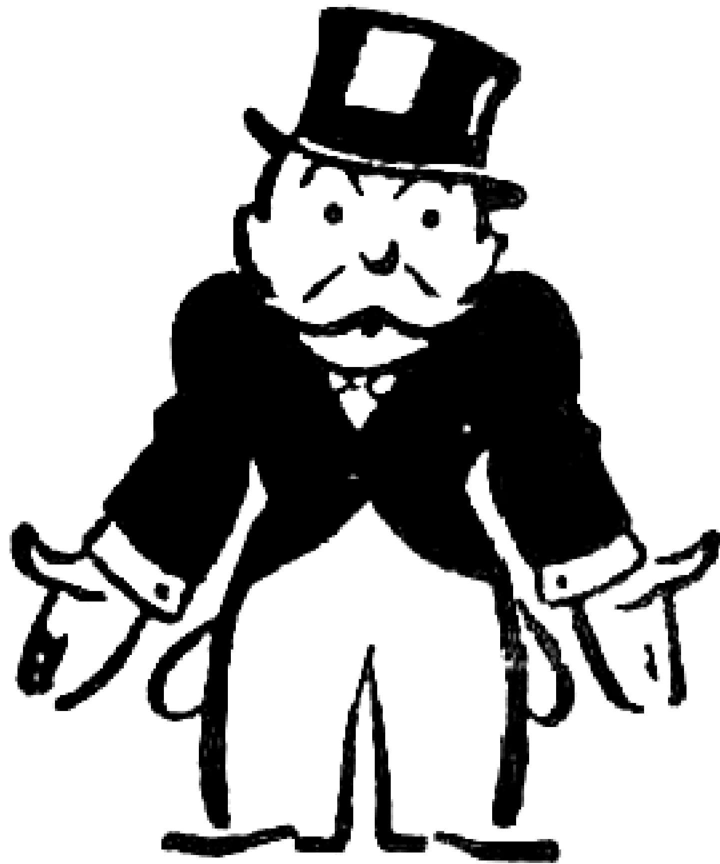
Corporate Governance After the Dodd-Frank Act: Recent Developments



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IOSCO Annual Meeting

April, 2011

MAJOR DEVELOPMENTS

1. Proxy Access: 3% can now propose nominees for 25% of the board's seats at low cost. Issue: Who will use it?
2. "Say on Pay": A non-binding, advisory vote on executive compensation. But how often?
3. Executive Compensation Disclosure: Disclose (a) the relationship between shareholder gains and executive compensation, and (b) CEO compensation and median employee compensation.
4. Independence of Compensation Committee (and new authority to hire consultants and counsel).
5. Incentive-Based Compensation at Large Financial Institutions: SEC proposes 3 year deferral of at least 50% of such compensation.
6. Compensation Clawbacks: Clawback of incentive-based compensation extends for 3 years back from any accounting restatement for "erroneously awarded" compensation.
7. Whistleblower Bounties: Between 10% and 30% of SEC recovered monetary sanctions must be paid to informants who provide original information that leads to successful enforcement.
8. New SEC Enforcement Powers and Extraterritorial Limitations

A. PROXY ACCESS

1. Probably the most controversial change in corporate governance enacted in the Dodd-Frank Act is that set forth in Section 971 (“Proxy Access”) of the Act, which authorizes the SEC to adopt rules (1) enabling shareholders to submit one or more nominees for inclusion in the corporation’s own proxy statement for election by the shareholders to the board of directors, and (2) specifying procedures for proxy access.

2. The SEC has responded by adopting Rule 14a-11 (which it has stayed pending resolution of litigation challenging its decision-making process in adopting the Rule). Rule 14a-11 will enable a shareholder, or a shareholder group, to submit nominees for up to 25% of the company’s board of directors (or one nominee, whichever is greater) for inclusion in the company’s proxy statement. This significantly reduces the cost of running such a proxy contest. However, to nominate directors in this fashion, the shareholder or shareholder group must (a) hold 3% of the voting power at the company’s annual meeting, (b) have held such minimum amount continuously for at least three years, and (c) represent that it is not seeking control.

3. The three percent ownership test is well within the reach of institutional investors, but the three year holding period will exclude most hedge funds from nominating board candidates.

Practical Impacts

1. Broker Votes: Proxy activists, seeking to use proxy access, are assisted by Section 957 of the Dodd-Frank Act, which requires national securities exchanges to forbid their member firms from voting proxies for which they have not received instructions from the beneficial owners on votes relating to the election of directors, "executive compensation, or any other significant matter as determined by the Commission . . ."

2. This disqualification of broker votes (absent express instructions from the beneficial owner) means that shares held by retail shareholders are less likely to be voted, and thus that shares held by institutional investors will hold the decisive balance of power.

