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SEC Adopts Final Say on Pay Rules

Practical Considerations for Your Upcoming Annual Meeting Proxy Statements

On January 25, 2011, the Securities and Exchange Commission (the "SEC") adopted final rules implementing the "say on pay" and "say on frequency" provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"). The SEC had previously issued proposed rules regarding say on pay and say on frequency, and, as expected, the SEC's final rules are generally similar to the proposed rules. Like the proposed rules, the final rules require most companies to hold a say on pay and say on frequency vote this year. In addition, the final rules provide that these companies will be required to ask their shareholders to approve executive compensation arrangements at least once every three years going forward, and give shareholders an advisory vote on whether the say on pay vote should occur annually, biennially or triennially at least once every six years. The results of these shareholder votes are not binding on the company, which still allows a company flexibility in determining its compensation policies and the frequency with which executive compensation must be put to a shareholder vote.

Furthermore, the final rules require additional disclosure of golden parachute arrangements and a shareholder advisory vote on these arrangements in connection with corporate transactions. The final rules on golden parachute votes and disclosure apply to proxy statements and other transaction-related SEC filings filed on or after April 25, 2011.

Changes from Proposed Rules

The final rules include a few notable differences from the proposed rules:

Compensation Discussion and Analysis ("CD&A"). Public companies that are subject to the new rules will now be required to discuss the impact on the company of the most recent say on pay vote in their CD&A. The discussion must include whether and how the company has considered the results of the vote, and how that consideration has impacted the company's executive compensation policies and decisions. This provision will likely increase pressure on companies to act in accordance with the outcome of the non-binding say on pay vote, as they will be required to publicly justify their decision-making if they do not.

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Exclusion of Shareholder Proposals on Say on Pay. The proposed rules would have allowed a company to exclude shareholder proposals seeking a say on pay vote or relating to the frequency vote if the company had implemented the voting frequency that received a plurality of votes at the last shareholder meeting. However, the final rules increased this threshold such that shareholder proposals regarding say on pay or say on frequency may only be excluded if the company's chosen voting frequency received a majority of the votes cast at the last meeting at which such a vote was required. Because shareholders must be given the choice between four different options regarding frequency (every one, two, three years or abstain), it is possible that no single frequency option will receive a majority of votes cast. Thus, this change in the final rules is likely to reduce the chances that say on pay or say on frequency shareholder proposals can be excluded.

Form 8-K. The proposed rules provided that a company would be required to disclose its decision on frequency in the first Form 10-Q or 10-K following a shareholder say on frequency vote. The final rules instead provide that this disclosure must be made on Form 8-K within 150 calendar days after the end of the shareholder meeting in which the vote took place, but no later than 60 calendar days prior to the deadline for the submission of shareholder proposals for the next annual meeting, as disclosed in the company's most recent proxy materials. By moving the required disclosure from a Form 10-Q/10-K to a Form 8-K, the SEC has given companies substantially more time in which to make a say on frequency decision after the shareholder vote. Note that, as a technical matter, this disclosure will take the form of an amendment to a previously filed Form 8-K under Item 5.07, which companies are already required to file within four business days of a shareholder vote to report the results of that vote.

Smaller Reporting Companies. The new rules requiring additional disclosure of golden parachute arrangements and a shareholder advisory vote on these arrangements in connection with a corporate transaction are immediately applicable to "smaller reporting companies." However, the rules regarding say on pay and say on frequency will have a delayed impact. Companies that qualify as smaller reporting companies as of January 21, 2011, and newly public companies that qualify as smaller reporting companies after January 21, 2011, will become subject to the new rules for shareholder meetings on or after January 21, 2013. This transition period will provide welcome relief for smaller companies, and will allow them to assess the impact of the rules on larger companies before being faced with implementing the rules themselves.

Practical Considerations

Below are some practical considerations and answers to common questions that our clients should take into account while preparing for these important votes.

