

## Securities Alert

### SEC Adopts Say-On-Pay Rules: What Companies Need To Do Now

January 31, 2011

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On January 25, 2011, the Securities and Exchange Commission (SEC) adopted rules implementing the shareholder advisory votes and related disclosures required pursuant to Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). Specifically, the rules will require public companies subject to the proxy rules<sup>1</sup> to—

- provide shareholders with an advisory vote to approve executive compensation (“say-on-pay”) at least once every three years
- provide shareholders with an advisory vote to determine whether the say-on-pay vote occurs every one, two or three years (“say-on-frequency”)
- provide shareholders with an advisory vote to approve golden parachute compensation arrangements (“say-on-golden parachutes”) in connection with mergers and other similar corporate transactions.

In light of the new rules, we discuss in this alert what companies should be doing as they prepare for their upcoming annual shareholder meetings. The new rules will take effect 60 days after publication in the *Federal Register*.<sup>2</sup> Companies should note, however, that, even though the new SEC rules are not yet effective, companies are currently required under the Dodd-Frank Act to provide a say-on-pay vote and say-on-frequency vote at the first annual or other meeting of shareholders for which SEC rules require compensation disclosure that occurs on or after January 21, 2011. We recommend that companies filing their annual proxy statements prior to the effective date of the new SEC rules look to the new rules for guidance in crafting their say-on-pay and say-on-frequency disclosures. We also discuss below some specific transition issues that will arise for companies filing proxy statements before the effective date of the new rules.

### Say-on-Pay

The new rules require companies to give shareholders an advisory vote to approve the compensation of the company’s named executive officers (NEOs), as such compensation is disclosed pursuant to Item 402 of Regulation S-K, including the Compensation Discussion and Analysis (CD&A), the compensation tables and other narrative executive compensation disclosures required by Item 402. The say-on-pay vote does not extend to director compensation or disclosure of risks relating to a company’s compensation policies and practices for employees generally. In addition to the say-on-pay vote, companies must discuss in their proxy statements the general effect of the say-on-pay vote, including whether it is nonbinding.<sup>3</sup>

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<sup>1</sup> Smaller reporting companies will not become subject to the say-on-pay and say-on-frequency requirements until the first annual or other meeting of shareholders at which directors will be elected occurring on or after January 21, 2013. Smaller reporting companies, however, will be subject to the say-on-golden parachutes requirement from the outset. The SEC is also exempting companies that have indebtedness outstanding under the Troubled Asset Relief Program (TARP) from the new say-on-pay and say-on-frequency votes until such indebtedness has been repaid, because they already must give shareholders an annual say-on-pay. The new rules also contain some other disclosure differences for companies subject to TARP that are beyond the scope of discussion in this alert.

<sup>2</sup> Except that the say-on-golden parachutes requirement will apply to covered proxy statements and other forms and schedules concerning a merger or corporate transaction that are initially filed with the SEC on or after April 25, 2011.

<sup>3</sup> After the inaugural say-on-pay vote, companies will be required to disclose in their future proxy statements whether and, if so, how their executive compensation policies and decisions have taken into account the results of the most recent shareholder say-on-pay vote.



In light of the new rules, companies should be considering the following—

*Determine wording and location of resolution.* The SEC did not mandate precise wording for the say-on-pay resolution, but the rules do require a company to indicate that the say-on-pay vote is to approve the compensation of the company's NEOs as disclosed pursuant to Item 402 of Regulation S-K. The SEC provided the following non-exclusive example of a resolution that would satisfy the new rules:

“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.”

Based on our review of proxy statements that have been filed so far, it appears that most companies have been including the say-on-pay proposal, as well as the say-on-frequency proposal, immediately after the proposal relating to the ratification of auditors and before any other shareholder proposals that the company may be including in its proxy statement. Within the discussion relating to each of these proposals, companies typically state that such votes will not be binding on the board of directors, but that the board (or compensation committee) values the opinions of shareholders and will take into account the outcome of the vote when considering future named executive officer compensation decisions or when determining the frequency of future say-on-pay votes, respectively. With respect to the say-on-pay vote, most companies also highlight in the proposal certain aspects of their executive compensation programs that shareholders should consider when voting, often providing support for how the company's programs link executive compensation to financial performance and align the interests of executive officers with those of shareholders.