3. Proxy Advisers: Because indexed institutional investors face numerous votes and tend therefore to rely on proxy advisers, firms such as ISS gain considerable power and influence from the combination of "proxy access" and the elimination of "broker votes."

4. Who Will Use It? Activist hedge funds are unlikely to use Rule 14a-11 because (a) they may want to elect more than 25% of the board; (b) they are unwilling to represent that they are not seeking control; (c) they have not held the stock for three years, or (d) the costs of a full scale proxy fight are not significant to them. Thus, the more likely users of "proxy access" are diversified public pension funds.

B. EXECUTIVE COMPENSATION

1. “Say on Pay”

1. Following the British practice, Section 951 of Dodd-Frank imposes on public companies (i.e., those registered under Section 12 of the 1934 Act and subject to the proxy rules) an obligation to provide a non-binding vote on executive compensation. This obligation will begin with the first shareholder meeting after January 21, 2001.

2. Such a vote must be taken at intervals no greater than every three years. The initial proxy statement for the first meeting after January 21, 2011 must give shareholders the decision as to the frequency of such vote: annually, every two years, or at most every three years. As of early March, 2011, Georgeson & Co. finds that slightly over 50% of public companies are opting for a triennial vote (but 31% of the S&P 1,500 are favoring an annual vote).

3. “Say on Frequency”: At least once every six years, shareholders must be provided with a new opportunity to vote on the frequency of “Say on Pay” votes.

4. “Say on Golden Parachutes”. A non-binding shareholder vote must be given to shareholders, by separate resolution, in connection with any vote on a merger, consolidation, sale of assets or similar transaction, to approve “golden parachute compensation” (unless the agreements or understandings relating to such compensation were the subject of a similar “say on pay” vote under Section 951).

5. Pressure on the Compensation Committee: “Say on Pay” votes may compel compensation committees to preclear executive compensation programs with proxy advisers (such as ISS). As many as 8,000 or more “say on pay” votes will be held in 2011, and investors may not give individualized attention, but instead vote as the proxy adviser recommends. Large institutional investors are required to disclose annually how they voted on both types of “Say on Pay” votes.

2. Executive Compensation Disclosure

1. Pay for Performance: Section 953 of Dodd-Frank requires public companies to disclose in their proxy statements:

   A. "the relationship between executive compensation actually paid to the executives 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."

   B. this section contemplates a multi-year chart or graph showing how the shareholders have done in relation to changes in executive compensation (if the lines cross, "Houston, we have a problem").

   C. the ratio between (a) the median of the annual total compensation of all employees (other than the CEO), and (b) the annual total compensation of the CEO.

2. Hedging: Section 955 mandates disclosure of the ability of executives to purchase put options, equity swaps or collars, or prepaid variable forward contracts.

3. Separation of CEO and Chairman Positions: Dodd-Frank requires disclosure of why the board has chosen to separate (or not to separate) these two positions.

3. Compensation Committee Independence

1. Section 952 of Dodd-Frank requires that all members of the Compensation Committee be "independent" (as defined). This provision further requires the NYSE and Nasdaq to promulgate a definition of independence that takes account of:

   (1) total compensation, including advisory, consulting and other fees paid by the issuer to such committee member; and

   (2) any affiliation of such member or his/her family with the issuer, a subsidiary, or an affiliate.

   Potentially, outside directors could simply be paid too much by their company to be deemed independent.

2. The Compensation Committee must be authorized "in its sole discretion" to retain, terminate, or obtain the advice of, its own counsel and compensation consultant, <u>but</u> it may only select a compensation consultant, legal counsel, or other adviser that meets specified independence criteria (which criteria must consider the fees paid to the adviser as a percentage of its total revenue as well as other services performed for the issuer).

3. Each issuer must provide for appropriate funding, as determined by the Compensation Committee, for payment of reasonable compensation to the consultants and counsel chosen by the committee. These provisions override Delaware law, but the board is not obligated to follow the committee's recommendations on compensation.

4. "Foreign private issuers" are excluded from this requirement; SEC rules must be promulgated by July, 2011.

C. EXECUTIVE COMPENSATION AT LARGE FINANCIAL INSTITUTIONS

1. Consistent with the G-20 rules agreed to in April, 2009, Section 956 of the Dodd-Frank Act requires the SEC and other financial regulators to prohibit incentive-based payment arrangements at “covered financial institutions” that encourage inappropriate risk-taking at financial institutions.

2. In March, 2011, in combination with other U.S. financial regulators the SEC has tentatively proposed that, in the case of “larger covered financial institutions” (generally those with $50 billion or more in total consolidated assets but including broker dealers), at least 50% of the incentive-based compensation of an “executive officer” would have to be deferred over a period of at least three years.

