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Alert

SEC Disclosure and Corporate Governance

SEC Implements Mandatory Say-on-Pay Advisory Votes for Executive Compensation

Also Implements Golden Parachute Disclosures and Advisory Vote

Introduction

Last week the U.S. Securities and Exchange Commission approved final rules implementing the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 that require U.S. public companies to conduct a separate shareholder advisory vote on:

- the compensation of their named executive officers (a “say-on-pay” vote) – at least once every three calendar years;
- whether the say-on-pay vote should be held annually, biennially or triennially (the “frequency vote”) – at least once every six calendar years; and
- any golden parachute compensation arrangements of their named executive officers in connection with a “M&A transaction” that is presented to shareholders for approval (a “say-on-golden parachute” vote).

The outcomes of these votes are not binding on the company or its board of directors; they do not affect the validity of compensation arrangements or the fiduciary duties of directors regarding compensation matters. However, they will represent an important expression of shareholder views on a company’s executive compensation policies, with a potentially significant impact on shareholder relations. In considering these votes, companies should also keep in mind that, under recently adopted rules required by the Dodd-Frank Act, brokers will no longer have discretion to vote on these matters any customer shares for which they have not received voting instructions.

As mandated by the Dodd-Frank Act, companies already have been conducting say-on-pay and frequency votes for annual meetings taking place on or after January 21, 2011. Except as noted below, the new SEC rules become effective 60 days after publication in the Federal Register. While the new rules were adopted largely as proposed, a number of changes were made and companies still working on their proxy statements should carefully review the rules in final form.

We will be issuing a separate Alert covering the say-on-golden parachutes vote and the new disclosures that will be required for M&A transactions. Companies must comply with those new requirements beginning with initial filings on or after April 25, 2011.

Summary of Rules

Companies are required, not less frequently than once every three years, to provide a separate shareholder advisory vote to approve the compensation of their named executive officers, as disclosed pursuant to Item 402 of Regulation S-K (i.e., in the “CD&A”, the compensation tables and other required executive compensation disclosures).

Annual Meetings Only

A say-on-pay vote is required only when proxies are solicited for an annual meeting of shareholders (or special meeting in lieu of an annual meeting) at which directors will be elected and for which executive compensation disclosures are required.

- This applies to the first annual or other meeting held on or after January 21, 2011 (January 21, 2013 for smaller reporting companies); and
- thereafter no later than the annual or other meeting held in the third calendar year after the last required vote.

Scope of Say-on-Pay

The say-on-pay vote applies only to executive compensation disclosed pursuant to Item 402 of Regulation S-K and does not cover Item 402 disclosures about the compensation of directors (402(k)) or policies for compensating employees as they relate to risk management (402(s)).

- A company should consider pointing out in its proxy statement that these areas are excluded from the vote (being sure to attach a separately identifiable heading to these areas in the proxy statement).

Form of Say-on-Pay and Frequency Resolutions

Although the rule does not require companies to use any specific language or form of say-on-pay resolution to be voted on, an instruction states that the company’s “resolution shall indicate that the shareholder advisory vote ... is to approve the compensation of the [company’s] named executive officers as disclosed pursuant to Item 402 of Regulation S-K.” The instruction also provides a non-exclusive example of a satisfactory say-on-pay resolution: “RESOLVED, that the compensation paid to the company’s named executive officers, as disclosed pursuant to Item 402 of Regulation S-K, including the Compensation Discussion and Analysis, compensation tables and narrative discussion is hereby APPROVED.” No SEC guidance is given regarding the form of the frequency vote resolution.

- The rule and instruction appear to require a “resolution” format that references “Item 402 of Regulation S-K” specifically. Clarification from the SEC staff should be forthcoming as to whether this actually will be the case.

Form of Proxy Card

The proxy for the frequency vote must provide shareholders with four choices (1, 2 or 3 years, or abstain).¹

No Preliminary Proxy Statement

The SEC confirmed that a preliminary proxy statement filing obligation is not triggered by the company including in its proxy statement either a say-on-pay vote or a frequency vote, nor any other shareholder advisory vote on executive compensation, even one not required by the Dodd-Frank Act.

Disclosure in CD&A of Consideration Given Recent Say-on-Pay Voting Results

Once a say-on-pay vote has been held, to facilitate better investor understanding of a company's compensation decisions, a company will be required to include in the compensation discussion and analysis ("CD&A") section of its proxy statement² disclosure as to whether and, if so, how the company has considered the results of the most recent say-on-pay vote in determining compensation policies and decisions and, if so, how that consideration has affected the company's executive compensation decisions and policies.³ The SEC also believes that companies should address their consideration of the results of earlier say-on-pay votes to the extent such consideration is material to the decisions and policies discussed in the CD&A.

