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House Committee Approves Bill to Repeal Key Provisions of Dodd-Frank

On May 4, 2017, the House Financial Services Committee approved the Financial CHOICE Act ("CHOICE Act") to repeal and roll back significant pieces of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The Committee voted to send the CHOICE Act to the House floor, 34-26, along party lines.

The principal focus of the CHOICE Act is the banking provisions of Dodd-Frank and the Consumer Financial Protection Bureau. In addition, the CHOICE Act includes provisions relating to agency rulemaking requirements, judicial review of agency actions and capital formation. In the context of executive compensation and corporate governance, if ultimately approved by Congress, the CHOICE Act would make the following changes to Dodd-Frank:

- Repeals or modifies certain executive compensation and corporate governance requirements
- Requires proxy advisory firms to register with the Securities and Exchange Commission (SEC)
- Directs the SEC to change its rules on shareholder eligibility to submit proxy proposals

The following is a summary of the key provisions of the CHOICE Act specifically related to compensation, corporate governance and regulation of proxy advisory firms.

Repeal of Selected Dodd-Frank Provisions Related to Executive Compensation and Corporate Governance

The CHOICE Act would ***repeal*** the following Dodd-Frank provisions related to executive compensation and corporate governance:

- CEO pay ratio disclosure
- Disclosure of a company's policy on employee or director hedging of company securities
- SEC's authority to issue rules on proxy access
- SEC's authority to issue rules to require disclosure on a company's board leadership structure (i.e., Chairman and CEO structures)
- Federal financial regulators' ability to prohibit types and features of incentive compensation arrangements maintained by covered financial institutions

Amendment of Dodd-Frank Provisions Related to Executive Compensation and Corporate Governance

The CHOICE Act also would amend the following Dodd-Frank provisions related to executive compensation and corporate governance:

- **Mandatory clawback**. Under Dodd-Frank, public companies are required to adopt a no-fault mandatory clawback policy in accordance with rules written by the SEC (currently, the SEC has issued a proposed rule on the mandatory clawback requirement). The proposed rule would require companies to clawback "excess" incentive compensation that results from certain financial restatements. The CHOICE Act would modify Dodd-Frank to apply the mandatory clawback requirement solely to an "executive officer" who "had control or authority over the financial reporting that resulted in the accounting restatement."
- **Frequency of Say on Pay vote**. Currently, Dodd-Frank requires public companies to hold Say on Pay votes at least once every three years (however, the overwhelming majority of companies hold Say on Pay votes each year). In addition, Dodd-Frank allows shareholders to make a non-binding advisory vote every six years on whether companies should hold Say on Pay votes annually, biennially or triennially ("Say on When Vote"). The CHOICE Act would amend Dodd-Frank by requiring a public company to hold Say on Pay votes only in those years "in which there has been a material change to the compensation of executives of an issuer from the previous year." The CHOICE Act would also eliminate the Say on When Vote requirement under Dodd-Frank.

Meridian comment. The proposed CHOICE Act provides an early preview into House Republicans' view on Dodd-Frank mandates in the area of executive compensation and corporate governance. The CHOICE Act would bring welcomed relief to public companies on a number of significant regulatory mandates. Of particular note is the CHOICE Act's repeal of the CEO pay ratio disclosure and significant modification to the mandatory clawback requirement. Some public companies may also welcome the possibility of holding less frequent Say on Pay votes. However, as Say on Pay has become a ubiquitous feature of corporate governance, we believe most mid and large cap companies will continue to hold annual Say on Pay voting, regardless of the statutory requirements.

The Trump administration has made no public comment on the CHOICE Act.

The CHOICE Act would not affect the Dodd-Frank provisions relating to: (1) compensation committee independence requirements and (2) disclosure on the relationship between executive pay and corporate performance. In 2015, the SEC adopted a proposed rule on the pay-for-performance disclosure requirement. However, under Republican control, the SEC would appear unlikely to adopt a final rule.

Modification of SEC Rules on Shareholder Proposals

Under current SEC rules, a shareholder may submit a proposal for inclusion in a company's proxy filing if the shareholder has held for at least one year (1) company shares with a market value of at least $2,000 ("Dollar Eligibility Requirement") or (2) 1% of the company's outstanding voting securities ("1% Eligibility Requirement"). SEC rules also allow a shareholder representative to submit a proposal on behalf of the shareholder. In addition, SEC rules allow a shareholder to resubmit a proposal that is similar or the same as a prior proposal if the initial proposal received certain threshold levels of shareholder support ("Resubmission Rule").

