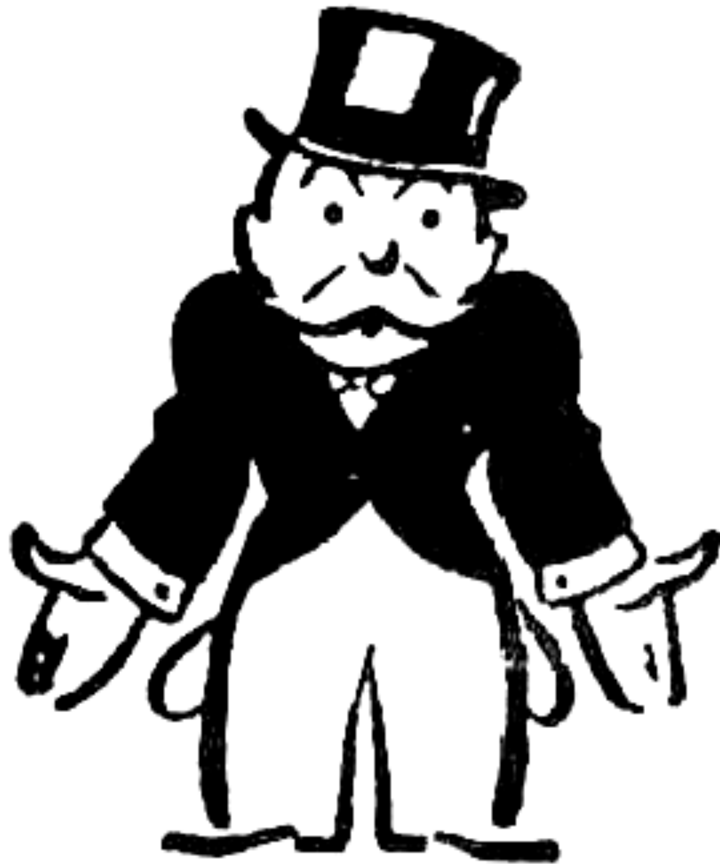
The Litigation and Corporate Governance Impact of the Dodd-Frank Act



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1. The Dodd-Frank Act represents the most significant revision in the structure of U.S. financial regulation in over 75 years.
2. Although its primary focus is on systemic risk regulation and the financial sector, it also addresses corporate governance, both directly and indirectly.
3. These latter provisions fall under four headings.
   A. Corporate Governance and Shareholder Voting;
   B. Executive Compensation;
   C. Financial Institution Governance; and
   D. Liability and Enforcement Rules.

A. CORPORATE GOVERNANCE CHANGES

I. 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, and (b) have held such minimum amount continuously for at least three years.

3. The three percent ownership test is well within the reach of institutional investors for all but possibly the largest U.S. corporations, but the three year holding period will exclude most hedge funds from nominating board candidates. Although unable to nominate, less than three year holders can vote and can solicit.

Procedures and Coverage

1. Under Rule 14a-11, if more than one shareholder group seeks to nominate directors, the group with the largest voting power wins. However, if it seeks to nominate less than 25%, the balance up to 25% may be nominated by the second-largest group.
2. "Surprise" attacks are precluded, as notice must be given to the corporate board 120 to 150 days prior to the date on which last year's proxy materials were distributed.
3. "Foreign private issuers" (as defined in SEC Rule 3b-4) are exempt from the U.S. proxy rules, but foreign issuers not qualifying as a "foreign private issuer" (because a majority of their stock is owned by U.S. residents) must comply with Rule 14a-11. Even in these cases, however, such issuers are exempted if the governing foreign law does not permit shareholders to nominate candidates for the board. Nor need such non-exempted foreign issuers include a nominee who is barred by foreign law from serving as a director of their company.

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 RiskMetrics gain considerable power and influence from the combination of "proxy access" and the elimination of "broker votes."

4. Combination With "Say on Pay": Although the ability of activists to find nominees willing to run on minority slates who are acceptable to institutions remains an uncertainty, proxy access may have its greatest impact when shareholders vote against proposed executive compensation (but management ignores them). Such "say on pay" votes are non-binding, but could be enforced by a proxy challenge conducted at low cost pursuant to proxy access.

Majority Vote in Uncontested Elections

1. Former Section 971 of the Senate Bill would have required the SEC to direct the NYSE, Nasdaq and other securities exchanges to prohibit the listing of any issuer that does not adopt a majority voting rule for uncontested elections.

2. The Conference Report struck Section 971 in its entirety. Delaware Will Not Be Challenged on Majority Voting Rules!

Separation of Chairman and CEO

1. The SEC is also instructed to require disclosure in the annual proxy statement of "the reasons why the issuer has chosen the same person to serve as chairman of the board of directors and chief executive officer" or "different individuals to serve. . . ."
2. In short, reasons must be disclosed in either case; it is intended as a mild incentive to separate the two positions.

B. EXECUTIVE COMPENSATION

1. “Say on Pay”

1. 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.
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 RiskMetrics). Remember: “broker votes” are prohibited by Section 957 with respect to “executive compensation” votes (absent express authorization by the beneficial holder). Large institutional investors are required to disclose annually how they voted on both types of “Say on Pay” votes.

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, but 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.

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.

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.