Disclosure of Next Say-on-Pay Vote

After a company's initial say-on-pay and frequency votes, in subsequent proxy statements a company must disclose the then current frequency of the say-on-pay vote (as determined by the board) and when the next scheduled say-on-pay vote will occur.

New 8-K Disclosure for Company's Decision on Frequency of Say-on-Pay

Following an annual or other meeting at which shareholders voted on the frequency of the say-on-pay votes, the company will need to disclose in a Form 8-K (under a revised Item 5.07) the company's decision, in light of such vote, as to how frequently the company will include the say-on-pay vote in its proxy statement (until the next required frequency vote). This can be accomplished by an amendment to the initial Item 5.07 Form 8-K reporting the result of the frequency vote, but the amendment must be filed not later than the earlier of (i) 150 calendar days after the end of the meeting at which the frequency vote occurred and (ii) 60 calendar days prior to the deadline for the submission of shareholder proposals under Rule 14a-8 for the subsequent annual meeting (as disclosed in the proxy statement for the meeting).

- Companies should schedule time at a board and/or committee meeting to deliberate this decision, and disclosure timetable checklists should be updated for this addition to Item 5.07, particularly since an untimely filing would result in, among other things, the loss of Form S-3 eligibility.

Ability of a Company to Exclude Rule 14a-8 Shareholder Proposals Seeking Say-on-Pay or Frequency Votes

Although the Dodd-Frank Act and the new implementing rules mandate say-on-pay and frequency votes, shareholders may nonetheless submit their own proposals to companies on these subjects and seek to have them included in the board of directors' proxy statement pursuant to SEC Rule 14a-8. The SEC has clarified that in certain circumstances a company may exclude from its proxy statement a Rule 14a-8 shareholder proposal that would provide a say-on-pay vote or seek future say-on-pay-

votes or that relates to the frequency of say-on-pay votes. Specifically, a shareholder proposal may be omitted if, in the most recent shareholder vote on frequency, any of the three alternatives (i.e., one, two, or three years) received the support of a majority of votes cast and the company has adopted a policy on frequency that is consistent with that choice.⁴ A company that intends to exclude a proposal on this basis, however, will still need to follow the customary shareholder proposal process of making a no-action request to the SEC staff.

- The adopting release says that a shareholder proposal providing an advisory vote or seeking future advisory votes “on executive compensation with substantially the same scope as the [required] say-on pay vote ... [that is –] the approval of executive compensation as disclosed pursuant to Item 402 of Regulation S-K” would be subject to the new exclusion. How close to a say-on-pay resolution a compensation-related proposal must be in order to be “substantially the same” and therefore subject to exclusion is an open interpretative issue.

Golden Parachute Disclosures and Advisory Votes

As required by the Dodd-Frank Act, the SEC also has adopted rules requiring new disclosures regarding golden parachute arrangements in a proxy or consent solicitation statement seeking approval of an acquisition, merger, consolidation or sale or other disposition of all or substantially all assets of a company (an “M&A transaction”) and requiring a shareholder advisory vote on such arrangements. Specifically (subject to certain exceptions), whenever a company solicits a shareholder vote on an M&A transaction (a vote subject to Item 14 of Schedule 14A), the company must provide for a shareholder advisory vote on “any agreement or understanding, whether written or unwritten, between [a] named executive officer [of the acquiring company or the target company] and [either] the acquiring company or the target company, concerning any type of compensation, whether present, deferred or contingent, that is based on or otherwise relates to” the transaction. In general, if the arrangement has been disclosed by a company in accordance with the new requirements in a proxy statement seeking a say-on-pay vote and has been the subject of a say-on-pay vote, it need not be submitted to a say-on-golden parachute vote. The golden parachute disclosure and advisory votes will be discussed further in a separate Alert.

Treatment of IPO Companies and Smaller Reporting Companies

A newly public company will be required to include say-on-pay and frequency votes in the proxy statement for its first annual meeting after its initial public offering. Smaller reporting companies (generally companies have a public equity float of less than \$75 million) were given a partial deferral. Smaller reporting companies as of January 21, 2011, and newly public companies that qualify as smaller reporting companies after January 21, 2011, will not be required to conduct say-on-pay and frequency votes until the first annual (or special in lieu of annual) meeting of shareholders occurring on or after January 21, 2013. A similar delay will not apply to the requirement to hold a say-on-golden parachute vote, and the new disclosures about golden parachute arrangements will be required in M&A proxy statements.

