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Financial Reform Act: Preparing for Mandatory Say-on-Pay

With enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, mandatory say-on-pay has become federal law.[1] Say-on-pay under the Reform Act requires significant preparation on the part of issuers and their boards of directors and is one step in what we anticipate will be a long and ongoing dialogue with investors about compensation. The requirement is effective for shareholder meetings held on or after January 21, 2011.

The Reform Act and Say-on-Pay

Say-on-pay refers to a shareholder advisory vote on the compensation of an issuer's named executive officers. Say-on-pay has been a focus of shareholder advocates and the frequent subject of shareholder proposals on executive compensation for several years.[2] Prior to the Reform Act, a number of legislative proposals included a say-on-pay requirement and, in 2009, mandatory say-on-pay became the rule for participants in the Troubled Asset Relief Program.

The new say-on-pay requirement is embodied in Section 14A of the Securities Exchange Act of 1934. It applies generally to issuers that are subject to the proxy solicitation requirements of the Exchange Act.[3] These include all domestic issuers listed on the national securities exchanges or who otherwise voluntarily solicit proxies from their shareholders, subject to further exemption by the SEC. Section 14A does not apply to foreign private issuers whose shares are traded in the United States.

1 The Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, Pub. L. 111-203, was signed by President Obama on July 21, 2010. For a general discussion of the compensation-related provisions of the Reform Act, see *Financial Reform Act Brings Significant Executive Compensation Change*, Shearman & Sterling LLP Client Publication, July 15, 2010, available at http://www.shearman.com/financial-reform-act-brings-significant-executive-compensation-change-07-15-2010/.

2 Shearman & Sterling LLP's annual survey of the public filings of the top 100 U.S. companies by market capitalization shows that, as had been the case in 2008 and 2009, requests that companies institute advisory say-on-pay votes represented the most frequent compensation-related shareholder initiatives during the 2010 proxy season. See *Shearman & Sterling LLP 2010 Corporate Governance of the Largest US Public Companies, Director & Executive Compensation*, to be available July 2010, at http://www.shearman.com/corporategovernance/.

3 A companion provision in the Reform Act requiring proxy solicitations relating to a merger or other sale transaction to include disclosure of named executive officer compensation that is based on or otherwise related to the transaction, together with a separate shareholder vote to approve the compensation, will be the topic of a forthcoming Shearman & Sterling LLP Client Publication.

New Section 14A of the Exchange Act requires issuers to include in proxy statements and consent solicitations that include compensation disclosure a separate non-binding shareholder resolution approving the compensation of executives as disclosed in the tables and narrative required pursuant to Item 402 of Regulation S-K.[4] The issuer's shareholders must have the opportunity to approve a say-on-pay resolution no less frequently than once every three years. New Section 14A also requires issuers to allow shareholders to vote once every six years on whether the say-on-pay vote should occur every one, two or three years.

The first shareholders' meeting occurring on or after January 21, 2011 must include both a say-on-pay resolution and a timing resolution. Neither resolution is binding on the issuer. In fact, Section 14A specifically provides that these resolutions will not be construed to: (i) overrule the board's compensation decisions, (ii) impose additional fiduciary duties on the board or (iii) limit shareholders' ability to make other compensation-related proposals.

Unlike many other provisions of the Reform Act, the say-on-pay requirement is self-implementing and by its terms does not require the issuance of regulatory guidance by the stock exchanges or the SEC. Nevertheless, it is anticipated that some rulemaking may be forthcoming. At a minimum, it is reasonable to expect that the SEC will exempt the inclusion of Section 14A say-on-pay resolutions from the requirement to file a preliminary proxy statement as it did for say-on-pay resolutions under TARP.

Getting Ready for Say-on-Pay

The most recent proxy season demonstrates that the possibility of shareholders failing to approve an issuer's compensation program is not merely theoretical; at least three companies who held say-on-pay votes failed to win majority support for their compensation policies in 2010. In at least one instance where say-on-pay was not on the ballot, criticism of the company's pay practices appears to have been translated to rejection, by a wide majority, of a new long-term incentive plan.

The experience with say-on-pay illustrates the importance of the vote to shareholders and suggests the value of careful preparation on the part of issuers in advance of a shareholder vote. Furthermore, going forward, the other provisions of the Reform Act may well have an effect on the incidence of negative say-on-pay votes. For instance, under a separate provision of the Reform Act, stock exchanges must prohibit brokers from voting shares owned by customers on compensation matters unless the brokers receive voting instructions from the shareholders.[5] In addition, the Reform Act will require institutional investors to disclose how they vote on say-on-pay.[6] With this requirement in place, institutional investors are likely to be more sensitive in making voting decisions to compensation practices that have received significant attention in the press.

[4] Schedule 14A requires compensation disclosure in the proxy statement if action is to be taken at a shareholders' meeting with regard to the election of directors or any plan, contract or arrangement in which any director, nominee for election as a director, or executive officer will participate, or the granting or extension to any such person of any options, warrants or rights, other than those issued to securityholders on a *pro rata* basis.

[5] This broker non-vote rule also applies to voting in director elections and generally mirrors the amendment to the New York Stock Exchange broker voting rule that was approved last year by the SEC. See *SEC Proposed Amendments – Proxy Disclosure, Solicitation Enhancements and NYSE Rule 452*, Shearman & Sterling LLP Client Publication, July 9, 2009, available at http://www.shearman.com/sec-proposed-amendments-proxy-disclosure-solicitation-enhancements-and-nyse-rule-452/.

