Say What?

By Lois Yurow

After many years in which public companies typically dreaded shareholder resolutions seeking advisory votes on executive compensation, Congress stepped in last July and made "say-on-pay" the norm. Under Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, you are now required to sponsor say-on-pay resolutions, even if your shareholders are not demanding an opportunity to vote. Moreover, you must enable your shareholders to decide how frequently they want to vote on executive compensation (known as "say-when-on-pay"), and to vote on golden parachute arrangements. Granted, shareholder votes on these matters are advisory—you are not bound by the results—but tallies must be made public. Ignore overwhelming investor sentiment at your peril.

Congress often delegates the details of such mandates by directing the SEC to draft rules compelling specific actions. For example, the statutory provision requiring a say-on-golden-parachute vote calls for proxy disclosure "in accordance with regulations to be promulgated by the [Securities and Exchange] Commission." In such a case, the statutory mandate is not effective until the SEC adopts the related rules. In contrast, the Dodd-Frank Act itself imposes the requirements for the say-on-pay and say-when-on-pay votes, making both effective for an issuer's first annual meeting that occurs after January 21, 2011, without any need for SEC action. However, for all three types of vote, the SEC has authority to grant exemptions and to adopt implementing rules.

On January 25, the SEC adopted rules to flesh out the terms of say-on-golden-parachute disclosure and voting. These rules are effective for documents filed after April 25, 2011. At the same time, the SEC adopted rules governing the say-on-pay and say-when-on-pay votes, and granted a two-year exemption from these requirements for smaller reporting companies. Technically, these rules are effective for documents filed after April 4, 2011, but transition guidance effectively extends the rules to proxies that are filed earlier. Issuers that already are required to hold an annual say-on-pay vote because they received TARP funds do not need to comply with some of the new rules (a say-when-on-pay vote would be superfluous) until the next annual meeting after they satisfy their TARP obligations.

Say-on-Pay

The first say-on-pay votes mandated by Dodd-Frank have already begun; most public companies that are not exempt will hold such a vote during their 2011 annual meetings. Thereafter, a vote must occur at least once every three calendar years (not necessarily within three years of the last vote), but you can choose to hold a vote more frequently. The results of the say-when-on-pay vote (explained below) may drive this decision.

The say-on-pay vote relates only to the compensation of the "named executive officers" in your proxy (the CEO, the CFO, and the three other highest paid executives), and does

not apply to compensation for directors or other employees. You can seek a vote on your executive compensation as a package, or you can seek votes on individual features of compensation, so long as all executive compensation is the subject of a vote.

The SEC has only nominally changed proxy disclosure requirements to facilitate say-on-pay. Generally speaking, the shareholder vote will be based upon information you are already required to provide in your CD&A. However, the new rules also require you to "explain the general effect of the vote, such as *whether the vote is non-binding*" (emphasis added). You will look through the rule release in vain for a clue as to when the vote would not be non-binding, and, as noted above, the Dodd-Frank Act specifically provides that say-on-pay votes are advisory only. An attorney in the Division of Corporation Finance told me over the phone that a company could voluntarily commit to abiding by the vote results, but it would still be a matter of state law whether that commitment made the vote "binding." It is also not clear how a company can "abide by" a simple yes or no vote on a matter with as many moving parts as executive compensation.

After a say-on-pay vote, at least two things must happen. One, you must report the results (together with the results of any other vote that took place during the shareholder meeting) in an 8-K filed within four business days after the vote tally is confirmed. Two, beginning the year after your first say-on-pay vote, your CD&A must discuss whether and how the board considered the most recent vote in determining compensation policies and decisions. (This discussion should cover earlier say-on-pay votes if material.) Again, you are not required to *actually* honor shareholder sentiment, but if you don't, you should have a good explanation. Note that you are only required to discuss your treatment of say-on-pay votes mandated by Dodd-Frank. You can, but are not required to, discuss the results of say-on-pay votes offered at your own initiative or as a result of a shareholder resolution.

Say-When-on-Pay

Public companies that are not exempt under the SEC rules must hold their first say-when-on-pay vote during the same meeting at which they hold their first say-on-pay vote. Thereafter, a say-when-on pay vote must occur at least once every six years.

As with say-on-pay, you must explain in the proxy the "general effect" of the say-when-on-pay vote, including whether you intend to be bound by the results.

In setting up the say-when-on-pay vote, you must enable your shareholders to choose among four options: an annual say-on-pay vote, a biennial say-on-pay vote, a triennial say-on-pay vote, or abstain. You may support a particular voting frequency, but cannot restrict shareholders to accepting or rejecting that recommendation; shareholders must have the means to specifically select annual, biennial, or triennial voting, or to abstain.

