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The Votes Are In…Say-on-Pay Is Mandatory

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After years of anticipation (and anxiety), mandatory shareholder advisory votes on executive compensation – more commonly known as "say-on-pay" votes – are here. On January 25, 2011, the Securities and Exchange Commission (SEC) commissioners, by a vote of 3-2, adopted rules to implement Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

Although they have a bit more history in Europe and elsewhere, shareholder advisory votes on executive compensation are relatively new to the corporate governance scene in the United States. Momentum for requiring say-on-pay has been building over the past decade, thanks in part to the post-Enron push for stronger corporate governance, lavish executive pay packages and "golden parachutes" at certain prominent companies as well as upward trends in executive compensation widening the disparity between CEO and general employee pay and the current lower level of trust in corporations and management.

According to the AFSCME Office of Corporate Governance and Investment Policy, seven U.S. companies voluntarily included say-on-pay votes at their 2006 annual shareholder meetings. By 2008, that number had increased to 79 companies. In 2009, say-on-pay became mandatory for companies that received funds from the federal government's Troubled Asset Relief Program (TARP).

While the momentum had already been growing and it is difficult to pinpoint a single "final straw," the massive bonuses paid by Wall Street firms to their employees in the midst of the 2008 financial meltdown did little to dissuade Congress from including mandatory say-on-pay in the Dodd-Frank Act. Indeed, the Dodd-Frank Act amends the Securities Exchange Act of 1934 ("Exchange Act") to require that a non-binding say-on-pay vote be held at least once every three years and that, at least every six years, shareholders be given the opportunity to cast a non-binding advisory vote on whether say-on-pay votes should be held every one, two or three years. Both proposals are required to be included for the first meeting of shareholders occurring on or after January 21, 2011.

Say what?

Pursuant to Rule 14a-21(a), companies are required, at least once every three years, to provide for a separate, *non-binding* shareholder advisory vote in their proxy statements to approve the compensation of their named executive officers. The SEC's rules provide the following with respect to these say-on-pay votes:

Scope of advisory vote. The shareholder vote would be to approve the compensation of the public company's named executive officers (NEO), as that compensation is disclosed in the Compensation Discussion and Analysis ("CD&A"), compensation tables and other narrative compensation disclosures required by Item 402 of Regulation S-K. The final rule does provide a temporary exemption for smaller reporting companies (generally, companies with less than $75 million in public float) so that these issuers will not be required to conduct either a shareholder advisory vote on executive compensation or a shareholder advisory vote on frequency of say-on-pay until the first annual meeting or other meeting of shareholders occurring on or after January 21, 2013.

Director compensation not included. The compensation of directors is not subject to the say-on-pay vote.

No prescribed form of resolution. The SEC's rules do *not* require companies to use any specific language or form of resolution to be voted on by shareholders, as the SEC believes that companies should retain flexibility to craft the resolution language. To date, companies that have already filed their proxy statements for 2011 have used a multitude

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of approaches for their say-on-pay proposals.

Addition to CD&A. The SEC's rules require companies to address whether (and, if so, how) their compensation policies and decisions have taken into account the results of the most recent shareholder advisory vote on executive compensation in their CD&A. This requirement would not apply to a smaller reporting company unless similar considerations would be material to an understanding of its Summary Compensation Table, in which case similar disclosure would be required under Item 402(o) of Regulation S-K.

Say when?

As noted above, the Dodd-Frank Act also mandated a "say-on-frequency" vote that must be held this year and at least every six years hereafter. The SEC's adopted rules provide the following with respect to these say-on-frequency votes, which are also non-binding and advisory in nature:

Scope of advisory vote. The shareholder vote would be to determine whether say-on-pay votes will occur every one, two or three years.

Shareholders must be given four choices. Although the SEC's proposed rules permit boards to recommend how the shareholders should vote, it is clear that the resolution (and proxy card) cannot be written to seek shareholder approval of that recommendation. Rather, shareholders must be given the opportunity to vote on whether say-on-pay votes should occur every one, two or three years or to abstain from voting on the matter.

What is the "correct" say-on-pay frequency? Commentators generally agree that the answer might be different for different companies, depending on their facts and circumstances. RiskMetrics Group/Institutional Shareholder Services (ISS) has issued 2011 policy guidelines providing that it will recommend a vote for *annual* say-on-pay votes. Certain other groups and institutional shareholders have voiced support for biennial or triennial say-on-pay votes, which might facilitate greater focus on pay for performance over time and also enable boards and compensation committees to thoughtfully consider shareholder feedback when making changes to their executive compensation programs.

