Restoring American Financial Stability Act of 2010: Senate Bill Would Make Significant Changes in Governance Rules for Public Companies

On May 20, 2010, the United States Senate passed the *Restoring American Financial Stability Act of 2010*, in order to "provide for financial regulatory reform, to protect consumers and investors, to enhance Federal understanding of insurance issues, to regulate the over-the-counter derivatives markets, and for other purposes."[1] The 1,616-page Senate bill is an amended version of the financial reform legislation passed by the House of Representatives on December 11, 2009. While both bills cover a wide range of issues, this memorandum focuses on the potential ramifications of the Senate bill for boards of directors and individual directors of public companies.

If enacted into law, the Senate bill would: significantly alter the manner in which directors are elected at many public companies; underscore efforts to provide greater proxy access for shareholders; impose new rules on disclosure of executive compensation and compensation committee independence; impose restrictions on proxy voting by brokers; and impose disclosure rules regarding the Chairman and CEO structures of public companies. The Senate bill would require that the Securities and Exchange Commission ("SEC") direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with any of these new rules.

I. Majority Voting In Election of Directors

The Senate bill would require majority support for a nominee in an uncontested election for membership on the board of directors. If a nominee does not receive a majority of the votes cast, the director would have to resign. The board could either accept the director's resignation, or decline to accept the resignation by unanimous vote and within 30 days make public the specific reasons that the board chose not to accept the resignation. The board would also have to address why the decision was in the best interests of the issuer and its shareholders. If the board accepted the resignation, it would have to make public the date on which the resignation will take effect. The bill would allow the SEC to exempt an issuer from these rules based on the issuer's size, market capitalization, number of shareholders of record or any other criteria the SEC "deems necessary and appropriate in the public interest or for the protection of investors." In contested elections, if the number of nominees exceeds the number of directors to be elected, each director shall be elected by a plurality vote of the shares represented and entitled to vote at a meeting.[2]

II. Proxy Access

The Senate bill would provide shareholder access to proxy solicitation materials by amending Section 14(a) of the Securities Exchange Act of 1934 ("Exchange Act"). The bill would permit, but would not require, the SEC to prescribe rules and regulations that would allow shareholders to access proxy solicitation materials supplied by an issuer of securities for the purpose of nominating individuals to membership on the board of directors of the issuer, including a requirement that a solicitation include a nominee submitted by a shareholder to serve on the board. The Senate bill would leave the remaining details of this for the SEC to determine, "under such terms and conditions as the Commission determines are in the best interests of shareholders and for the protection of investors."[3]

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1 Restoring American Financial Stability Act of 2010, H.R. 4173, 111th Cong., at 1 (as passed by Senate May 20, 2010).

2 *Id.* § 971.

3 *Id.* § 972.

III. Executive Compensation

The Senate bill would require any proxy or consent or authorization for an annual or other meeting of the shareholders for which the proxy solicitation rules of the SEC require compensation disclosure to include a separate resolution subject to shareholder vote to approve the compensation of executives. This vote, however, would not be binding on the issuer or its board of directors. It could not be construed as overruling a decision by such issuer or board of directors, creating or implying any change or addition to the fiduciary duties of such issuer or board of directors or restricting or limiting the ability of shareholders to make proposals for inclusion in proxy materials related to executive compensation.[4]

The SEC would also have to prescribe rules that require public companies to provide shareholders with a comparison of executive pay and corporate performance. Specifically, public companies would have to disclose in any proxy or consent solicitation material for an annual meeting "a clear description of any compensation required to be disclosed" by Item 402 of Regulation S-K, "including information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions." Issuers would also have to disclose the median of the annual total compensation of all employees except the CEO, the annual total compensation of the CEO, and the ratio of the total compensation for these two amounts.[5]

The SEC would also have to establish rules that would require public companies to disclose any policy they have regarding incentive-based compensation based on financial information that is subject to reporting requirements under the securities laws. If a public company with incentive-based compensation is required to restate its financial statements due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, such issuer would have to implement a policy enabling recovery of compensation from any current or former executive officer who received incentive-based compensation during the 3-years preceding the date of the restatement, in excess of what would have been paid to the executive officer based on the restated financial statements.[6]

The Senate bill would also require the SEC to prescribe rules requiring public companies to disclose in any proxy or consent solicitation material for an annual meeting, whether any employee is permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities either granted to them as part of their compensation, or is otherwise directly or indirectly held by them. The same rule would also apply to designees of the employee, directors, and directors' designees.[7]

IV. Compensation Committee Independence

The Senate bill would also require the SEC to issue rules that would require each member of the compensation committee of a public company's board of directors to be independent. The national securities exchanges already have such rules in place. What the Senate bill would do is specifically identify factors that would have to be taken into account to determine the independence of compensation committees and consultants, legal counsel or other advisors. To determine compensation committee independence, the Senate bill would specifically require the SEC to consider "the source of compensation of a member of the board of directors of an issuer, including any consulting, advisory, or other compensatory fee paid by the issuer to such member of the

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4 Restoring American Financial Stability Act of 2010, H.R. 4173, 111th Cong. § 951 (as passed by Senate May 20, 2010).

5 *Id.* § 953.

6 *Id.* § 954.

7 *Id.* § 955.

board of directors; and . . . whether a member of the board of directors of an issuer is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer."[8]

In selecting compensation consultants and other compensation committee advisors, a compensation committee would have to take into account factors relating to the consultant or advisor's independence. Such factors are to include "the provision of other services to the issuer," "the amount of fees received," and the "policies and procedures of the person" that employs the consultant, legal counsel or other advisor. The committee would also have to consider any business or personal relationship of the consultant, legal counsel or other advisor with a member of the compensation committee as well as any stock of the company owned by the consultant, legal counsel or other advisor.[9]

V. Proxy Voting By Brokers

The Senate bill would restrict the ability of brokers to vote by proxy in any "significant matter, as determined by the Commission," including shareholder votes with respect to the election of a member of the board and executive compensation. Specifically, the bill would require exchange rules to "prohibit any member that is not the beneficial owner of a security registered under Section 12 from granting a proxy to vote the security in connection with a [significant, as described above] shareholder vote . . ., unless the beneficial owner of the security has instructed the member to vote the proxy in accordance with the voting instructions of the beneficial owner." The bill would also allow a national securities exchange to prohibit a member that is not the beneficial owner of a security registered under Section 12 from granting a proxy to vote the security in connection with a shareholder vote not described above.[10]

VI. Disclosures Regarding Chairman and CEO Structures

The Senate bill would also amend the Exchange Act to require that, no later than 180 days after the bill is enacted, the SEC issue rules that would require an issuer to disclose in their annual meeting proxy either—

- why the issuer has chosen the same person to serve as chairman of the board of directors and CEO (or in equivalent positions), or
- why the issuer has chosen different individuals to serve in those positions.[11]

This provision expands on disclosures required by Regulation S-K Item 407 of the Securities Act of 1933, which requires annual proxies to disclose "whether the same person serves as both principal executive officer and chairman of the board, or whether two individuals serve in those positions . . . ."[12]

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Guillaume Buell at 212.701.3012 or gbuell@cahill.com.

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8 These concepts in the Senate bill are similar to those in Rule 10A-3 under the Exchange Act regarding the independence of Audit Committee members.

9 Restoring American Financial Stability Act of 2010, H.R. 4173, 111th Cong. § 952 (as passed by Senate May 20, 2010).

10 *Id.* § 957.

11 *Id.* § 973.

12 17 C.F.R. 229.407(h).