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*Goverance*

# SEC Contemplating Governance Reforms

By Michael Stocker and Christopher Keller

***AFTER ENACTING REFORM** in the finance and healthcare sectors, legislators and regulators have staked out a new battleground: the antiquated machinery of U.S. corporate governance. Provisions on corporate governance in the Dodd-Frank Wall Street Reform and Consumer Protection Act, together with a new concept paper on corporate*

governance mechanics recently issued by the SEC, signal a broad re-examination of the role of the shareholder in U.S. corporations.

It is not surprising that policy-maker soul searching over the causes of the financial crisis has turned to corporate governance. While the credit ratings industry and corporate leveraging practices have much to answer for in the catastrophes of 2007 and 2008, the structure of shareholder-management relations in the United States may have played a significant role in exacerbating the strife in the markets.

The Dodd-Frank Act contains several significant measures aimed at increasing shareholder participation in key areas of corporate decision-making, especially in connection with compensation of top executives. Dodd-Frank grants shareholders the right to a periodic non-binding advisory vote on compensation payable to named executive officers as described in the proxy statement. Shareholders are permitted a similar vote on compensation payable to named executive officers in connection with change-in-control transactions, unless such arrangements have previously been subject to a say-on-pay vote.

Moreover, the statute contains provisions giving institutional investors an incentive to actually exercise their new rights to participate in decision-making. Under the new rules, institutional investors are required to report at least annually how they voted on any shareholder say-on-pay or golden parachute proposals, unless their vote is otherwise required to be publicly reported.

While some question whether there are real teeth in non-binding say-on-pay resolutions, experience with executive compensation votes at Motorola and Occidental Petroleum has shown that many boards are reluctant to override the will of shareholders on such a sensitive topic.

### PROXY VOTING WILL CHANGE

Another notable way this law will shape shareholder voting relates to the ability of brokers to vote shares on behalf of beneficial owners. Under the old rules, if shares were held by a broker, the broker was able to direct how the investor's shares would be voted even without getting instructions from the investor.

Now, when votes are to be held on key issues, like the election of directors or executive compensation, the national securities exchanges are required to prohibit brokers who are not beneficial owners from granting a proxy to vote shares if they have not received voting instructions from the beneficial owner. If investors do not complete the voting instructions, their shares will not be considered when directors are elected.

Dodd-Frank also contains several additional proxy disclosure requirements designed to increase investors' knowledge of executive compensation systems. Perhaps most important, the new legislation requires that proxy statements disclose the relationship between executive compensation actually paid and the company's financial performance, taking into account any change in the value of stock and any dividends and distributions. This requirement gives investors a much deeper understanding of whether, in offering rich executive compensation packages, a corporation is getting what it's paying for.

In a similar vein, the statute also requires that companies disclose the ratio of the chief executive officer's compensation to median compensation. Specifically, it requires that any prospectus, proxy statement or annual report filed with the SEC include a disclosure of: the median of the annual total compensation of all employees of the issuer (not including the chief executive officer); the annual total compensation of the chief executive officer; and the relationship between the foregoing amounts.

In addition, Dodd-Frank requires the SEC to amend its rules to require disclosure of whether any employee or member of the board of directors is permitted to purchase financial instruments in order to hedge or offset any decrease in the value of equity securities of the issuer. This helps investors to get a clearer picture of how well corporate compensation systems work to encourage executive employees to perform well. If executive employees are permitted to heavily hedge against the risks of devaluation in the securities that they are acquire in bonus packages, they will have less incentive to perform well. They may even profit if the companies they run perform especially poorly.

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Finally, the statute specifically authorizes the SEC to issue rules requiring issuers to include nominees submitted by shareholders in their proxy materials for the election of directors. These provisions are likely to spark considerable debate before Commission rulemakers, as it has already proven to be a hot topic for legislators. A key concept to be ironed out is whether minimum share requirements should be imposed on investors interested in submitting their own nominees.

### BUYING VOTES

The changes to corporate governance are not limited to the new rules under Dodd-Frank. The SEC has recently released a concept paper of its own, signaling an appetite to overhaul the mechanics of corporate governance in the United States. On July 14, the Commission issued a "concept release" announcing a broad review of the U.S. proxy system. The concept paper is part of a wide-ranging effort to increase the transparency and integrity of the shareholder voting system, which accounts for 600 billion shares voted every year.

A key issue addressed by the concept paper is "empty voting," which occurs when a shareholder exercises voting rights that exceed his or her economic interest in the company – that is, by buying votes, a surprisingly common practice. A recent Commission enforcement action alleged that a registered investment adviser developed a vote-buying strategy in order to influence the outcome of a vote involving the acquisition of a company in which the investment adviser held a large block of stock. The investment adviser purchased shares in the acquiring company and entered swap transactions with the banks from which it purchased the shares. It was thus able to acquire voting rights to nearly ten percent of the acquirer's stock with no economic risk, no real economic stake in the company and no significant financial outlay.

In the concept paper, the Commission suggests remedies for empty voting ranging from merely requiring disclosure of such practices, to limiting voting to persons who hold pure long positions (economic interests that are not shorted or hedged), to prohibiting empty voting altogether.

The concept paper also outlines serious concerns regarding the role of "proxy advisory firms," which advise institutional shareholders on how they should vote on shareholder proposals. These advisory firms often provide dual services by advising an issuer how to formulate corporate governance proposals that shareholders will approve, while simultaneously advising the shareholders how to vote on those proposals. Moreover, these firms advise issuers on how to improve their position in the advisers' own corporate governance rankings.

The Commission has expressed concern about the potential for conflict of interest in these practices. It has suggested increasing the disclosure requirements for proxy advisory firms, along the lines of standards now applied

to nationally recognized statistical rating organizations, such as Moody's and Standard & Poor's.

Another key area for debate identified in the concept paper relates to direct communications between corporations and their shareholders. Under the current system, shares are considered owned by the depository which holds them for the beneficiary owners, for voting purposes. Roughly 80 percent of outstanding shares are treated this way.

Presently, some shareholders (termed "objecting beneficial owners" or OBOs) can choose to remain anonymous, while others (termed "non-objecting beneficial owners" or NOBOs) permit their identities to be disclosed to issuing corporations. Corporations have limited means of communicating directly with OBOs, and any communication – including the exercise of the shareholder's voting rights – must be through a web of intermediaries, such as third-party proxy agents, proxy advisory firms, proxy solicitors, share depositories, proxy service providers and vote tabulators.

To remedy this situation, the SEC suggests that it is willing to abolish or modify the OBO classification. This proposal has already proved to be contentious. Many institutional investors prefer to retain their anonymity to protect the confidentiality of their trading strategies.

In addition, some investors and financial institutions have filed comments with the SEC arguing that corporate boards already have too much power, and that giving them more influence by enabling direct communications with shareholders would not improve corporate governance. Commentators supporting the proposed change point out that when the identities of actual shareholders are hidden from issuers, issuers are prevented from engaging in any meaningful communications directly with their shareholders.

There is sure to be much additional argument over the proposals in the SEC's concept paper and the implementation of the new reform legislation. However, if there is one message U.S. businesses can draw from these developments, it is that corporate governance as we now know it may soon be a thing of the past.


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