[6] Section 14A requires that institutional investment managers subject to Section 13(f) of the Exchange Act report their say-on-pay voting activity at least once every year.

A negative vote on say-on-pay, while not binding on the issuer, is likely to have a deleterious effect on shareholder relations and may, as a practical matter, require that issuers modify their pay practices in response to shareholders' concerns. Issuers should continue to place an emphasis on thoughtful compensation design and should take steps now to ensure that shareholders have a reasonable understanding of both the issuer's compensation program and the reasons for the compensation decisions the issuer has made.

In preparing for say-on-pay, issuers should consider the following:

- Identify Key Players. An issuer's internal and external compensation team will need to be tapped in order to successfully prepare for mandatory say-on-pay. Players from human resources, executive compensation, legal, investor relations, treasury and other stakeholders should be convened to begin tackling this issue, with the help of the issuer's proxy solicitor and other advisers.
- Review Compensation Practices and Arrangements. Issuers should review their compensation plans and arrangements to ensure there is an appropriate alignment between the issuer and its shareholders in the context of pay. Additionally, issuers should take into consideration the voting policies of key shareholders and their proxy advisers, where available, with a view to identifying potentially controversial pay practices that may trigger negative votes.
- Develop Views on Timing Vote. Issuers should evaluate the merits of having say-on-pay every one, two or three years. Although shareholders will have the right to vote on this question, issuers should be prepared to formulate a recommendation based on factors such as duration of performance periods, year-over-year consistency in type and amount of pay and the investor relations policies of the issuer.
- Analyze Vote Counting Issues. Issuers should revisit the approval standard and the standard for counting votes for both the say-on-pay vote and the timing vote based on a review of the issuer's bylaws and certificate of incorporation, as well as applicable state law. Issuers that have adopted say-on-pay have not been uniform in reporting in their proxy statements the voting standard required for approval of a say-on-pay resolution. While in some instances the issuers have indicated that a majority of votes cast is required for approval, others have indicated that a majority of votes present and eligible to vote is required (which, in the latter case, would cause an abstention to be the equivalent of a no vote). Obviously, in a close vote, the standard that is applied can have an impact on the outcome of the vote.
- Know Your Shareholder Base. As detailed further in the next section, having a sense of who are the issuer's key shareholders, and if possible their voting policies, will be a key element of the issuer's preparation for say-on-pay.
- Examine Compensation Disclosure. Issuers should take maximum advantage of the compensation disclosure rules to explain the "hows" and "whys" of the compensation paid to named executive officers. An issuer's disclosure is critical to ensuring that investors understand the issuer's compensation, as well as the underlying rationale for the type and amount of pay. Disclosure gives issuers the opportunity to provide a meaningful explanation of their compensation decisions and the reasons why the board members approving the compensation felt it was appropriate under the facts. The Reform Act also expands the disclosure rules by requiring issuers to set out the relationship between compensation and financial performance, and the relationship between the median total annual compensation of all employees (other than the CEO) and the total annual compensation of the CEO. Both of these additional requirements call for disclosure that will need to be explained in context in the other related disclosures in the proxy statement and could affect how shareholders vote on say-on-pay.

Engaging with Investors

Ultimately, issuers' efforts to reshape features of their compensation programs and optimize their disclosure serves as a prelude to engagement with stockholders and their representatives in proxy advisory firms. A challenge for issuers in preparing for a say-on-pay vote is to achieve an open communication with shareholders *before* the vote is held. How issuers will go about establishing a line of communication with shareholders will depend significantly on the composition of their investor base. In any event, in communicating with shareholders, issuers must be careful to avoid "selective disclosure" of material, non-public information and should consider implementing policies and procedures to help them to comply with the requirements of Regulation FD.[7]

Issuers should also seek to understand if particular institutional shareholders have formulated their own voting policies or if they tend to rely upon the recommendations of proxy advisory firms such as RiskMetrics and Glass, Lewis in determining how to vote. Although it is not always practical to do so, issuers may also wish to discuss with these firms how likely they are to apply their policies in a specific situation and whether there are actions that may be taken to improve the likelihood of a recommendation for a positive say-on-pay vote. Success at achieving an ongoing dialogue with investors will have the added benefit of aiding directors when putting new programs in place and generally establishing a positive company-wide tone for the issuer with its shareholder base.

Conclusion

The say-on-pay requirement in the Reform Act will likely magnify the already intense focus for many issuers on compensation design. Many issuers will feel increased pressure to adopt what are considered "best practices", and mandatory say-on-pay may fuel a trend in the United States toward more uniform compensation programs, as has been observed in other countries that have adopted mandatory say-on-pay.

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[7] Generally, Regulation FD prohibits issuers (or directors, officers or other persons acting on the issuers' behalf) from selectively disclosing material, non-public information to a shareholder under circumstances in which it is reasonably foreseeable that the shareholder will purchase or sell the issuer's securities on the basis of that information. Regulation FD does not, however, prohibit directors speaking privately with shareholders if safeguards are in place. See Regulation FD, Compliance and Disclosure Interpretations, Section 101, Q. 101.11, U.S. Securities and Exchange Commission, available at http://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm#101-11 (Jun. 4, 2010).