May 28, 2010

Senate Passes Financial Reform Bill with Corporate Governance and Disclosure Implications for All Public Companies

On May 20, 2010, the U.S. Senate passed the Restoring American Financial Stability Act of 2010, a comprehensive financial regulatory reform bill, which includes several corporate governance and disclosure provisions that would impact all U.S. public companies, not just financial institutions. The bill must now be reconciled with the corresponding U.S. House of Representatives bill that was passed in December 2009. President Obama is expected to sign the resulting compromise bill into law this summer.

While the Senate bill is primarily aimed at overhauling the financial regulatory framework in the wake of the recent global financial crisis, the corporate governance and disclosure provisions applicable to all public companies could have a significant impact on director elections and executive compensation as early as the 2011 proxy season. The following summary of these provisions is intended to assist our clients with preparing for the coming regulatory changes.

Key Corporate Governance Provisions

Proxy Access. Both the Senate bill and the earlier House bill authorize the Securities and Exchange Commission (the "SEC") to adopt rules permitting shareholders to include their own director nominations in a public company's proxy solicitation materials. Companies would continue to have the ability to exclude other types of shareholder proposals from their proxy solicitation materials under certain circumstances. As the SEC issued a proposed rule mandating proxy access last year, it will likely act quickly to adopt a final rule.

"***Say on Pay***." Both the Senate bill and the House bill would require public companies to include a non-binding proposal to approve the compensation of their named executive officers in any proxy statement containing executive compensation disclosure. Shareholders effectively would have an advisory vote on executive compensation at each annual meeting of shareholders.

Gerald Roach
Bio | 919.821.6668
groach@smithlaw.com

Amy Meyers Batten
Bio | 919.821.6677
abatten@smithlaw.com

Margaret Rosenfeld
Bio | 919.821.6714
mrosenfeld@smithlaw.com

SMITH ANDERSON
Smith, Anderson, Blount, Dorsett, Mitchell & Jernigan, L.L.P.

Majority Voting. The Senate bill includes a provision that would require directors of companies that are listed on a securities exchange to be elected by a majority of the votes cast in an uncontested election, as opposed to a plurality vote. A director who fails to receive a majority of the votes cast would be required to tender his or her resignation. The company's board of directors could decline to accept the resignation by a unanimous vote, in which case the company must publicly disclose, within 30 days after the shareholder vote, the board's specific reasons and supporting analysis for not accepting the resignation. The plurality standard would continue to apply in contested elections. The SEC would be given authority to exempt certain companies from adopting the majority voting standard based on their size, market capitalization, number of shareholders, or other criteria as it deems appropriate. The House bill does not contain a majority voting provision.

Clawback. The Senate bill would require exchange-listed companies to adopt policies under which "excess" incentive-based compensation (including stock options) must be recovered by the company from current and former executive officers in the event the company is required to restate its financial statements due to material non-compliance with financial reporting requirements. "Excess" incentive-based compensation is the amount by which the incentive-based compensation paid based on erroneous data during the three years preceding the restatement exceeds the incentive-based compensation that would have been paid based on the restated financial statements. Unlike the clawback provision in the Sarbanes-Oxley Act of 2002, this provision does not require misconduct. The House bill does not contain a clawback provision.

Compensation Committee Independence (and Independence of Advisers). Both the Senate bill and the House bill contain provisions that would impose heightened independence requirements on the directors who serve on an exchange-listed company's compensation committee similar to those currently imposed on audit committee members. Compensation committee members would not be permitted to receive compensation from the company other than for their service as board and committee members, and in the case of the Senate bill, may not be affiliated with the company or its subsidiaries. Also similar to audit committees, compensation committees would be given authority to retain and supervise independent compensation consultants, counsel, and other advisers. Compensation committees would have to consider specific independence factors to be identified by the SEC in selecting such consultants, counsel, and advisers.

Broker Discretionary Voting. The Senate bill would prohibit broker discretionary voting on director elections, executive compensation, or any other significant matter as determined by the SEC. Beginning in 2010, brokers are already prohibited from voting on director elections without instructions from beneficial owners of securities, but the Senate bill would also prohibit broker discretionary voting on a "say on pay" proposal. The House bill does not contain a similar provision.