Disclosure of results on Form 8-K. To comply with this requirement, companies will need to file an amendment to their prior Form 8-K filings under Item 5.07 that disclosed the preliminary or final results of the shareholder vote on frequency. This amended Form 8-K will be due no later than 150 calendar days after the date of the end of the annual or other meeting in which the advisory vote took place, but in no event later than 60 calendar days prior to the deadline for the submission of shareholder proposals under SEC Rule 14a-8 for the subsequent annual meeting.

Other notes about say-on-pay and say-on-frequency

No preliminary proxy statement required. The SEC's adopted rules add the say-on-pay and say-on-frequency votes to the list of items that do *not* trigger the requirement to file a preliminary proxy statement with the SEC.

Broker discretionary voting prohibited. In accordance with the Dodd-Frank Act's specific mandate, the SEC's rules direct national securities exchanges (e.g., NYSE and NASDAQ) to expressly *prohibit* broker discretionary voting in say-on-pay and say-on-frequency votes.

No impact on board's fiduciary duties. Pursuant to the Dodd-Frank Act, no say-on-pay or say-on-frequency advisory vote:

◆ can be construed as overruling a decision by the company or its board of directors;

◆ creates or implies any change to the fiduciary duties of the company or its board of directors; or

◆ creates or implies any additional fiduciary duties of the company or its board of directors.

What are they saying so far?

Based on reports from commentators tracking filings and voting results, as of mid-March 2011, the breakdown of company recommendations for the say-on-pay frequency vote in proxy statements that have been filed for the 2011 proxy season were as follows:

◆ approximately 49% of companies had recommended an annual vote;

◆ approximately 45% of companies had recommended a triennial vote;

◆ approximately 3% of companies had recommended a biennial vote; and

◆ approximately 3% of companies had made no recommendation.

With respect to companies that have reported the results of their annual meetings, there appears to be shareholder preference for annual votes, in line with ISS's policy guideline to recommend an annual vote.

Disclosure and shareholder approval of "golden parachutes"

The SEC has also adopted new rules relating to the disclosure and shareholder approval of certain "golden parachute" compensation arrangements. The details of these enhanced disclosures and "say-on-golden-parachute" votes include the following:

Trigger for disclosure requirement. Section 14A(b)(1) of the Exchange Act requires any company seeking shareholder approval of an acquisition, merger, consolidation proposed sale of all or substantially all of its assets to provide "clear and simple" disclosure regarding any agreements or understandings that the company has with its NEOs concerning compensation that is based on or otherwise relates to the proposed transaction. The disclosure is required to be provided in the proxy statement soliciting approval of the transaction.

Scope of enhanced disclosures. The SEC's adopted rules would require both tabular and narrative disclosure of golden parachute arrangements with the NEOs. The prescribed table would include amounts for the individual elements of compensation (e.g., cash severance/bonus, value of accelerated equity awards, pension or deferred compensation enhancements, perquisites, etc.) to be received by each NEO based on or relating to the transaction. Single-trigger and double-trigger amounts and arrangements would be specifically identified in footnotes to the table. The narrative disclosure requirements require companies to describe, among other things, any material conditions or obligations applicable to an NEO's receipt of payment (e.g., non-competition and non-solicitation arrangements), the specific circumstances that would trigger payment, and whether the payments would be made in a lump sum or over time (and, if so, the duration of such payments).

Say-on-golden-parachute shareholder advisory vote. As mandated by the Dodd-Frank Act, the adopted rules require a company to provide for a separate, non-binding shareholder advisory vote on golden parachute arrangements in its proxy statement seeking shareholder approval of an acquisition, merger, consolidation or proposed sale of all or substantially all of the company's assets.

Conclusion

While the early results from shareholder votes appear to indicate a preference toward annual advisory votes, there is one recommendation that appears frequently in the say-on-pay commentary – companies should use their CD&A to clearly explain and justify their executive compensation and not overload their support for the say-on-pay advisory vote proposal with repetitive disclosures, as this may exasperate shareholders and cause them to vote against executive compensation out of annoyance.