Typically, shareholders have three possible votes on a proxy question: yes, no, and abstain. During 2011, while proxy services are adjusting their systems to accommodate

four possible votes for say-when-on-pay, you may omit the "abstain" option. However, as discussed below, if shareholders cannot abstain, you cannot vote uninstructed shares.

After the say-when-on-pay vote, you must report the results in the post-meeting 8-K. This report must be specific, giving the voting results for each frequency choice. Later, the 8-K must be amended to disclose how often you will put a say-on-pay vote on the proxy in the future, and when the next vote will occur. The amended 8-K is due within 150 calendar days after the shareholder meeting (to give you a chance to consider the voting results and confer with shareholders before committing), and at least 60 calendar days before the deadline for shareholders to submit proposals for the next proxy (so shareholders that don't like your choice have time to propose a different frequency).

Again, you are not required to adopt the frequency favored by shareholders. However, you cannot reject a shareholder proposal seeking more (or less) frequent say-on-pay votes unless you have adopted the frequency chosen by the majority of votes cast (not counting abstentions) in the most recent say-when-on-pay vote. In other words, the most recent vote has to have generated a clear favorite—not just a plurality—and you have to have implemented that choice.

Say-on-Golden-Parachutes

Dodd-Frank adds both disclosure and advisory vote requirements for golden parachutes—the often lucrative arrangements to compensate executives who lose their jobs, possibly due to a merger or acquisition. Proxy rules already required issuers to disclose compensation that executives would receive upon a change in control, but those requirements focus on arrangements between an issuer and its executives unrelated to any specific transaction. In addition, a target issuer seeking shareholder approval of a merger was already required to disclose "any substantial interest" that any of the target's executive officers or directors had in the proposed transaction. Dodd-Frank directs the SEC to seek more specific golden parachute disclosure for any "proxy or consent solicitation . . . [seeking shareholder approval of] an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all of the assets of an issuer."

The resulting SEC rules require disclosure of "all golden parachute compensation relating to the merger among the target and acquiring issuers and the named executive officers of each." This discussion is in addition to, not instead of, the change in control and substantial interest disclosures described above. The required information, which is to be presented in one or more tables and a supporting narrative, is limited to compensation arrangements that are directly related to a proposed transaction; you need not disclose things like previously vested equity awards and future employment arrangements. The rule release goes into considerable detail about calculating the data called for by the table.

The scope of the SEC's golden parachute disclosure rule is actually broader than required; Dodd-Frank only calls for disclosure of arrangements involving the soliciting issuer—not both parties to the transaction. Despite the expansive disclosure, the voting rules adhere to the scope of the statute. Thus, shareholders of a target will learn about

golden parachute arrangements between the acquirer and the target's executives, but will not have the opportunity to vote on those arrangements.

The new rule permits you to avoid this disclosure and the related vote in a merger proxy if you previously included the requisite information in the proxy statement for a standard annual meeting and held the say-on-golden-parachute vote at that meeting. The vote need not even have been favorable. However, this exception only applies if the golden parachute arrangements presented to the shareholders do not change; any new or different terms will require updated disclosure and a new vote.

There are a couple of reasons this advance disclosure and voting approach is not ideal. First, there is a very real possibility that golden parachute arrangements will be tweaked in the event of an actual proposed transaction, which would nullify the earlier vote. Second, if golden parachute arrangements are part of the general executive compensation discussion, investors and proxy advisers will consider those arrangements when voting (or making voting recommendations) regarding compensation generally.

Smaller public companies are exempt for two years from holding mandatory say-on-pay and say-when-on-pay votes, but there is no delayed effectiveness for say-on-golden-parachutes.

Uninstructed Shares and Discretionary Voting

Some shareholders will be energized by these new opportunities to express their views and will make a point of voting. Others will be less enthused (or less attentive) and may return incomplete proxy cards. You will want the right to vote those uninstructed shares.

Under the new SEC rules, if you satisfy the following three conditions, you can vote uninstructed proxies regarding say-when-on-pay:

- management must recommend a particular voting frequency (1, 2, or 3 years);
- shareholders must have the option to abstain from voting on the matter; and
- the proxy card must explain, very obviously, how uninstructed shares will be voted.

Remember, in the first year of say-when-on-pay, you can omit the "abstain" option from the proxy card for administrative ease, but if you choose that approach you cannot vote uninstructed shares.