Impact on Foreign Private Issuers

Foreign private issuers are not required to conduct say-on-pay and frequency votes.

Practical Considerations

What should be the frequency vote recommendation?

Whether a company should subject its executive compensation to an annual, biennial or triennial say-on-pay vote depends on the circumstances surrounding the company's pay practices and its relations with its shareholders and with proxy voting advisors.

- **Annual Votes** allow shareholders to provide input every year; show commitment to engaging with shareholders; are beneficial because less frequent votes may allow a poor pay practice to continue too long; and will likely be supported by activist shareholders and proxy voting advisors.
- **Triennial Votes** make sense for companies whose executive compensation programs incentivize and reward performance over a multi-year period; provide companies with time to consider the results of their say-on-pay votes and respond appropriately; and provide shareholders a longer timeframe over which to evaluate the effectiveness of short- and long-term compensation strategies and related business outcomes of the company.
- **Biennial Votes** strike a balance between annual and triennial votes.

The rules do not require that companies make recommendations on the vote. Most boards will likely make (and have been making) a recommendation. Retail shareholders, if they vote, generally follow the board's recommendation. If a frequency vote choice is not made on a signed proxy card, then the proxy holder (generally, the company's management) has the discretion to vote the board's recommendation as indicated on a proxy card. If no recommendation is made, management forgoes this opportunity.

As of January 28, 2011, of the 205 companies that filed proxy statements for meetings to be held on or after January 21, 2011:

- 120 companies (including 34 smaller reporting companies) recommended a triennial vote;
- 60 companies (including 11 smaller reporting companies) recommended an annual vote;
- 13 companies (including two smaller reporting companies) recommended a biennial vote; and
- 12 companies (including four smaller reporting company) made no recommendation.⁵

A triennial vote is favored by the United Brotherhood of Carpenters and some other institutional investors who are concerned about the demands the new vote will place on them to analyze CD&As and other disclosures for all the companies in their portfolios on which they are to vote and to "engage" with other shareholders. Several prominent institutional investors are expected to support generally, if not exclusively, an annual vote. Institutional Shareholder Services Inc. ("ISS") has stated that it supports an annual vote but has not adopted a policy penalizing a company this year for a different board recommendation (e.g., a company should not expect ISS to recommend a vote against the approval of a stock plan if the board recommended a triennial say-on-pay vote). Those companies that believe an annual say-on-pay vote is not appropriate for them should consider conducting outreach with their large institutional shareholders in addition to explaining in proxy materials why a biennial or triennial vote is best for their circumstances. Next year, expect ISS to view in a negative light failure by a board to abide by a clear mandate from shareholders on the frequency of the say-on-pay advisory vote.

How will ISS use Say-on-Pay?

ISS has announced that its recommendation to vote “against” a company’s say-on-pay resolution will be used as its primary means for expressing dissatisfaction with a company’s compensation policies and practices, rather than recommending a withhold or against vote on compensation committee members.⁶ In addition, if the company has what ISS considers egregious pay-practices, or if the board fails to respond to concerns raised by a prior year’s negative say-on-pay vote, then ISS will recommend a withhold or against vote on compensation committee members (or, if the full board is deemed accountable, all directors). Consequently, if a majority or, perhaps, a smaller but still large number of shareholders vote against in a say-on pay vote and the board does not respond with changes, it is likely that the compensation committee members will the next year face substantial withhold or against votes on their re-election.

