

Alert

“Say on Pay” and the 2011 Annual Meeting

Guidance for This Year’s Vote and an Overview of Evolving Market Practice

January 11, 2011

Beginning on Jan. 21, 2011, most domestic public companies will be required to submit their executive compensation to a non-binding shareholder vote. This requirement is mandated by new Section 14A(a) of the Exchange Act, which was adopted as part of Dodd-Frank. Specifically, beginning with this year’s annual meeting, companies will be required to:

- Submit named executive officer compensation to a non-binding “say on pay” vote at least once every three years and
- Take a non-binding shareholder vote on the frequency of the SOP vote (this “say on frequency” vote must occur at least once every six years).

These requirements are generally applicable to all domestic public companies including smaller reporting companies, although there are exceptions for TARP recipients, which are not discussed in this *Alert*.

On Oct. 18, 2010, the SEC published proposed rules, which are discussed below, that expand upon the SOP and SOF requirements of new Section 14A(a) of the Exchange Act. These proposed rules also contain and expand upon the “say on golden parachute” vote required by Dodd-Frank and newly adopted Section 14A(b) of the Exchange Act. The comment period on the proposed rules closed on Nov. 18, 2010. The final rules are expected to be substantially similar to the proposed rules and are expected to be adopted during the first quarter of 2011.

“Say on Pay”

The SOP vote is required to cover all named executive officer compensation required to be disclosed under Item 402 of Regulation S-K, including the CD&A (in the case of companies other than smaller reporting companies), compensation tables and related narrative disclosure. The vote cannot, for example, only apply to NEO compensation policies and procedures. The SOP vote is not required to cover director compensation or, to the extent disclosed in the proxy statement, practices relating to risk management and risk-taking incentives as they relate to employees generally. However, to the extent that risk considerations are a material aspect of a company’s NEO compensation policies or decisions, they are required to be discussed in the CD&A and would therefore be considered by shareholders as part of the SOP vote.

The SOP resolution to be voted on by shareholders is not required to follow a particular format or contain particular language. Accordingly, the vote may be structured as an “up or down” vote or “multi-part” vote, and there is market precedent for both approaches among companies that have held voluntary SOP votes. An “up

or down” vote is structured as a single resolution. A “multi-part” vote, in contrast, splits the vote out into multiple resolutions, for example with overall executive compensation philosophy, policies and procedures covered in one resolution and NEO compensation for a specified period covered in a separate resolution. Although the SEC allows either approach, institutional shareholders generally have expressed a preference for “up or down” votes. And, thus far, for 2011, all of the annual meeting proxy statements that have been filed have contained an “up or down” vote.

Under the proposed rules, the proxy statement also will be required to include two specified disclosures relating to the SOP vote. It will be required to indicate that the SOP vote is being provided as required pursuant to Section 14A of the Exchange Act and the proxy statement will be required to briefly explain the general effect of the vote, such as that the vote is nonbinding.

“Say on Frequency”

Under Section 14A(a) of the Exchange Act, shareholders also must be given the opportunity to vote on the frequency of the SOP vote. Specifically, they must be given the option to vote on a frequency of one, two or three years or to abstain.

The board may make a recommendation on the frequency of the SOP vote, although the proposing release indicates that the proxy statement must indicate that the SOP vote is on the frequency of the SOP vote, and not on the board’s recommendation.

As with the SOP vote, the proposed rules would require the proxy statement to indicate that the SOP vote is being held pursuant to Section 14A of the Exchange Act and to explain briefly the general effect of the vote.

Recommendations by Early Filers

Because SOP and SOF will apply to annual meetings beginning on Jan. 21, proxy statements that take these new requirements into account already have been filed. Of the approximately 78 proxy statements that have been filed through Jan. 5 for meetings occurring on or after Jan. 21, 43 recommend a triennial SOP vote. Factors most commonly cited by companies in support of a triennial SOP vote include that (1) a triennial voting cycle is more closely aligned with the performance period under their executive compensation programs, (2) it will provide shareholders with sufficient time to evaluate the effectiveness of incentive programs, compensation strategies and company performance, and (3) it will provide the board and compensation committee with sufficient time to thoughtfully evaluate and respond to shareholder input and effectively implement desired changes to compensation programs. Some of the other factors cited by companies include a high level of prior support for compensation policies by proxy advisory firms, the cost of including a SOP vote in the annual meeting proxy statement every year and that their executive compensation programs do not change significantly from year to year.

Of the remaining companies, 18 have recommended an annual SOP vote. Reasons cited for this recommendation include the view that it is good governance to seek annual shareholder input on executive compensation and, without referring specifically to good governance, a desire for frequent investor input on executive compensation, including because NEO compensation is evaluated, adjusted and approved annually.

Biennial SOP vote recommendations have been less common, thus far being limited to 9 companies. In support of a biennial recommendation, many of these companies have indicated their belief that a biennial SOP vote strikes the appropriate balance between providing shareholders with enough time to evaluate executive compensation policies and programs and providing the company with sufficient time to engage with shareholders to understand and respond to SOP vote results.

And finally, 8 filers’ boards declined to make a recommendation, deciding to consider the results of the SOF vote before determining SOP frequency.

Because the SOF vote is nonbinding, a board could, at least in theory, hold its SOP vote less frequently than the interval that receives the most shareholder votes. However, under the SEC’s proposed rules, if the frequency that is adopted is consistent with the plurality of the votes cast, a company will be permitted to exclude as having been “substantially implemented” a Rule 14a-8 proposal relating to SOF or SOP.