C. Financial Institution Governance

1. Section 956 of Dodd-Frank requires "each covered financial institution to disclose to the appropriate Federal regulator the structure of all incentive-based compensation arrangements offered by such [institution] sufficient to determine whether the compensation structure –

   (A) provides an executive officer, employee, director or principal shareholder . . . with excessive compensation, fees or benefits; or

   (B) could lead to material financial loss to the covered financial institution."

   "Covered financial institution" covers depository institutions, their holding companies, broker-dealers, investment advisers, credit unions (except that institutions with assets under $1 billion are excluded).

2. Section 165(b) of Dodd-Frank authorizes the Federal Reserve to adopt a "contingent capital standard" for systematically significant financial institutions. "Contingent capital" is a debt security that automatically converts into an equity security at certain pre-defined trigger points in order to avert a default and bankruptcy. The design of such a security remains in debate. See Coffee, "Bail-ins versus Bail-outs: Using Contingent Capital to Mitigate Systemic Risk," (available on SSRN).

D. Enforcement and Litigation 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).

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.

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 likely impact of National Australia Bank.

3. A New Cause of Action Against Ratings Agencies

Section 933 ("State of Mind in Private Actions") of the Dodd-Frank Act substitutes for the existing language in the Securities Exchange Act (which requires a plaintiff to plead particularized facts giving rise to a "strong inference of fraud") a new standard that specifies that for pleading purposes:

> "it shall be sufficient for purposes of pleading any required state of mind in relation to such action that the complaint state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed –
>
> (1) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or
>
> (2) to obtain reasonable verification of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter."

This is the only new private cause of action in Dodd-Frank.

What Will Be the Impact?

1. Section 933(b) is framed in the alternative. A credit rating agency can either (a) conduct its own reasonable investigation, or (b) rely on an independent third party "due diligence" firm to provide it with "reasonable verification."
2. It seems likely that the CRAs will rely on the second option and insist on the use of a third party firm. But, at this stage, they still must obtain "reasonable verification." The cost of the due diligence firm will presumably be borne (as in the past) by the underwriter.

Remaining Issues

3. Can a "third party" due diligence firm be independent if it receives a large portion of its total income from one underwriter?
4. What is the liability of the third party due diligence firm?
   - A. Of course, the SEC can sue it as an aider and abetter (based on a standard of recklessness).
   - B. However, if the due diligence report is publicly disclosed, investors may also be able to rely upon information in it as a material fact (i.e., just as they can rely on conclusions in an auditor's opinion). But this leaves it up to the SEC as to whether to require public disclosure of due diligence reports (as an attachment to an NRSRO rating) and how detailed they must be.

What Happens After the Motion to Dismiss?

1. Section 933(b) frames the standard for the motion to dismiss only. A plaintiff cannot obtain discovery or proceed further without surviving this hurdle.
2. But, if the case goes forward, Section 933(a) provides that:

   > "The enforcement and penalty provisions of this title shall apply to statements made by a credit rating agency in the same manner and to the same extent as such provisions apply to statements made by a registered public accounting firm or a securities analyst under the securities laws. . . ." (except that the safe harbor for forward-looking information is expressly made inapplicable).

3. Thus, if the case goes to trial, plaintiffs must still prove scienter on the part of the CRA in a Rule 10b-5 action. Scienter does not equate with the absence of "reasonable verification;" that is, the fact that the due diligence firm did a poor job does not imply "severe recklessness" on the part of the CRA – unless possibly if the CRA was consciously aware of the inadequacy in the verification procedure. Thus, discovery must enable the plaintiff to show that the CRA was aware of underlying problems and had undisclosed doubts about the accuracy of its rating.
4. Finally, any motion for summary judgment should be governed by Section 933(a), not Section 933(b).

Long-Term Models for Reform

1. Curbing the "Issuer Pays" Business Model

   Three routes to this end have been proposed:

   1. The Government As Umpire
      Under Dodd-Frank, the decision has been delegated to the SEC to determine (after a two year study) if a Credit Rating Agency Review Board should be created to select the initial rater for structured finance ratings (the issuer could then purchase additional ratings).

   2. Jumpstarting a "Subscriber Pays" Model (not in Dodd-Frank)
      Either:

      (A) Institutional investors are required to obtain a rating from a non-issuer paid CRA; or

      (B) Issuers who hire a CRA must pay for a second rating from an investor owned CRA; or

      (C) The Government Agency Selects the CRA preferred by a poll or vote of investors.

      Goal: Induce CRAs to Compete for Investor Favor.

   3. The Government Utility Model (the European Commission appears to be considering pursuing this route).
      The government prepares its own ratings (but issuers presumably remain free to purchase ratings). But is the Government really objective and neutral about home country issuers?

An Assessment

1. Some of these governance reforms may work at cross-purposes to the general intent of Dodd-Frank to control systemic risk.

2. Because the easiest way for a bank to increase its profitability is to increase its leverage, activist shareholders may pressure the managers of financial institutions to increase leverage. Rule 14a-11 may enable such activists to place a Carl Icahn-like figure on the bank's board and thus to increase shareholder pressure for greater risk and leverage.

3. Of all affected institutions, the credit rating agencies probably face the most uncertain future; they are subject to new liability provisions but still assert their First Amendment defenses. The SEC has two years to decide whether to seek to restrain the "issuer pays" model, and political tides may constrain the SEC.

4. Otherwise, Dodd-Frank imposes relatively mild constraints on executive compensation (modest in proportion to the Populist anger in the U.S.) and largely follows U.K. practices on "say on pay" and board composition.