- *Consider adding an executive summary to CD&A:* Because shareholder focus on compensation disclosures will be keen during this inaugural year of say-on-pay, companies should devote extra attention to the 2011 proxy statement. The company's message should not get lost in the voluminous compensation disclosures now required in proxy statements. Companies, if they have not already done so, should consider adding an executive summary to their CD&A section that highlights the most significant compensation decisions of the preceding year and clearly ties them to the company's performance and objectives.
- *Address problematic pay practices:* Even though the shareholder say-on-pay vote is nonbinding, boards and management will obviously want to avoid the embarrassment of a high negative vote. Consequently, boards should take a close look at the appropriateness of their pay practices and proactively address any problem areas, paying particular attention to practices that ISS and other proxy advisory firms oppose.

## Say-on-Frequency

In addition to the say-on-pay vote, companies must also give shareholders an advisory vote in 2011 on whether the say-on-pay vote should occur every one, two or three years.<sup>4</sup> Companies must also disclose in their 2011 proxy statements the general effect of the vote, such as whether the vote is nonbinding.<sup>5</sup>

In light of the new rules, companies should be considering the following—

- *Determine wording and location of resolution:* Consistent with the language in the Dodd-Frank Act, the new rules specify that companies must include a separate “resolution” relating to the say-on-frequency vote, but the SEC did not mandate the precise wording of the resolution or where it should appear. Drafting a resolution for the say-on-frequency vote has proven difficult because shareholders are not being asked to approve or disapprove the frequency of say-on-pay votes, but, rather, are being asked to choose between a frequency of every one, two or three years or abstain from voting. As such, based on our review of proxy statements that have been filed so far, many companies do not include a specific resolution, but, instead, just include language explaining to shareholders that they have the opportunity to vote, on a nonbinding advisory basis, on whether they prefer that the company seek a say-on-pay vote every one, two or three years. Most companies further discuss the board's recommendation on such frequency and the reasons for such recommendation.

<sup>4</sup> All companies (other than smaller reporting companies and companies subject to TARP) must provide the say-on-frequency vote at the first annual or other meeting of shareholders occurring on or after January 21, 2011. Thereafter, companies will be required to give shareholders a say-on-frequency vote at least once every six calendar years.

<sup>5</sup> After the inaugural say-on-frequency vote, companies will be required to disclose in their future proxy statements the current frequency of the say-on-pay vote and when the next say-on-pay vote will occur.

A few companies have, however, included a resolution. An example of such a resolution is as follows—

“RESOLVED, that the shareholders recommend, in a non-binding advisory vote, whether a non-binding advisory vote to approve the compensation of the company’s named executive officers should occur every one, two or three years.”

As noted above, most companies have been including the say-on-pay and say-on-frequency proposals immediately after the proposal relating to the ratification of auditors and before any other shareholder proposals that the company may be including in its proxy statement.