Actions to Take

- ***Consider making a frequency vote recommendation.*** Given the complexity of compensation plans and the fact that they often are designed to induce and reward performance over a multi-year period, boards may wish to recommend that the advisory vote be held every two or three years rather than every year. Some institutional shareholders are likely to support holding the vote on a less frequent than annual basis. However, annual votes allow shareholders to provide input every year and make the votes more routine and may be perceived by some institutional shareholders to show a commitment to engaging with shareholders on compensation. The assistance of a proxy solicitor may be helpful in discerning the likely level of support of the company’s shareholder base for a proposed recommendation.
- ***Review proxy statements already filed with the SEC by other companies.*** Among the numerous companies that have already filed proxy statements including say-on-pay votes, the disclosure, generally speaking, has been fairly brief (one page), consisting of: (i) the Dodd-Frank Act origins of the vote; (ii) what shareholders will be voting on and statement of its non-binding nature; (iii) a few sentences about the Company’s financial results and/or compensation programs with cross-references to the CD&A, compensation tables and narrative; (iv) the resolution; (v) the required vote; (vi) a statement about the board taking into account the vote results and a reiteration of its non-binding nature; and (vii) the board recommendation. The disclosure relating to frequency votes has been even more brief, consisting of: (i) the Dodd-Frank Act origins of the vote; (ii) what shareholders will be voting on; (iii) the board’s recommendation and its rationale; (iv) the resolution; (v) the required vote; (vi) a statement relating to the board taking into account the vote results and a reiteration of the vote’s non-binding nature; and (vii) the board’s recommendation.
- ***Read new rules and comply with new disclosure requirements.*** Many companies that have already filed proxy statements for say-on-pay vote used the SEC’s proposing release as a guide. Now that the final rules have been adopted (with differences from the proposals), companies should be sure to review the final rules carefully (and be wary of using other companies’ prior disclosures as precedent). Companies should also update their disclosure controls and procedures for the new Form 8-K Item 5.07 filing requirements.
- ***Be aware of shareholder and proxy advisor “hot buttons.”*** Now more than ever companies need to know and consider the “hot buttons” of their shareholders and the proxy voting

advisors with respect to compensation, keeping in mind that broker discretionary voting will no longer be available for say-on-pay (and frequency votes). For many companies, as a practical matter, their executive compensation practices and disclosures may need to satisfy ISS' voting guidelines – for if they do not, a company risks a substantial stockholder vote against on say-on-pay. If ISS' s perceived “offensive practices” remain un-remedied, the company further risks an eventual withhold or against vote in the election of the compensation committee or board of directors. Companies should be sure to review ISS' revised policy on “problematic pay practices” because it now also applies to the say-on-pay vote.⁷ Companies should also be sure to review prior years' reports by proxy advisors.

- **Consider inclusion of a summary in CD&A.** Consider including an executive summary at the beginning of the CD&A section of the proxy statement to provide easy access to the key information needed to cast informed say-on-pay votes. Companies may find it useful to communicate in one place their key messages to shareholders (and proxy advisors) in a clear and concise (one page or so) manner. “Summary” is a misnomer since it should not try to summarize all aspects of the CD&A. Instead, it should be reserved for highlighting key points that are important to investors. Elements of the summary might include: (i) a description of business results for the past year (and multiple years since compensation may be linked to multi-year performance), emphasizing performance measures that were used for short- and long-term incentives; (ii) an explanation of the relationship of these results to compensation awards in the past year; (iii) the key accomplishments of the CEO and/or executive team and a description of the compensation actions taken; and (iv) any new corporate governance or executive compensation policies that have been adopted during the last year, as well as any existing practices, that are likely to be well-received by investors (e.g., clawback policies, stock ownership policies, limits on perquisites and severance benefits, and use of an independent compensation consultant).

If you have any questions on these matters, please do not hesitate to speak to your regular contact at Weil, Gotshal & Manges LLP or to any member of the Firm's Public Company Advisory Group:

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Endnotes

¹ If a proxy card is signed by a stockholder but no choice is made, the SEC has clarified that the company may vote such uninstructed shares in accordance with management's recommendation if it follows the existing requirements of Rule 14a-4 by (1) including a recommendation for the frequency of say-on-pay vote in the proxy statement, (2) permitting an abstention on the proxy card, and (3) including language regarding how uninstructed shares will be voted in bold on the proxy card.

² This will be required by an addition to the rule's statement of what the CD&A is to cover in Regulation S-K, Item 402(b)(1).

³ This new requirement is not applicable to smaller reporting companies (which are not required to have a CD&A), but the SEC's adopting release notes that there may be circumstances where such disclosure may nonetheless be required under other existing disclosure requirements.

⁴ Abstentions would not count as a vote cast for this purpose. The SEC prescribed this voting standard solely for the purpose of determining the scope of the new Rule 14a-8(i)(10) exclusion; it is not applicable for determining when a say-on-pay vote has received the requisite shareholder support to constitute shareholder action such that the say-on-pay resolution has been adopted, a matter governed by state law.

⁵ Borges' Proxy Disclosure Blog (January 30, 2011), www.compensationstandards.com.

⁶ See ISS' 2011 U.S. Proxy Voting Guidelines Summary, at p. 40 (Dec. 16, 2010), available at <http://www.issgovernance.com/files/ISS2011USPolicySummaryGuidelines20101216.pdf>.

⁷ See Weil Alert, Required Reading: ISS Issues Policy Updates for 2011 Proxy Season (Dec. 7, 2010), available at <http://www.weil.com/news/pubdetail.aspx?pub=10063>.

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