Make Your CD&A Persuasive. When the SEC first mandated the use of the CD&A, it envisioned the section as a narrative way to "provide material information" about a company's compensation arrangements. Taking the SEC's cues, most companies have focused on the CD&A as an exercise in describing their compensation policies. With the advent of say on pay, however, the CD&A is likely to become the primary tool for convincing shareholders to vote in favor of the company's compensation policies and decisions. Thus, the CD&A cannot be viewed simply as check-the-box disclosure, but must also be viewed as a marketing tool. For example, companies should consider the use of executive summaries and clear graphs highlighting important concepts or metrics such as pay vs. performance. We expect an executive summary will receive significant attention from shareholders. Companies should also consider having its marketing and/or investors relations team review the CD&A prior to filing to ensure it is as clear and persuasive as possible.

Understand Your Shareholders. If you haven't already, now may be the time to reach out to your shareholders. As an initial matter, particularly with large institutional investors, it helps to find out who actually makes the proxy voting decisions for the investor, as this person may differ from your usual investor relations contact, and how they generally arrive at a voting decision. A company may then engage, through surveys, group meetings, one-on-ones or other avenues, with that person or department to understand the investor's concerns regarding executive compensation. The investor relations department may be key in initiating and maintaining this investor outreach. It is also helpful to know which, if any, proxy advisory services are used by the investor in deciding how to vote. If this process identifies compensation practices that are problematic to investors, a company may consider adopting revisions to alleviate those concerns prior to the say on pay vote and highlight any changes in the CD&A. If a company is unable to communicate with its investors prior to holding a say on pay vote, it may prove beneficial to compare current compensation practices to similar companies. While this comparison may not identify specific shareholder concerns that would be common to the company, it will assist the company in determining if their compensation practices deviate considerably from the rest of the market, which could potentially affect shareholder voting. Notwithstanding investor concerns or market deviations, a company that decides to stay the course with its compensation practices should take care to explain and rationalize those practices in the CD&A to provide the best chance for approval.

Decide on a Recommendation for Say on Frequency. As discussed above, public companies will need to ask their shareholders how often to hold a say on pay vote – every one, two or three years. Shareholders must be given the ability to choose any of those three options (or abstain), and a company's board of directors will have the ability to make a recommendation. In deciding which frequency to recommend, a board should consider several key issues. First, as executive compensation is often structured around long-term goals, an argument can be made that a two or three year say on pay vote is more appropriate than a one year vote. On the other hand, a two or three year vote makes it difficult to interpret the results of a say on pay vote. Specifically, if shareholders vote "no" after two or three years without a vote, it may not be clear as to whether they are voting against the current compensation arrangements or against compensation arrangements in prior years. In addition, an annual vote on say on pay provides shareholders with ample opportunity to formally voice their approval or disapproval of a company's executive compensation programs. It is for these reasons that Institutional Shareholder Services Inc. ("ISS"), in its 2011 proxy voting policy, states that it will always recommend a vote in favor of one year say on pay votes. Boards of directors may also find that other considerations are relevant in formulating a frequency recommendation including, among other things, the known preferences of its shareholder base, the tenor of prior shareholder discussions on compensation, practices of peer companies in the same industry, and whether the company has a classified board. Notably, as of the date of this memo, there appears to be a trend of shareholders opposing management triennial recommendations and favoring annual votes. A few companies (including Monsanto, Inc., Costco Wholesale Corp. and Air Products & Chemicals, Inc.) have recommended triennial votes for meetings held in January and early February, and their shareholders have voted in favor of annual votes. Therefore, it is important to give this item significant thought prior to making a recommendation on say on frequency.

Common Questions

(Note that because the final say on pay and say on frequency rules have a delayed impact on smaller reporting companies, most of the following Q&As are not applicable to smaller reporting companies until January 21, 2013.)

Question: How will a company's proxy statement look different this year as a result of the Act?

Answer: A company's proxy statement will differ primarily in that it will include two new proposals seeking a shareholder advisory vote on executive compensation and a shareholder advisory vote as to whether to seek the say on pay vote every one, two or three years.

Question: Is a company required to include a say on frequency proposal in this year's proxy statement?

Answer: Yes. The final rules require that all annual shareholder meetings held on or after January 21, 2011 must hold a say on frequency vote.

Question: Does a company have to hold a say on pay or say on frequency vote every year?

Answer: No. The final rules provide that after holding the initial say on pay and say on frequency votes this year a company must hold a say on pay vote at least once every three calendar years, and a say on frequency vote at least once every six calendar years. Of course, a company may decide to hold these votes more frequently, particularly if shareholder votes indicate a more frequent vote is desired.

