Morgan Lewis

financial regulatory reform lawflash

alert

www.morganlewis.com

Financial Reform Bill Imposes New Corporate Governance Requirements

The latest on financial reform provisions relating to proxy access, board leadership structure, board risk and compensation committees, broker voting, and internal control over financial reporting that will affect many public companies.

July 21, 2010

As a vehicle to reform not only financial services firms but also most public companies, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), signed into law by President Obama today, focuses on systemic regulation, creation of a financial stability oversight council, enhanced resolution authority, and increased regulation. In addition, the Act has provisions relating to executive compensation and corporate governance that directly and significantly affect executives, directors, companies, and shareholders, and continue the federalization of corporate governance that largely began with Sarbanes-Oxley. Our July 16, 2010 LawFlash focused on the Act's key provisions relating to executive compensation.[1] Below, we discuss the corporate governance implications of the Act.

Proxy Access

The Act amends Section 14(a) of the Exchange Act to provide that the SEC may, but is not required to, issue rules either allowing or requiring a company to permit its shareholders to use the company's proxy solicitation materials for the purpose of nominating directors. The SEC has discretion to exempt certain issuers from proxy access requirements, taking into account considerations such as whether the requirements would disproportionately burden small issuers.

While the Act does not stipulate when such rules would need to be implemented, the SEC already proposed proxy access rules in June 2009. These proposed rules generated considerable debate, and the SEC subsequently received numerous comment letters questioning both the advisability of proxy access and the SEC's authority to adopt its proposed rules. Once given the express statutory authority to do so by this legislation, the SEC is expected to proceed with final rules applicable to the 2011 proxy season. The possibility of proxy access requirements is perhaps the most controversial and potentially divisive aspect of the corporate governance reforms, with some business organizations, such as the U.S. Chamber of Commerce, threatening litigation if the SEC adopts the proposal.

Chairman and CEO Positions

Within 180 days after the Act's enactment, the SEC must issue rules mandating disclosure by companies in their annual proxy statements of the reasons why they have chosen the same person, or different

---

1 The July 16 LawFlash, "Financial Reform Bill Imposes Significant New Executive Compensation and Corporate Governance Requirements," is available at http://www.morganlewis.com/pubs/FRR_NewExecCompAndCorpGovReq_LF_16jul10.pdf.

individuals, as the case may be, to serve as chairman of the board and chief executive officer.

The Act's provisions in this area may not affect most companies' current disclosure. The SEC amended its proxy rules in December 2009 to require similar disclosure regarding board leadership structure, including whether and why a company has chosen to combine or separate the chief executive officer and chairman of the board positions, and the reasons why the company believes that this board leadership structure is the most appropriate.

Risk Committees

The Act requires all publicly traded nonbank financial companies supervised by the Board of Governors of the Federal Reserve System to establish a risk committee, with the responsibilities described below, within one year of the date of receipt of final determination by the Board of Governors.

In addition, each publicly traded bank holding company with assets of $10 billion or more must have a risk committee. The Board of Governors is authorized, but not required, to require publicly traded bank holding companies with assets of less than $10 billion to also establish risk committees.

The risk committee required by the Act will be responsible for oversight of the company's enterprisewide risk management practices. The Board of Governors will determine the number of independent directors required to serve on the committee, based on factors such as the nature of the company's operations, the size of the company's assets, and other criteria. The risk committee must, however, include at least one risk management expert with experience in identifying, assessing, and managing large, complex firms.

The SEC's proxy rules as amended in December 2009 already require disclosure by all public companies of their risk oversight procedures. Under these new rules, the SEC directs companies to address the board's role in risk oversight, recognizing that different types of companies will have different structures for overseeing risk, with most companies engaging their audit, compensation, and governance committees as well as the full board in the process. While some companies already have risk committees, typically to address highly technical or specialized financial operations, the requirement in the Act to impose a "one size fits all" requirement for the supervised nonbank financial companies appears to run counter to what most corporate governance commentators have determined to be current "best practice."

