May 27, 2010

Corporate Governance Update: Senate Bill Adversely Affects the Landscape

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The final version of the financial reform bill[1] adopted by the Senate last week included a number of corporate governance and executive compensation provisions that would apply to all U.S. public companies. The Senate bill will now need to be reconciled with the corresponding bill adopted late last year by the House of Representatives,[2] but it appears likely that most of these provisions will remain in the final legislation in some form. The House-Senate Conference Committee that intends to propose a final bill before July 4, 2010, will be led by Representative Barney Frank, the primary author of the House bill, and will include Senators Christopher Dodd, Blanche Lincoln, Richard Shelby and Saxby Chambliss.[3]

Corporate Governance

The corporate governance provisions of the Senate bill primarily address four issues: mandatory proxy access, majority voting requirements, separation of the positions of chairman of the board and chief executive officer (CEO), and broker discretionary voting. Many of these provisions appear in similar form in the House bill. Importantly, the final version of the Senate bill does not include any limitation on public companies having staggered boards absent shareholder approval or ratification as had been proposed by Senator Charles Schumer in the

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[1] "Restoring American Financial Stability Act of 2010," H.R. 4173 (adopted by the Senate on May 20, 2010 by a vote of 59 to 39), available at frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173eas.txt.pdf.

[2] "The Wall Street Report and Consumer Protection Act of 2009," H.R. 4173 (adopted by the House on Dec. 11, 2010 by a vote of 222 to 202), available at financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/hr4173eh.pdf. The House bill is 1279 pages and the Senate bill is 1616 pages, as it regulates derivatives and other matters not covered by the House bill.

[3] Rachelle Younglai and Kevin Drawbaugh ,"Wall Street critic Frank to shepherd final reform bill" Reuters, May 24, 2010, available at http://www.reuters.com/article/idUSTRE64I5JQ20100524. Other Senators expected to be included on the Conference Committee are Tim Johnson, Charles Schumer, Tom Harkin, Patrick Leahy, Jack Reed, Mike Crapo, Judd Gregg and Bob Corker. *Id.*

Shareholder Bill of Rights Act of 2009.[4] Similarly, the House bill has no limitation on staggered boards.

The Senate bill expressly authorizes the SEC to adopt mandatory proxy access rules under which shareholders would be able to nominate directors using the company's proxy materials. While this is a change from the requirement that the SEC adopt proxy access rules, which was contained in Senator Schumer's Shareholder Bill of Rights Act, the change may be a distinction that is irrelevant in light of the SEC's continued stated commitment to implement mandatory proxy access.

Proxy access has the potential to wreak havoc with American business and we have previously expressed the view that the SEC's adoption of proxy access rules is dangerous, unwise and unnecessary.[5] While the advocates of proxy access argue that it is designed to "help shift management's focus from short-term profits to long-term growth and stability,"[6] given the short-term outlook of many hedge funds and other institutions most likely to use proxy access, in our experience, it will do exactly the opposite. In our view, proxy access will only further empower activists who are focused on a short-term agenda and become another tool in the toolbox for corporate gadflies and special interest groups.

To the extent that the SEC moves forward with mandatory proxy access rules, the SEC should increase the eligibility thresholds and otherwise take steps to try to address the many risks that mandatory proxy access entails.[7] The SEC's most recent proposal requires issuers to include in their proxy materials director nominees proposed by shareholders who satisfy ownership and other requirements. Any shareholder or group of shareholders that has held at least one percent of the stock of a public company (with larger thresholds for small-cap companies) for at least a year would be entitled to have their proposed nominees for up to 25 percent of the entire board included in the company's proxy statement and on its proxy card, on a first-come, first-served basis. The one percent threshold is extremely low and will further empower activists to manipulate the corporate process in pursuit of their own agenda. The first-come, first-served procedure proposed by the SEC will give shareholders a perverse incentive to rush to nominate directors to ensure their place in line.

Moreover, the SEC proposed proxy access rule does not require a nominating shareholder to commit to hold stock in the company for any period of time if it succeeds in electing a nominee to the board. It would be detrimental to provide increased rights to

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[4] Shareholder Bill of Rights Act of 2009 (S. 1074), available at frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:s1074is.txt.pdf.

