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financial regulatory reform lawflash

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Proposed Corporate Governance Changes Applicable to Public Companies

Proposed financial reform provisions relating to director elections, proxy access, board leadership structure, board risk committees, and broker voting will affect many public companies.

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In response to the severe and prolonged recession, a major financial crisis, the near collapse of our banking system, and increased corporate and financial scrutiny by regulators and the public, both houses of Congress have undertaken the ambitious goal of sweeping financial reform. On December 12, 2009, the U.S. House of Representatives passed the Wall Street Reform and Consumer Protection Act of 2009, and on May 20, 2010, the U.S. Senate passed the Restoring American Financial Stability Act of 2010. The bills are in the process of reconciliation by a House-Senate conference committee. On June 10, 2010, Senate Banking Committee Chairman Chris Dodd presented a working draft of the conference committee's compromise bill, modeled primarily on the Senate bill. A final bill is expected to be presented to President Obama by July 4, 2010.

As a vehicle to reform not only financial services firms but also most public companies, the June 10 compromise bill focuses on systemic regulation, creation of a financial stability oversight council, enhanced resolution authority, and increased regulation. In addition, the bill also has provisions relating to executive compensation and corporate governance that would, if enacted, directly and significantly affect executives, directors, companies, and shareholders, and continue the federalization of corporate governance that largely began with Sarbanes-Oxley. Our May 27, 2010 LawFlash focused on the House and Senate bills' key provisions relating to executive compensation.[1] Below, we discuss the corporate governance implications of the compromise bill.

Majority Voting

The bill would require 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. Under new Section 14B of the Securities Exchange Act of 1934, any director of a listed company who does not receive the majority of the votes cast in an uncontested election must tender his or her resignation to the board. The board would then be required either to accept the resignation or, upon a unanimous vote to reject the resignation, to disclose publicly within 30 days its reasons for the rejection, the board's analysis, and the specific reasons why the rejection was in the best interest of the company and its shareholders. New Section 14B provides that director nominees in contested elections must receive a plurality of votes cast.

[1] The May 27, 2010 LawFlash, "Financial Reform Addresses Executive Compensation and Corporate Governance," is available online at http://www.morganlewis.com/pubs/FRR_ExecCompAndCorpGov_LF_27may10.pdf.

Within one year of the legislation's enactment, the SEC must require the exchanges to prohibit the listing of companies not in compliance with the voting standards described above. Certain companies, however, may be exempted by the SEC from such requirement depending on their size, market capitalization, number of shareholders of record, or other appropriate criteria. For example, we anticipate that the SEC would consider exempting certain companies that are already exempt from several New York Stock Exchange corporate governance standards set forth in NYSE Rule 303A, such as controlled companies, limited partnerships and companies in bankruptcy.

Proxy Access

The bill would amend 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. An earlier version of the Senate bill had required the SEC to issue such proxy access rules.

While the bill 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 in the coming months. 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

The bill would add new Section 14B to the Exchange Act to require the SEC to issue rules mandating disclosure by companies in their annual proxy statements of the reasons why they have chosen the same person, or different individuals, as the case may be, to serve as chairman of the board and chief executive officer. These rules would be required to be issued within 180 days after enactment of the legislation.

The bill's provisions in this area would 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 bill would require 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. The term "nonbank financial company supervised by the Board of Governors" refers to a company (other than a bank holding company or a subsidiary thereof) that is substantially engaged in financial activities in the United States if the Financial Stability Oversight Council determines that such company's material financial distress would pose a threat to the financial stability of the United States.

In addition, each publicly traded bank holding company with assets of more than $10 billion 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 also to establish risk committees.

The risk committee required by the bill would be responsible for oversight of a company's enterprise-wide risk management practices. The Board of Governors would determine the number of independent directors required to serve on the committee, based on factors including 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 bill 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

Independence

The bill would require 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, companies would take into account all relevant factors, specifically including:

(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 would 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 principal additions proposed by the bill are that, in determining a director's independence, 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, if this provision is included in any final legislation, companies may still need to comply with at least three

differing sets of requirements regarding the composition of their compensation committees.

Use of Advisors

The bill requires that compensation committees have the authority and the funding necessary to retain their own compensation consultants, independent counsel, and other advisors to assist them with compensation-related duties and obligations. The compensation committees would be responsible for hiring, paying, and overseeing the consultants and other advisors. Before hiring any counsel, consultant, or advisor, compensation committees would be required to evaluate the advisor's independence, taking into account several factors to be described in rules issued by the SEC, including whether the advisor's employer provides other services to the issuer, the relative amount of fees it receives from the issuer, and whether it has conflict-of-interest policies and procedures, as well as any relationship between the advisor and members of the issuer's compensation committee and any equity ownership in the issuer the advisor may have.

Consultant Disclosures

The bill would also require companies to disclose whether their compensation committees obtained advice from a compensation consultant, whether the consultant's services created any conflict of interest, and, if so, the nature of the conflict and how the conflict is being addressed.

Broker Voting

The bill would amend 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, executive compensation, or any other significant matter, 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 bill would expand that prohibition to apply to executive compensation generally. Therefore, the bill would preclude brokers from voting on the "Say on Pay" proposal also required by the bill, and would authorize the SEC to identify other matters on which brokers could not vote.

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 its 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.

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