Compensation Committees

The Act contains numerous provisions regarding the substance and disclosure of executive compensation; such provisions were discussed in detail in our July 16, 2010 LawFlash. Accordingly, we discuss herein only the Act's corporate governance provisions relating to compensation. The SEC has 360 days after enactment of the Act to adopt rules that direct the national securities exchanges to prohibit the listing of any security of an issuer that does not comply with these requirements relating to compensation committees. The Act directs the SEC to adopt rules that permit the exchanges to exempt a category of issuers from the requirements, taking into account the potential impact of the requirements on smaller reporting issuers.

Independence

The Act requires public companies other than controlled companies, limited partnerships, companies in bankruptcies, certain foreign private issuers, and open-ended management investment companies to have compensation committees composed entirely of independent directors. To determine independence, the SEC's rules must provide that companies should take into account all relevant factors, specifically including the following:

(i) The specific sources of compensation of a member, including any consulting, advisory, or other compensatory fees paid by the issuer to the member

(ii) Whether the member is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer

The exchanges will have discretion to exempt certain relationships as they determine appropriate, based on relevant factors, including the company's size.

Although not mandated by Sarbanes-Oxley, the corporate governance listing criteria of both the New York Stock Exchange and the NASDAQ Stock Market already require that executive compensation be reviewed and administered either by a compensation committee composed of independent directors (NYSE) or by such a committee or a majority of the independent directors (NASDAQ). The Act goes further to provide that consideration be given to the sources and nature (apart from the amount) of any compensation the director receives and to whether a director is "affiliated" with the public company or its subsidiaries. Affiliate status (in this context, meaning share ownership) is currently not an "independence" criteria in either exchange's listing rules, although it is a criterion for eligibility to serve on an audit committee under the Sarbanes-Oxley Act and the related SEC rules.

The provision fails to address the "outside director" requirement of Section 162(m) of the Internal Revenue Code or the "nonemployee director" requirement of SEC Rule 16b-3. As a result, companies will have to comply with at least three differing sets of requirements regarding the composition of their compensation committees.

Use of Advisors

The Act requires that compensation committees have the authority to retain their own compensation consultants, independent counsel, and other advisors to assist them with compensation-related duties and obligations. Before hiring any counsel, consultant, or advisor, a compensation committee is to evaluate factors identified in SEC rules that affect the independence of such third parties, such as (i) whether the advisor's employer provides other services to the company, (ii) the amount of fees received by the advisor's employer (as a percentage of the total revenue of the employer), (iii) conflict-of-interest policies and procedures of the advisor's employer, (iv) any relationship between the advisor and members of the compensation committee, and (v) any equity ownership that the advisor may have in the company. The Act requires companies to provide adequate funding to allow their compensation committees to retain independent compensation consultants, counsel, and other advisors.

Consultant Disclosures

Any proxy or consent solicitation material for an annual meeting of the shareholders (or a special meeting in lieu of the annual meeting) occurring on or after one year from the enactment of the Act will be required to disclose, pursuant to SEC rules, whether the compensation committee retained or obtained advice from a compensation consultant and whether the consultant's services created any conflict of interest, and, if so, the nature of the conflict of interest and how the conflict is being addressed.

Broker Voting

The Act amends Section 6(b) of the Exchange Act to require the rules of a registered national securities exchange to preclude brokers from voting securities that they do not own beneficially for the election of directors or for executive compensation, or any other significant matters, as determined by SEC rule, unless the beneficial owner of the securities instructs the broker on how to vote. Although the New York Stock Exchange already precludes brokers from voting on a discretionary basis on the election of directors and various other matters, including the approval of equity-based compensation plans and certain other compensatory and retirement plans, the Act expands that prohibition to apply to executive compensation generally. Therefore, the Act precludes brokers from voting on the "Say on Pay" provisions also required by the Act, and authorizes the SEC to identify other matters on which brokers should be precluded from voting.