[5] *See* David A. Katz and Laura A. McIntosh, "Corporate Governance Update: Populists' Wish Lists Offer Legislative Parade of Horribles" NYLJ, July 23, 2009; *see also* David A. Katz and Laura A. McIntosh, "Corporate Governance Update: SEC Revisits Shareholder Access to Director Nominations," NYLJ, Aug. 30, 2007; David A. Katz and Laura A. McIntosh, "Corporate Governance Update: Proxy Access—Not Then, Not Now," NYLJ, Sept. 28, 2006.

[6] Senate Committee on Banking, Housing, and Urban Affairs, "Summary: Restoring American Financial Stability, available at banking.senate.gov/public/_files/FinancialReformSummaryAsFiled.pdf

[7] *See* Wachtell, Lipton, Rosen & Katz, "Comments on the SEC's Proxy Access Proposals" (Aug. 17, 2009) available at http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.16917.09.pdf.

shareholders who are free to seek short-term gain through the manipulation of board composition (and perhaps corresponding movements in stock price) without requiring such shareholders to continue to have an ongoing economic stake in the company. If the point of requiring a nominating shareholder to hold a substantial number of shares is to be sure that the shareholder has real "skin in the game," that shareholder ought to be obliged to maintain its "skin" for some period should its nominee be elected to the board of directors.

The Senate version of the financial reform bill also requires that the stock exchanges implement majority voting in uncontested elections. The majority voting standard would apply only to uncontested elections (the plurality standard would still apply in contested elections) and would require that the number of shares voted "for" a director's election exceed 50 percent of the votes cast with respect to that director's election. Incumbent directors who are not reelected by a majority vote would be required to tender their resignation to the board of directors and the board would either have to accept the resignation or vote to reject it, in which case the company would have to publicly disclose the reasons for the rejection and why the rejection was in the best interests of the company and its shareholders. The House bill does not mandate majority voting.

The Senate bill would require the SEC to mandate disclosure of whether a company has separated its chairman of the board and CEO positions and its rationale for separating (or not separating) the positions. With respect to the separation of chairman of the board and CEO disclosure, it is not clear whether the Senate bill's requirement would go beyond the rules that the SEC has already implemented. There are numerous justifications for having the same person hold the chairman of the board and CEO positions and we believe that so long as a board of directors has a majority of independent directors and an effective lead director, there is no real corporate governance benefit to separating the chairman and CEO positions.[8]

Finally, the Senate bill would require that the stock exchanges prohibit broker discretionary voting in connection with the election of directors, executive compensation or any other significant matter, as determined by the SEC. This prohibition would likely prevent brokers from being able to vote on most or all management proposals, such as management say-on-pay proposals that would also be mandated under the Senate bill. Effective in the 2010 proxy season, the SEC has already provided that brokers cannot vote on behalf of clients who fail to provide voting instructions in uncontested director elections at NYSE-listed companies. This is a significant change, as broker votes accounted for approximately 19 percent of votes cast with respect to directors during the 2009 proxy season.[9]

Although not strictly a corporate governance provision, the Senate bill, in its regulation of derivatives, would amend Sections 13(d), 13(f) and 13(g) of the Securities Exchange Act of 1934 to include within their beneficial ownership reporting requirements a market participant who "becomes or is deemed to become a beneficial owner [of an equity

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[8] *See, e.g.,* PricewaterhouseCoopers "Lead Directors: A study of their growing influence and importance," April 2010, available at www.pwc.com/en_US/us/forensic-services/assets/lead-director-survey.pdf.
[9] For an in-depth discussion of the issues raised by this rule, *see* David A. Katz and Laura A. McIntosh, "Corporate Governance Update: Activist Shareholders Would Gain Power from Proposed Rule Change," NYLJ, Mar. 27, 2009.

security] upon the purchase or sale of a security-based swap" under SEC rules. This is a change that should provide needed transparency to the markets, especially in the context of proxy contests and takeover battles, and is long overdue.

Executive Compensation

The executive compensation provisions of the Senate bill are largely unchanged from the initial version of the bill proposed by Senator Dodd. Unlike the House bill, the Senate bill does not require shareholder approval of golden parachutes.

