

Authors

Douglas P. Faucette
202-220-6961
dfaucette@lockelord.com

John Bruno
202-220-6963
jbruno@lockelord.com

Eric B. Hamburg
202-220-6993
ehamburg@lockelord.com

www.lockelord.com

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Executive Compensation and Corporate Governance in Regulatory Reform Bill

This week Senators continued debate on S.3217, the Restoring American Financial Stability Act of 2010. Various amendments have been voted on, including an amendment that passed that eliminated the so-called “\$50 Billion Bailout Fund,” and more amendments are likely to be offered as debate continues. At this time, over 200 amendments to S.3217 have been proposed. While this may alter certain provisions of S.3217, commentators expect the major changes to the bill to be focused on the portions of the bill that industry representatives most strongly disagree with including the resolution of institutions previously considered “Too Big to Fail” and the proposed new Consumer Financial Protection Bureau.

Initially, many commentators were predicting a passage of the bill in a partisan manner similar to that of the recently enacted health care bill, whereby the Democrats would push S.3217 through without many major changes, only lining up enough Republican support to prevent a filibuster. Republican party leadership initially attempted to keep all its members voting together to oppose S.3217, however, the leadership later released their members to vote as they pleased because there was no “grass-roots” effort to oppose financial regulatory reform as there was with health care, and Republicans did not want to be viewed as standing up for Wall Street. Consequently, numerous amendments to S.3217 have been offered by Republicans attempting to improve S.3217, rather than just block the bill. Most commentators believe S.3217 will eventually be approved by the Senate clearing the way for a joint Senate-House conference to be held to reconcile the bill with the House version, H.R. 4173. Then a reconciled bill would head to the president for his signature as soon as mid-summer.

Although the focus of S.3217 is on financial regulatory reform, it also contains numerous provisions affecting the corporate governance and

executive compensation of all public companies including say-on-pay, director elections, proxy access and clawbacks.

Say-On-Pay

Under S.3217, every public company would be required to include in its annual proxy statement a nonbinding shareholder resolution to approve the company’s executive compensation. Although these resolutions will be nonbinding, they will bring a heightened level of scrutiny to all executive compensation decisions. Although at this time, only companies that receive TARP are required to include mandatory say-on-pay provisions, other companies have begun to include them voluntarily. Already, at two large U.S. public companies, Motorola and Occidental Petroleum, shareholders have not approved their company’s executive compensation. Combined with heightened congressional sensitivity with respect to executive compensation levels, it can be expected that boards will be reluctant to oppose the will of the shareholders and maintain compensation levels.

Director Elections

Under S.3217, stock exchanges would be directed to impose new listing standards requiring a majority vote in an uncontested director election. Companies would be forced to require the resignation of any director who receives less than a majority of votes cast in an uncontested director election, unless the board unanimously decides to reject the resignation. If the board does reject the resignation, it must disclose the specific reasons for that decision and why that decision was in the best interests of the issuer and its shareholders. With respect to contested elections, S.3217 provides that directors may be elected by a plurality.

Last year, the U.S. Securities and Exchange Commission ("SEC") required the exchanges to no longer permit broker discretionary voting in connection with director elections. This recent change, coupled with S.3217, takes on heightened importance for all public companies that currently use plurality voting in uncontested director elections. Public companies would immediately become more susceptible to "withhold-the-vote" campaigns by activist shareholders.

A "withhold-the-vote" campaign is an effort by an activist shareholder to unseat members of the board of directors by convincing other shareholders to withhold their votes on any such members. However, this is only effective if every board member must receive a majority of the votes cast, as proposed in S.3217. During director elections at public companies, shareholders can either vote for a director or withhold their support from a particular director. With plurality voting, as long as at least one share is voted for the election of a director, that director will gain their position on the board—irrespective of the number of votes withheld by the remaining shareholders.

There are certainly other issues that may arise at particular companies due to this change in director election standards. In companies in which all directors seek election or re-election annually, a company with a very unpopular board (or an effective activist shareholder) could conceivably find itself with no directors at all. Additionally, depending on the particular circumstances of each company and which directors are not elected, such outcomes could adversely affect the number of independent directors required for stock exchange listing standards or covenants in the company's debt instruments, having direct implications for a company's creditors. The SEC is required to enact rules to direct

exchanges to follow the majority standard in director elections and these rules could address these issues.