The say-on-pay vote is easier: a blank vote (not an abstention) on the proxy card will be treated as a vote in favor of management's recommendation, just like a blank vote to ratify the auditors or to elect the recommended slate of directors. (Editorial aside: The SEC in its adopting release, and every bit of commentary I have seen about the new rules, ignore this detail. Perhaps the folks who deal with this stuff every day think everyone understands that a blank vote on a proxy card is always a vote for management, even in the sensitive area of compensation. I think they are mistaken, especially since under pending NYSE and Nasdaq rules mandated by Dodd-Frank, brokers cannot vote their

clients' uninstructed shares in any executive compensation matter, including golden parachutes and say-when-on-pay.)

Presenting the Questions in the Proxy

You are not required to use any particular language or format to present these advisory votes to your shareholders. For say-on-pay, it simply must be clear that the vote relates to all compensation for the named executive officers that is disclosed under Item 402 of Regulation S-K.

The SEC's adopting release offers this regrettable model (but by no means mandatory) form of 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."

I think it is fair to ask whether the average investor is familiar with Item 402 and knows what compensation is disclosed "pursuant to" that provision. Fortunately, in a Compliance and Disclosure Interpretation published by the Division of Corporation Finance, the staff confirms that issuers can use more straightforward language, such as "pursuant to the compensation disclosure rules of the Securities and Exchange Commission, including the compensation discussion and analysis, the compensation tables and any related material disclosed in this proxy statement."

The SEC did not provide model language for the say-when-on-pay or say-on-golden-parachute resolutions, and indeed does not even require that any of these three questions be put to shareholders in the form of a resolution.

Companies that have already filed their 2011 proxies have taken a variety of approaches to say-on-pay proposals. Most make a point of highlighting the advisory nature of the vote. Some explain why they are offering the vote. (Others seem to be trying to make it look like their own idea!) Many offer statements in support of their vote recommendations, while others refer readers back to the CD&A. A few issuers do not put the question in the form of a resolution. Though it is not required, most issuers make a brief (but not very specific) statement about what they will do with the voting results. Since the SEC promised issuers "flexibility" within the confines of the rule requirements, all of these approaches are sound. As a practical matter, though, a long supporting statement that repeats disclosure found elsewhere in the proxy may tax readers' patience.

Voting Trends

Despite the many concerns public companies have about say-on-pay, executive compensation programs are garnering overwhelming support so far. The Corporate & Securities Law Blog, maintained by the law firm Sheppard Mullin, reports that, as of March 8, only two companies had received less than a majority vote on their

compensation programs. The website say-on-pay.com puts the average favorable vote (without broker non-votes) at 90%.

Companies aren't doing quite as well with their say-when-on-pay recommendations. While the prevailing issuer recommendation is for a triennial vote (50.7% of issuer recommendations as of March 5), shareholders (backed by the ISS voting guidelines and a host of institutional investors) are decidedly in favor of annual say-on-pay (59% for votes reported through March 8). It is primarily at smaller companies, with more inside ownership, that shareholders are following triennial vote recommendations. Biennial votes are not particularly popular with issuers or investors.

Companies have begun recommending annual votes in greater numbers as they monitor the fate of triennial recommendations at other issuers' meetings. Still, an every-three-year vote remains an issuer favorite. One commentator has a theory about why. Dominic Jones thinks it's possible that companies recommending a triennial vote have two ulterior motives:

- to give shareholders something relatively unimportant to protest so they will be less likely to vote down the actual executive compensation; and
- to give institutional investors something relatively unimportant to protest so they can look good to their own investors when they report that they bucked management's triennial recommendation.

It is certainly plausible that triennial vote recommendations are straw men.

Of course, one can be just as suspicious of companies making annual vote recommendations. Are they trying to make the say-on-pay vote seem routine, like ratifying the accountants, so that investors will stop paying attention? Would they prefer that investors vote down compensation to express any dissatisfaction rather than refuse to re-elect the members of the compensation committee? (On that note, are issuers that implement a triennial say-on-pay vote putting their compensation committee members at risk in the "off" years?)

There are many ways to interpret the trends of recommendations and votes, but issuers are likely to decide that battling over frequency makes them look bad without sufficient compensating benefits. It takes many hours to prepare compensation disclosure every year regardless of whether there will be a say-on-pay vote on the proxy. ISS is telling its clients that annual votes are good. Many issuers are likely to succumb.

Good Disclosure is the Key

There is one piece of advice that appears repeatedly in the say-on-pay commentary: use your CD&A to clearly explain and justify your executive compensation. Use executive summaries, charts, and graphics to streamline and clarify your disclosure, and revisit the SEC's plain English requirements and guidance. An investor who cannot understand your CD&A, or is presented with a CD&A that is long and dry, may vote against executive compensation out of annoyance.

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