- *Determine board recommendation.* The board needs to determine whether to recommend a particular frequency of the say-on-pay vote to shareholders. In reaching a decision, there are several factors that a board should consider:
- *Major shareholder preferences.* The board should consider whether any of the company’s major shareholders support a particular frequency. While a few institutional investors have publicly announced their preferences, with most of them supporting an annual say-on-pay vote, other major institutions have suggested that they will support a triennial vote.
- *Proxy advisory firm preferences.* ISS and Glass Lewis both support an annual say-on-pay vote. ISS has indicated, however, that a recommendation by the company of a biennial or triennial vote will not result in a negative vote recommendation by ISS with respect to other matters being submitted to shareholders at the annual meeting.
- *Investor relations history.* Companies that have had tumultuous relations with their shareholders may wish to endorse an annual say-on-pay vote to cool investor ire, particularly if the contentious issues have centered on compensation practices.
- *Peer practices and early voting results.* Companies should also take into account the recommendations being made by peer companies, as well as overall company trends. Over half of the companies that have filed proxy statements to date have recommended the triennial option, about 30 percent have recommended the annual option and fewer than 10 percent each have chosen the biennial option or made no voting recommendation. Companies will also be able to gauge shareholder sentiment on the say-on-frequency vote by monitoring the voting results of shareholder meetings occurring early in the 2011 proxy season. Several major companies have their annual meetings scheduled in the next few weeks.
- *Effect of no recommendation on discretionary voting.* If management does not make any recommendation on the frequency of the say-on-pay vote, it will not have discretionary authority to vote proxy cards that are returned unmarked in favor of one of the say-on-frequency options.<sup>6</sup>
- *Vulnerability of compensation committee members.* An annual say-on-pay vote may reduce the risk of a high negative or withhold vote against compensation committee members of companies with questionable pay practices. If a company has what ISS considers to be “problematic” pay practices, ISS will generally recommend a negative vote on management’s say-on-pay proposal, but will recommend withholding votes from compensation committee members when a say-on-pay proposal is not on the ballot. Consequently, compensation committee members at companies with pay practices that are criticized by ISS will face a higher risk of receiving negative votes (and not being reelected if the company has majority voting) in years in which say-on-pay is not on the ballot.
- *Other compensation items on ballot.* If the company is seeking shareholder approval of a new equity compensation plan at the 2011 annual meeting, the company may want to recommend an annual vote on say-on-pay to take this issue “off the table” and allow the company to concentrate on obtaining shareholder approval of the plan.
- *Determine whether to follow shareholder recommendation.* The board of directors will also need to decide whether to follow the frequency vote preferred by shareholders, even if it is not the board’s recommended choice. If a single frequency (i.e., one, two or three years) receives a majority<sup>7</sup> of the votes cast, and the company adopts a policy on the frequency of say-on-pay votes that is consistent with that choice, then the company will be able to exclude from future proxy statements, as substantially

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<sup>6</sup> Companies may vote uninstructed proxy cards in accordance with management’s recommendation for the say-on-frequency vote only if the company follows the existing requirements of Rule 14a-4 to (i) include the recommendation on the frequency of say-on-pay votes in the proxy statement, (ii) permit abstention on the proxy card, and (iii) include language regarding how uninstructed shares will be voted in bold on the proxy card.

<sup>7</sup> The SEC had initially proposed that shareholder proposals could be excluded if the board followed the frequency that received a *plurality* of the votes cast, but raised the requirement to a *majority* of votes cast in the final rules.

implemented, any shareholder proposals submitted under Rule 14a-8 that relate to say-on-pay or say-on-frequency, including those drafted as requests to amend the company's governing documents.

The SEC has given boards considerable time after the conclusion of the shareholder meeting to make their decision regarding how frequently say-on-pay votes will be conducted. Companies will have to file a Form 8-K within four business days after the shareholder meeting to disclose the preliminary and/or final results of the say-on-pay and say-on-frequency votes. However, the board may have up to 150 days after the meeting to make a decision on the frequency of the say-on-pay vote. Companies must disclose their decision by filing an amendment to the prior Form 8-K that disclosed the results of the say-on-frequency vote. The amended Form 8-K will be due no later than 150 calendar days after the end of the shareholder meeting, but in no event later than 60 calendar days before the deadline for the submission of shareholder proposals under Rule 14a-8 for the next annual meeting. In the SEC's view, this will give boards sufficient time to weigh the results of the shareholders' expressed preference, but also allow enough time for shareholders to decide whether to submit a shareholder proposal on say-on-pay or say-on-frequency at the next annual meeting.

