Public Companies Take Notice: Government Regulation Is Growing

By Paul R. Hess

The month of July taught the public company world that the culture of extensive—and expensive—government regulation is growing stronger rather than weakening.

First, despite the hopes of many, the Sarbanes-Oxley Act of 2002 is alive and well and going to stick around. The groundbreaking legislative response to the huge accounting and financial scandals of companies such as Enron and WorldCom created regulatory and governance reforms designed to restore confidence in the public markets. However, Sarbanes has not been popular among public company officers and directors due to the extensive costs, regulatory burdens and time consumption involved.

In Free Enterprise Fund v. the PCAOB, the U.S. Supreme Court addressed the constitutionality of a technical provision of Sarbanes. While the ruling will not have any meaningful impact on public (or private) companies, the case re-affirmed the constitutionality of Sarbanes generally.

At issue was the validity of the establishment of, and the appointment of members to, the Public Company Accounting Oversight Board (PCAOB), which is the regulatory agency created by Sarbanes to oversee the auditors of public companies. Members of the PCAOB are appointed by the U.S. Securities and Exchange Commission and can only be removed by the SEC for cause. The lawsuit claimed that this limitation on the removal of members violated the Constitution's separation of powers clause.

Many news reports about the case suggested that the validity of all of Sarbanes was at stake, because its provisions were not severable. In other words, if any element of Sarbanes were ruled unconstitutional, the entire act would thereby be deemed such.

However, the Supreme Court, while striking down a provision that prevented the SEC from removing members of the PCAOB at will, not only upheld the establishment and constitutionality of the board, but also confirmed that the "Sarbanes-Oxley Act remains 'fully operative as a law' with these tenure restrictions excised."

Thus, the Sarbanes-Oxley Act remains intact, and this Supreme Court decision will make it very difficult to question its validity going forward.

Financial Reform

On July 22, after almost a year of deliberations, the Dodd-Frank Wall Street Reform and Consumer Protection Act took effect. While the central focus of the Dodd-Frank Act is aimed at regulating banks and other financial institutions, the act also includes corporate governance and compensation requirements affecting all public companies.

Leaders of public companies in Ohio would be wise to evaluate the potential impact on their organizations and plan accordingly.

Many provisions will take months, or even years, to be implemented and are subject to final rules and regulations to be adopted by regulatory agencies such as the SEC.

Some key provisions that will affect all public companies include:

• **Proxy access:** The act authorizes the SEC to issue rules requiring companies to include candidates nominated by shareholders who meet certain ownership thresholds in the company's proxy statement. On Aug.25, the SEC adopted proxy access rules and set forth specific requirements, which will be in effect for the 2011 proxy season.

• **"Say on Pay":** Beginning in 2011, companies will be required to give shareholders an annual nonbinding vote on executive compensation, although shareholders can elect for the Say on Pay vote to be taken only every two or three years.

• **Vote on golden parachutes:** Companies must give shareholders a nonbinding vote on any golden parachute-type executive compensation arrangements whenever shareholder approval is required for an acquisition or sale.

• **Discretionary voting/broker non-votes:** The act prohibits discretionary voting by brokers of shares held in "street name" that are not voted by the beneficial owners in the election of directors, on executive compensation and on other significant matters.

• **Executive compensation:** Companies must disclose the relationship between the executive compensation actually paid and the company's financial performance, as well as the ratio of the CEO's annual total compensation to the median annual total compensation of all other employees.

• **Hedging:** Companies will have to disclose their policy on whether directors or employees are permitted to purchase financial instruments designed to hedge or offset a decrease in the market value of the company's equity securities.

• **Clawbacks:** The act requires companies to adopt a clawback policy to recover excess incentive-based compensation received by executives for three years preceding an accounting restatement triggered by material noncompliance with any financial reporting requirements.

• **Compensation committee independence:** Each member of the compensation committee, and each of its advisors, is to be independent of the company.

• **Voting in director elections:** The requirement that directors be elected by a majority of shareholders, rather than by a plurality, was not included in the final act.

Given these recent developments, leaders of public companies in Ohio would be wise to evaluate the potential impact on their organizations and plan accordingly. While some provisions won't take effect until final rules are issued, it's never too early to get organized. ◊

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