3. Also, the deferred amounts would have to be adjusted for actual losses or other performance results that are realized or become known during this deferral period.

4. In addition, board of directors (or a committee) of such institutions must also (a) identify those persons (other than executive officers – i.e., traders) who have the ability to expose the institution to substantial losses (in relation to the institution’s size), and (b) approve the incentive-based compensation arrangements for such persons, after first determining that such compensation arrangement “effectively balances the financial rewards to the covered person and the range and time horizon of risk associated with the covered person’s activities.”

D. COMPENSATION CLAWBACKS

1. Section 954 of Dodd-Frank mandates a recovery (or “clawback”) of incentive-based compensation paid based on inflated earnings that are later restated. Specifically, it instructs the SEC to require national securities exchanges to adopt listing standards that require the recovery of “erroneously awarded” compensation attributable to:

   > “an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the federal securities laws, the issuer will recover from any current or former executive officer of the issuer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date . . . (of the restatement) . . . in excess of what would have been paid to the executive officer under the accounting restatement.”

2. This language seems to contemplate that if the accounting restatement reduces reported earnings from, say, $10 per share to say $6 per share, the corporation shall recover all stock options and other incentive compensation that were attributable to the $4 difference that was eliminated.

3. This language raises many ambiguous interpretive questions (for example, how do we know how much (if any) incentive compensation was attributable to the foregoing $4 difference). But this provision is far broader than a similar provision in Sarbanes-Oxley because it covers all current or former executive officers (not just the CEO and CFO), looks to the 3-year period preceding the date on which the company is required to prepare the restatement (SOX used a one year period), and requires no requirement (as SOX did) that “misconduct” caused the restatement.

4. According to Equilar, in 2009, 72.9% of Fortune 100 companies had publicly disclosed “clawback” policy (nearly all of these were adopted after 2006).

5. Still, securities exchanges are not eager to delist companies, and no private right of action is authorized. Nor is any deadline set for rulemaking.

E. Enforcement Remedies

1. Whistleblower Bounties

1. Whistleblower Bounties. Section 922 instructs the SEC to establish a whistleblower fund that would reward whistleblowers who "voluntarily provided original information to the Commission that led to the successful enforcement" of a covered action, with the reward being between 10% and 30% of the total "monetary sanctions" imposed in the action. The term "monetary sanction" includes disgorgement. The SEC would initially decide the bounty within this 10% to 30% range, but the whistleblower can appeal to court.

   Consequence: The economic incentive to "blow the whistle" in a securities fraud case will be greatly increased, particularly by the mandatory minimum provision. The culture within firms could change.

2. Plaintiff law firms are actively seeking to represent whistleblowers on a contingent fee basis, percentage-of-the-recovery basis. SEC fines and sanctions not infrequently have topped $100 million (current record for SEC sanctions: $800 million fine imposed on AIG).

3. But the SEC may have to delay because of budgetary constraints and Congressional opposition.

2. New SEC Enforcement Powers

Aiding and Abetting Liability

1. Attempts to overturn Central Bank of Denver have been unsuccessful, but the SEC will be empowered to sue a defendant for aiding and abetting a securities violation, with a reduced standard of recklessness satisfying the scienter requirement, under each of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act. (See Section 929O of Dodd-Frank).

Cease and Desist Proceedings

2. The SEC will also be able to obtain civil penalties in "cease and desist" proceedings against any person, not simply registrants. These are administrative proceedings before an SEC ALJ – thereby giving the SEC a "home court" advantage. The SEC has just used this new power for the first time in a high profile insider trading case against Rajat Gupta.

Extraterritorial Jurisdiction

3. The SEC (but not private litigants) is authorized by Section 929P(b) of Dodd-Frank to bring suit in cases where the securities transaction occurs outside the United States if (i) a significant step or steps in furtherance of the violation occurred in the U.S., or (ii) the foreign conduct or statements will have a foreseeable substantial effect on the U.S. market. In effect, this provision protects the SEC from the impact of National Australia Bank.

Unresolved Issues

1. Does Dodd-Frank work at cross purposes by enhancing shareholder power while seeking to restrict excessive risk taking? Will shareholders use their new powers – proxy access and "say on pay" – to pressure management for greater or lesser leverage and risk-taking?

2. Will the new executive compensation constraints affect "say on pay" voting? Will proxy advisers and shareholder activists seek to enforce them (e.g., the three year deferral) or compensate for them?

3. Will compensation clawbacks be enforced? By whom? No cause of action is provided and stock exchanges have little incentive to monitor.

4. Will anyone use "proxy access"? Activist hedge funds seem unlikely to, and diversified pension funds may support, but seem less likely to lead.