Act of 1934 to authorize the SEC to bring security-based swaps within the meaning of beneficial ownership. Specifically, Sections 13(d) and 13(g) would be amended to provide that beneficial ownership requiring reporting on Schedules 13D or 13G and Form 13F would include beneficial ownership “upon the purchase or sale of a security-based swap that the [SEC] may define by rule.” The House Bill contains a comparable provision.

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