Disclosure Provisions

The Senate bill would require all public companies to disclose the relationship between executive compensation and the company's financial performance, information about internal pay equity, a description of the company's policy on permitting employees and directors to

engage in hedging activities, and the reasons why the CEO and chairman of the board roles are or are not combined. With respect to internal pay equity, companies would need to disclose (1) the median of the annual total compensation for all employees except the CEO, (2) the annual total compensation of the CEO, and (3) the ratio between these amounts. The House bill does not contain these disclosure provisions.

Practical Impact

The greatest impact of the Senate bill's corporate governance provisions for most public companies, particularly small to midsize exchange-listed companies, will likely be the change from a plurality voting standard to a majority voting standard in uncontested elections. While many large companies have already switched to a majority voting standard of some type within the last few years as a result of pressure from shareholder activists and advisory firms, smaller companies still typically use a plurality voting standard. A change to the majority voting standard would require a charter or bylaw amendment, which would likely need to be submitted to a shareholder vote.

Under the plurality standard, the director nominee with the most "for" votes is elected. Shareholders can either vote "for" the director nominee or withhold authority to vote for the nominee. Because a "withhold" vote is effectively meaningless under the plurality standard, a director nominee can be elected with only one "for" vote, even if the nominee receives a majority of "withhold" votes among the votes cast for his or her election. Absent a contested election (in which there are more director nominees than board seats), the plurality standard ensures continuity of the board of directors, because there is almost no possibility that the director election process will result in a vacancy on the board.

A majority voting standard would require a director to receive the affirmative vote of the majority of votes cast in order to be elected. Under this standard, a "withhold" vote has real significance and could cause the director not to be elected. Because brokers are not permitted to vote in director elections without instructions from beneficial owners of securities, companies may find it difficult to obtain the necessary votes. Companies may need to engage proxy solicitation firms at additional expense to assist in soliciting votes from shareholders.

The adoption of the "say on pay" and proxy access provisions and the new disclosure requirements may also result in increased pressure on director elections. While the "say on pay" annual shareholder vote on executive compensation would be non-binding, shareholder disapproval of a company's executive compensation program will signal an expectation that the company change its compensation practices. If the company does not respond to shareholder concerns, shareholders could have the power to remove an exchange-listed company's directors by withholding votes for those directors at the next annual meeting and/or by nominating their own director nominees in the company's proxy statement. Public companies that are not listed on an exchange (such as OTCBB-traded companies) would not be subject to the majority voting standard, but their shareholders will still have a stronger voice in director elections and executive compensation through the "say on pay" and proxy access provisions.

Only the Senate bill includes the majority voting provision. The House bill does not have a corresponding provision. It is unclear whether the majority voting provision will survive the

reconciliation process, but some form of "say on pay" and proxy access will almost certainly make the cut. We will continue to monitor legislative activity in this area and keep our clients apprised of any significant developments.

Special thanks to Amy Wallace, contributing writer.

*　*　*　*　*

While every effort has been made to ensure the accuracy of this memorandum, it is not intended to provide legal advice as individual situations will differ and should be discussed with an expert and/or lawyer. For specific technical or legal advice on the information provided and related topics, please contact Gerald Roach (919.821.6668), Amy Batten (919.821.6677), or Margaret Rosenfeld (919.821.6714).

SMITH, ANDERSON, BLOUNT, DORSETT,
MITCHELL & JERNIGAN, L.L.P.

Offices:
2500 Wachovia Capitol Center
Raleigh, North Carolina 27601
Mailing Address:
Post Office Box 2611
Raleigh, North Carolina 27602
Telephone: 919.821.1220 **Facsimile**: 919.821.6800
Email: info@smithlaw.com **Website**: www.smithlaw.com

Copyright © 2010 by Smith, Anderson, Blount, Dorsett, Mitchell & Jernigan, L.L.P.
Reproduction in whole or in part is permitted when credit is given to
Smith Anderson.

Smith Anderson publishes *Alerts* periodically as a service to clients and friends. The purpose of this *Alert* is to provide general information about significant legal developments. Readers should be aware that the facts may vary from one situation to another, so the conclusions stated herein may not be applicable to the reader's particular circumstances.