The CHOICE Act would require the SEC to amend the foregoing rules on shareholder proposals in the following respects.

- **Eligibility to submit shareholder proposal**. The CHOICE Act would require the SEC to modify eligibility requirements to submit a shareholder proposal in the following respects:

  — Eliminate the Dollar Eligibility Requirement

  — Maintain the 1% Eligibility Requirement (or such greater percentage as determined by the SEC)

  — Adjust the 1-year holding period to 3 years

- **Submission through a representative**. The CHOICE Act would effectively prohibit third-party representatives from submitting proposals on behalf of a shareholder. Specifically, the CHOICE Act would require the SEC to prohibit a company from including in its proxy a shareholder proposal submitted by a representative of the shareholder.

- **Resubmission Rule**. Currently, the Resubmission Rule permits a company to exclude from its proxy a shareholder proposal if a similar proposal was last included in the proxy materials within the preceding three years and if, the last time it was included:

  — the proposal received less than 3% support, if proposed once within the last five years;

  — the proposal received less than 6% support, if proposed twice within the last five years; or

  — the proposal received less than 10% support, if proposed three or more times within the last five years.

  The CHOICE Act would require the SEC to substantially modify the Resubmission Rule to permit a company to exclude from its proxy a shareholder proposal if a similar proposal was last included in the proxy materials within the preceding five years and if, the last time it was included:

  — the proposal received less than 6% support, if proposed once within the last five years;

  — the proposal received less than 15% support, if proposed twice within the last five years; or

  — the proposal received less than 30% support, if proposed three times or more within the last five years.

Meridian comment. The proposed modification addresses long-held concerns voiced by major companies and business associations about the shareholder proposals and related ownership requirements. In particular, that those requirements go too far in protecting minority shareholders by allowing a shareholder of a mere $2,000 worth of stock to submit a proposal. Further, that the Resubmission Rule essentially allows for repeated resubmissions of a shareholder proposal despite the proposal garnering minimal support from shareholders. Collectively, these issues may cause corporations to spend considerable time and resources on proposals that may be of little or no interest to a meaningful segment of shareholders.

The significantly higher ownership requirement to submit a proposal and the higher level of prior shareholder support required to resubmit a proposal under the CHOICE Act would help to mitigate corporate concerns regarding share ownership requirements.

Registration of Proxy Advisors

The CHOICE Act would subject proxy advisory firms to a broad set of regulations with the ultimate goal of ensuring that such firms' voting recommendations are based on current and accurate information. Among other requirements, the CHOICE Act would require proxy advisory firms to (1) register with the SEC, (2) submit an annual report to the SEC, (3) maintain policies and procedures to address conflicts of interest, (4) maintain a staff sufficient to produce proxy voting recommendations that are based on accurate and current information and (5) file with the SEC and make publicly available its methodology for the formulation of voting policies and voting recommendations.

Of particular interest to many public companies, the CHOICE Act would require a proxy advisory firm to provide companies with a reasonable opportunity to comment on the firm's draft recommendations. In addition, a proxy advisory firm would be required to employ an ombudsman who would work to resolve company complaints.

Meridian Comment. Regulatory oversight of proxy advisory firms has long been the subject of debate. Boards and corporate management have expressed concerns about proxy advisory firms' concentration of power, potential conflicts of interest, lack of transparency, limited review time by issuers and absence of clear methods to resolve issues regarding vote recommendations. The CHOICE Act addresses many of these concerns. For the most part, proxy advisory firms should not find compliance with the CHOICE Act problematic. However, the one significant exception is the requirement that proxy advisory firms preview draft voting recommendations with each subject company, allow companies to comment on the recommendations and resolve complaints raised by a company. Given that proxy advisory firms issue voting recommendations on thousands of U.S. (and global) public companies, often in relatively narrow timeframes, proxy advisory firms' ability to comply with the foregoing requirements is a near impossibility absent a dramatic increase in their staffing.

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The ***Client Update*** is prepared by Meridian Compensation Partners' Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.