Institutional Shareholder and Advisory Firm Views

The institutional shareholder community and advisory firms are not in unanimous agreement that more frequent is better when it comes to SOP.

In its Nov. 19, 2010 U.S. Corporate Governance Policy 2011 Updates, Institutional Shareholder Services recommends a vote for an annual SOP vote. In the Policy Updates, ISS indicated that it believes that an annual SOP vote provides the highest level of accountability and direct communication between companies and their shareholders. ISS also indicated in the Policy Updates that, to the extent that a company does not hold an annual SOP vote, if there are problematic pay practices, during a year when SOP is not on the ballot, it generally will recommend a withhold or against vote for the reelection of compensation committee members.

In contrast to the position taken by ISS, some prominent institutional shareholders have indicated that they prefer a triennial vote due to bandwidth issues, as well as to enable them to engage in a more thoughtful review of NEO compensation.

“Say on Golden Parachutes”

Dodd-Frank and new Section 14A(b) of the Exchange Act require the SEC to adopt rules providing for a non-binding shareholder vote on golden parachute arrangements. In addition to requiring a SOGP vote, the proposed rules provide for enhanced tabular and narrative disclosure relating to golden parachute arrangements. This enhanced disclosure will be required in proxy statements and other disclosure documents relating to mergers, consolidations, sales or dispositions of all or substantially all of a company’s assets and other similar transactions. Enhanced golden parachute disclosure will not be required in annual meeting proxy statements and will be voluntary in this context. Furthermore, the SOGP requirements will not apply until the final rules are adopted by the SEC.

The SOGP vote will not be required to be held when shareholders are asked to approve a merger, consolidation or other significant asset transaction if the arrangements were previously voted on at an annual meeting and the enhanced golden parachute disclosure was voluntarily included in the annual meeting proxy statement. However, if a SOGP vote is taken at an annual meeting and the arrangements subsequently are modified or new arrangements are entered into, the modified or new elements will be subject to a new advisory vote.

Early sentiment appears to be leaning against seeking approval of golden parachute arrangements at annual meetings. In ISS’ 2011 Policy Updates, which include several factors that it will consider when evaluating golden parachute arrangements, it indicated that, if the golden parachute arrangements are incorporated into the SOP vote, it will evaluate the SOP proposal in accordance with its golden parachute guidelines and may give greater weight to that component of the overall evaluation. If the SOGP vote is held in connection with the change-of-control transaction, there is likely to be less impact from a negative advisory firm recommendation than in the annual meeting context, assuming that shareholders are otherwise supportive of the economics of the transaction.

Pre-Meeting Action Items

Adjust the Timeline. The 2011 annual meeting process will not be business as usual. Extra lead time will need to be factored in to account for SOP and SOF, both at the board and committee level and in the proxy statement drafting and review process. However, the good news is that SOP and SOF do not trigger the requirement to file a preliminary proxy statement.

Determine the Recommended Frequency of the SOP Vote. As indicated above, recommendations have thus far been mixed, albeit leaning toward a triennial SOP vote. A board’s recommendation should take into account (1) the company’s investor base, (2) general shareholder voting patterns, (3) shareholder voting history on compensation committee members and compensation matters, (4) the company’s compensation programs and philosophy, (5) peer group practice, if yet known, and (6) investor relations goals. The proxy statement also should include a sufficiently robust explanation supporting the SOF recommendation.

Review NEO Compensation. NEO pay practices that are problematic under ISS policies will affect ISS’ SOP recommendation. To the extent that any compensation arrangements are to be amended in advance of the SOP vote or new arrangements are being put in place, that also will need to be factored into the timeline.

Revisit CD&A Disclosure. In light of SOP and SOF, going forward, the CD&A should be viewed as an investor relations communication, and not merely as a disclosure requirement. With this in mind, consider whether last year's CD&A adequately and clearly communicated compensation decisions, philosophy and terms. Finally, consider adding an executive summary to the CD&A if it does not already have one.

Consider Shareholder Outreach Strategy. Consider whether to reach out to significant shareholders in advance of proxy season to explain and garner support for the company's executive compensation practices. In addition, as part of reaching a SOF recommendation, consider how institutional shareholders are likely to react, especially if the recommendation differs from ISS policy or a significant shareholder's particular SOF policy. Keep in mind that, under amended New York Stock Exchange rules adopted pursuant to Dodd-Frank, broker discretionary voting is not permitted in connection with either SOP or SOF votes.

Post-Meeting Follow Up

Under existing Form 8-K requirements, the results of the SOP and SOF vote must be reported on a Form 8-K within four business days following the shareholder meeting. In addition, under the proposed rules, if a SOF vote was held, the company's SOP frequency determination would be required to be disclosed in the next Form 10-Q or Form 10-K (if the annual meeting is held during the fourth quarter).

In addition, under the proposed rules, in subsequent years, the CD&A will be required to address whether and, if so, how compensation policies and decisions have taken into account the results of advisory votes on executive compensation. Assuming adoption of the proposed rules, this disclosure requirement would be applicable beginning with the 2012 CD&A. Smaller reporting companies would not be subject to this requirement, since they are not required to prepare a CD&A. However, under existing disclosure requirements, SRCs are required to provide a narrative description of any material factors necessary to an understanding of the information disclosed in the summary compensation table. If a prior executive compensation advisory vote is a material factor for these purposes, the vote would be required to be discussed in the SRC's proxy statement.

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