Question: Must a company change its executive compensation policies in response to a negative shareholder vote on say on pay?

Answer: The results of say on pay and say on frequency votes are non-binding, and therefore a company may choose to maintain its executive compensation policies even following a negative say on pay vote. However, failure to change practices in light of shareholder disapproval may result in negative publicity, campaigns against directors and shareholder nominations of directors. In addition, as discussed above, a company will be required to discuss in its CD&A disclosure whether and, if so, how the company considered the results of the most recent say on pay vote, and how that consideration has impacted the company's executive compensation policies and decisions.

Question: Can a board recommend a particular vote frequency (for example, a three year vote) and give shareholders the choice of accepting or rejecting the recommendation?

Answer: No. Shareholders must be given a total of four choices regarding the say on frequency vote: (i) one year, (ii) two years, (iii) three years and (iv) abstain. The board of directors is allowed to recommend one of the first three options, but the proxy card must be clear that shareholders are not limited to voting for or against the board's recommendation.

Question: Is a board required to make a voting frequency recommendation?

Answer: No. A company's board is not required to recommend a particular vote frequency; however, if the board does not make a recommendation for a particular frequency, the company will not be able to vote any uninstructed proxy at the shareholder meeting.

Question: Must our proxy statement phrase the say on pay vote as a resolution?

Answer: The final rule does not require the say on pay vote to be phrased as a resolution. However, we expect that many companies will phrase the vote as such. In addition, the SEC has provided a non-exclusive example that would satisfy the rules as follows: "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."

Question: What compensation policies are covered by the say on pay resolution?

Answer: As described in the SEC's example resolution above, the say on pay vote encompasses the company's executive compensation policies as disclosed in the proxy statement, including the CD&A, compensation tables and related narrative disclosure.

Question: Are any compensation policies not covered by the say on pay vote?

Answer: A company's compensation policies and practices regarding directors and board committees as they relate to risk management and risk-taking are not required to be covered by the say on pay vote, provided such policies and practices are not material and part of the company's compensation decisions for executive officers, and are not discussed in the CD&A.

Question: May brokers, banks and other nominees exercise their discretion to vote uninstructed proxies with respect to say on pay and say on frequency votes?

Answer: No. Say on pay and say on frequency votes are executive compensation votes on which brokers are not allowed to vote uninstructed proxies.

Question: If a shareholder does not indicate on a proxy card how to vote on say on frequency, may the company vote the uninstructed proxy in accordance with management's recommendation?

Answer: Yes, provided the company (i) includes a recommendation for the frequency vote in the company's proxy statement, (ii) provides an option to "abstain" on the proxy card and (iii) discloses how the uninstructed proxies will be voted in bold on the proxy card.

Question: Will companies be required to file preliminary proxy statements for meetings at which say on pay and say on frequency votes are held?

Answer: No. The SEC's final rules amend Exchange Act Rule 14a-6(a) to provide that a proxy statement that includes any advisory vote on executive compensation, including a say on pay vote or a vote on the frequency of say on pay votes, would not trigger a requirement that a company file the proxy statement in preliminary form, so long as all other matters to which the proxy solicitation relates include only the other excluded matters.

Question: Must I include a shareholder advisory proposal on golden parachute payments in my proxy statement this year?

Answer: It is not required. Technically a company may include a shareholder advisory proposal on golden parachute payments in the annual meeting proxy statement, so long as the additional disclosure required by the final rules is provided. However, if there are changes to golden parachute arrangements, in connection with a subsequent transaction the company will need to hold the advisory vote again. In addition, proxy advisory services have indicated that they will give more weight to a company's golden parachute disclosure in making their overall say on pay recommendation if such disclosure is included in an annual meeting proxy statement. Because of these limited benefits and potential for enhanced scrutiny, it appears that most companies will choose to wait and not include the additional disclosure in their annual meeting proxy statement.

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While every effort has been made to ensure the accuracy of this memorandum, it is not intended to provide legal advice as individual situations will differ and should be discussed with an expert and/or lawyer. For specific technical or legal advice on the information provided in this memorandum and related topics, please contact Gerald Roach (919.821.6668), Amy Batten (919.821.6677), or Margaret Rosenfeld (919.821.6714).

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