The Senate bill requires an annual advisory vote on executive compensation ("say-on-pay"); this vote would not be binding on the company although a negative vote would be noticeable. For example, in 2009, no major U.S. public company lost a say-on-pay vote, but in the 2010 proxy season, where over 300 say-on-pay proposals are expected to be voted on, two significant companies have already lost the advisory vote.[10]

The Senate bill also sets enhanced independence requirements for compensation committee members and consultants/advisers and requires enhanced disclosure regarding the compensation committee and its operation. The Senate bill also requires enhanced disclosure on the relationship between pay and performance as well as disclosure with respect to director and employee hedging activities.

Unlike the House bill, the Senate bill would require a mechanism for recovering incentive compensation from current or former executive officers in the event of specified accounting restatements. The amount of compensation "clawed back" would be determined by what would have been payable under the restated results.

Another provision that is in the Senate bill but not the House bill would require public companies to disclose in their Form 10-Ks or proxy statements the ratio between the CEO's compensation and the median compensation of all other employees (other than the CEO). While it may be important for compensation committees to consider internal pay equity analyses, it is unclear how comparing the ratio of the CEO's compensation to the median compensation of all other employees will be useful to investors; yet this disclosure requirement appears to be politically popular.

Conclusion

There remain a number of differences between the financial reform bill adopted by the Senate and the corresponding version adopted by the House of Representatives late last year, but it appears likely that most of the corporate governance and executive compensation provisions will be part of the final legislation as the House–Senate Conference Committee led by Representative Frank fashions a compromise bill.

While a number of public companies, academics and commentators are advocating the elimination or substantial revision of the corporate governance provisions of the

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[10] *See* Erin White, "Investors Start to Make Their Voices Heard on Pay," Wall Street Journal Online (May 10, 2010).

Senate bill, the growing likelihood is that they will be enacted largely in their current form and that public companies will have to address them in their proxy and compensation program planning in the near future. In our view, this will serve only special interests and investors with a short-term focus without enhancing the competitiveness of American companies in the global marketplace.

As we have said before, many of these reform proposals represent misguided attempts to assert federal control over areas that have traditionally, and successfully, been governed by state law.[11] The benefits of the state law model have been demonstrated time and again by states' useful regulatory innovations, timely responsive actions and individualized regimes that help companies to maximize efficiency and minimize unnecessary burdens. Especially with respect to the details of corporate governance, a one-size-fits-all, top-down approach would have the effect of forcing conformity where it does not belong and serves no useful purpose. SEC Commissioner Troy A. Paredes recently spoke about the benefits of private ordering versus mandatory legislative initiatives:

> Mandatory corporate law forces a universal governance scheme on all firms without permitting an enterprise to adapt its approach to governance and corporate accountability to its distinct circumstances. Recognizing that one-size-fits-all mandates are inappropriate for many businesses, the enabling approach defers to private ordering, spurred on by market discipline and competition, to determine how each firm should be organized to advance its interests most effectively. The enabling approach permits the internal affairs of each corporation to be tailored to its own attributes and qualities, including the company's personnel, culture, maturity as a business, and governance practices.
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> The virtue of private ordering, in sum, is that it does not force all corporations into the same governance box. Instead, in yielding to the unique features of different companies, enabling corporate law expects firms to follow different paths to achieve the best results for the enterprise.
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> Simply put, the countless characteristics that differentiate thousands of public companies in the U.S. from each other suggest that a one-size-fits-all approach to corporate governance is ill-advised.[12]

Early in his presidency, Barack Obama decried the "reckless culture and quarter-by-quarter mentality that in turn have wrought havoc in our financial system."[13] Unfortunately, it appears that the federal legislation that he currently supports will further that destructive culture instead of dismantling it.

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[11] For a thorough discussion of this issue and other related points, see Martin Lipton, Jay W. Lorsch and Theodore N. Mirvis, "A Crisis Is a Terrible Thing To Waste: The Proposed 'Shareholder Bill of Rights Act of 2009' Is a Serious Mistake," May 12, 2009.

[12] Commissioner Troy A Paredes, "Remarks at the 22nd Annual Tulane Corporate Law Institute" (April 15, 2010, available at sec.gov/news/speech/2010/spch041510tap.htm.

[13] President Barack Obama, Speech on Executive Compensation, Feb. 4, 2009.