Proxy Access

S.3217 explicitly gives the SEC authority to require companies to include nominees submitted by shareholders in a company's proxy solicitation materials. However, S.3217 does not require that the SEC promulgate such rules. Proxy access has been a hotly debated issue with the Delaware legislature recently passing a shareholder proxy access law and the SEC issuing an advanced notice of proposed rulemaking on shareholder proxy access.

Last year, the Delaware legislature passed Section 112 of its General Corporation Law which permits, but does not require, a company to adopt bylaw provisions that allow both company and shareholder nominees to be included in the company's proxy statement. Such shareholder access may be conditioned on the shareholder and nominee satisfying certain requirements such as: (i) minimum stock ownership; (ii) minimum duration of ownership; or (iii) preclusion of shareholders who have recently accumulated a certain ownership percentage in the company.

Also last year, the SEC issued an advanced notice of proposed rulemaking which would require public companies to include shareholders' nominees for election to the company's board of directors in the company's proxy statement and proxy card. The proposed SEC rules require a shareholder or group of shareholders to hold 1 percent-5 percent of the company's stock, depending on the size and filing status of the company, in order to have proxy access. Shareholders nominees would also be limited to one shareholder nominee or 25

percent of the company's board, whichever is greater. The SEC has received hundreds of comment letters on the proposed rules and a proposed vote on these rules scheduled for last November has been indefinitely delayed by the SEC. Most of the comments against the proposal have centered upon whether the SEC has the authority to adopt such proposals and that the rules inappropriately infringe on internal corporate affairs, traditionally the domain of state law.

Commentators disagree whether the SEC already has the authority to implement proxy access rules, although the proposed rulemaking by the SEC seems to indicate that they believe they possess such power. However, with the passage of S.3217, the SEC will have such powers expressed in specific statutory language and commentators believe this will speed the adoption of such proxy access rules. If the proposed rules are adopted, activist shareholders would now have an inexpensive and more effective way to nominate a dissident director.

Clawbacks

Under S.3217, the SEC would be required to adopt rules directing the exchanges to prohibit the listing of any public company that does not institute certain "clawback" provisions. A public company will have to institute policies requiring that, in the event of an accounting restatement due to a material non-compliance with any financial reporting requirement, any excess incentive compensation paid to executives due to the erroneous accounting must be repaid. The clawback must include compensation of current and former executive officers during the 3-year period preceding the date on which the company is required to prepare the restatement.

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Executive Compensation and Corporate Governance in Regulatory Reform Bill (cont'd.)

While Section 304 of the Sarbanes-Oxley Act of 2002 already requires certain clawbacks in the event of misconduct by executives, S.3217 does not include a misconduct requirement. Additionally, the Sarbanes-Oxley provision only applies to the CEO and CFO, while the clawback in S.3217 applies to all executives. Since S.3217 does not contain a definition of executive officer, presumably the SEC will interpret the phrase consistent with existing regulations.

Conclusion

While some provisions of S.3217 may change during the amendment and reconciliation process, most commentators believe that much of S.3217 will remain unchanged in the final bill and that a financial regulatory reform bill will be sent to the president for his signature relatively quickly, possibly even by mid-summer. While S.3217 is focused on financial regulatory reform, it will also affect the corporate governance and executive compensation of all public companies. While the S.3217's effects cannot be fully known until the SEC implements the required rules, it is clear that stricter rules are ahead for all public companies. While this may serve the interests of corporate democracy, it may also have the unwitting effect of destabilizing public companies which do not already have shareholders with significant ownership interests by exposing them to dissident election campaigns. Such campaigns may be motivated by political agendas and not always be in the corporation's best interest.

About the Authors

Douglas P. Faucette is a banking attorney in Locke Lord's corporate department and co-head of the TARP Group. Mr. Faucette has more than 30 years of experience representing publicly and privately held companies in a variety of corporate and securities transactions.

John Bruno is a partner at Locke Lord. Mr. Bruno has more than 20 years of experience in the financial industry as a regulator, attorney and investment banker, and he has in-depth knowledge of banking law, regulations, policies and procedures.

Eric B. Hamburg is an associate at Locke Lord's Washington, D.C. office. His practice focuses on representation of investment banks, private equity funds and public and private companies in mergers, acquisitions and various other corporate transactions.