Sarbanes-Oxley Attestation Exemption for Smaller Companies

The Act amends Section 404(b) of the Sarbanes-Oxley Act to exempt nonaccelerated filers from the requirement to have their external auditors audit management's assessment of internal control over financial reporting. The Act also requires the SEC 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 $75 million and $250 million. The Act will require the Comptroller General of the United States to conduct a study and report to Congress three years after enactment of the Act on various consequences of the elimination of the audit requirement for nonaccelerated filers. If this study were to reach various types of conclusions, such as that nonaccelerated filers have more restatements or lack the financial statement credibility of companies that are subject to the audit requirement, it is possible that Congress could reconsider the merits of the exemption.

Shareholder Vote on Executive Compensation – "Say on Pay" and Golden Parachutes

The Act requires a separate nonbinding vote (at least every three years) of company shareholders to approve the compensation of its executives ("Say on Pay"). Shareholders are required to vote (at least every six years) on whether the vote will occur every one, two, or three years. Shareholders must vote on both issues at the first shareholder meeting occurring more than six months after enactment of the Act (which means that "Say on Pay" will be effective for many companies for the 2011 proxy season). "Say on Pay" has been applicable for some time in Europe and for certain TARP companies in the United States, and may have a significant effect on disclosure practice and executive compensation structures.

In addition, the Act requires that shareholders approve "golden parachute compensation" at any shareholder meeting in which the shareholders are asked to approve an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all of the assets of the company. The company is required to provide its shareholders with proxy or consent solicitation material that includes, in clear and simple form in accordance with SEC rules, a summary of any agreements and understandings with any named executive officers concerning compensation related to the acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all of the assets of the company. The disclosure must address any agreements with the seller or buyer; will apply to present, deferred, or contingent compensation; and must disclose each type of compensation as well as the aggregate amount. The shareholders must vote on such agreements or understandings unless they have already voted on those agreements or understandings in the separate "Say on Pay" resolution discussed above.

Institutional investment managers subject to Section 13(f) of the Exchange Act must disclose at least annually how they voted on these proposals, unless such vote is otherwise required to be disclosed. The SEC may exempt issuers or classes of issuers from these nonbinding vote requirements, taking into account, among other things, whether the requirements disproportionately burden small issuers.

Majority Voting

Prior versions of the legislation had required companies with securities listed on an exchange to obtain the approval of a majority of the votes cast to elect a director in an uncontested election. The final version of the Act has eliminated such requirement.

* * * *

We will continue to monitor the ongoing developments of Financial Regulatory Reform. If you have any questions or would like more information on the issues discussed in this LawFlash, please contact the authors, **John F. Hartigan** (213.612.2630; jhartigan@morganlewis.com), **Marlee S. Myers** (412.560.3310; msmyers@morganlewis.com), **Howard L. Meyers** (215.963.5536; hmeyers@morganlewis.com), **Linda L. Griggs** (202.739.5245; lgriggs@morganlewis.com), and **Laura B. Dugan** (215.963.5466; ldugan@morganlewis.com), or any of the following Morgan Lewis attorneys:

Philadelphia		
Justin W. Chairman	215.963.5061	jchairman@morganlewis.com
New York		
Gary S. Rothstein	212.309.6360	grothstein@morganlewis.com
Washington, D.C.		
Benjamin I. Delancy	202.739.5608	bdelancy@morganlewis.com

In addition, Morgan Lewis's multidisciplinary Financial Regulatory Reform resource team is available to assist with a wide range of issues and areas of concern related to the reform effort. You can access a complete collection of the firm's updates and alerts on the subject on our website's Financial Regulatory Reform page.

About Morgan, Lewis & Bockius LLP
With 23 offices in the United States, Europe, and Asia, Morgan Lewis provides comprehensive transactional, litigation, labor and employment, regulatory, and intellectual property legal services to clients of all sizes—from global Fortune 100 companies to just-conceived startups—across all major industries. Our international team of attorneys, patent agents, employee benefits advisors, regulatory scientists, and other specialists—nearly 3,000 professionals total—serves clients from locations in Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, Minneapolis, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, Washington, D.C., and Wilmington. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

IRS Circular 230 Disclosure
To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. For information about why we are required to include this legend in emails, please see http://www.morganlewis.com/circular230.