## Say-on-Golden Parachutes

The new SEC rules also require companies to give shareholders a nonbinding vote on golden parachute arrangements in connection with any proxy statement seeking shareholder approval for a merger or similar transaction, unless the golden parachute arrangements were subject to a prior say-on-pay vote. Consequently, companies will need to—

- *Determine whether to include additional disclosure in proxy statement.* The board will need to determine whether to include golden parachute arrangements in the pay packages subject to the say-on-pay vote. There are several reasons why companies may wish to forgo the inclusion of these arrangements in the compensation subject to the say-on-pay vote. Among other things, additional tabular and narrative disclosure will be required in the proxy statement. Also, if any changes are made to the golden parachute arrangements or any new arrangements are entered into after the say-on-pay vote, such changes or arrangements will be subject to a separate say-on-golden parachute vote.<sup>8</sup>

Further, ISS has announced that, if a company decides to include the additional disclosure on golden parachute arrangements in the compensation subject to the say-on-pay vote, ISS may give greater weight to golden parachute arrangements in its overall say-on-pay recommendations. Consequently, if a company's golden parachute arrangements contain features that do not fall within ISS's standards (such as an excise tax gross-up provision or a single-trigger change-in-control provision), the company may be better off forgoing the disclosure in the annual proxy statement and, instead, waiting until shareholder approval is sought for a particular merger.

- *Start early if the additional disclosure is to be included.* If a company does decide to include the required additional disclosure on golden parachute arrangements in its 2011 proxy statement, it should promptly begin the process of assembling the required information.

## Transitioning to the New Rules

As discussed above, companies are required under the Dodd-Frank Act to provide a say-on-pay vote and say-on-frequency vote at the first annual or other meeting of shareholders at which directors will be elected on or after January 21, 2011, even though the SEC's rules will not become effective until 60 days after publication in the *Federal Register*.<sup>9</sup> In the adopting release for the new rules, the SEC provided guidance for companies filing proxy statements prior to the effective date of the new rules, as well as guidance for companies whose proxy service providers may not yet be able to accommodate the voting choices for the say-on-frequency vote:

- *No preliminary filing required.* One of the new SEC rule amendments will provide that inclusion of the say-on-pay and say-on-frequency votes in a proxy statement will not trigger the requirement to file the proxy statement in preliminary form. The SEC

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<sup>8</sup> Changes that result only in a reduction in value of the total compensation payable will not require a new shareholder vote, but other changes, including a change in compensation because of a new NEO, additional grants of equity compensation in the ordinary course and increases in salary, would be subject to a new shareholder vote.

<sup>9</sup> The say-on-golden parachute requirement will apply to covered proxy statements and other forms and schedules that are initially filed with the SEC on or after April 25, 2011.

will not require companies filing before the effective date of the new rules to file their proxy statement in preliminary form if the only matters that would require a preliminary filing are the say-on-pay and say-on-frequency votes.

- *Form of proxy card.* Rule 14a-4 currently requires that, with respect to all matters other than the election of directors, the proxy card must give shareholders a choice between approval and disapproval. The new SEC rules will amend Rule 14a-4 to require that the proxy card give shareholders the opportunity to vote on the frequency of say-on-pay by specifying by box 1, 2 or 3 years or abstaining. Not all of the proxy service providers, however, are currently able to give shareholders four choices. Consequently, the SEC has stated that, for any proxy materials filed for a meeting to be held on or before December 31, 2011, the SEC will not object if the proxy card allows shareholders to specify by boxes just the three choices of 1, 2 or 3 years. In such case, because shareholders would not be given an opportunity to abstain, companies would not have discretionary authority to vote proxies on the say-on-frequency matter in the event the shareholder does not select one of the boxes.
- *Smaller reporting companies.* The new SEC rules will give smaller reporting companies a two-year exemption from the requirements to conduct the say-on-pay and say-on-frequency votes. The SEC will not object if a smaller reporting company does not include these votes in its proxy materials for a meeting occurring before effectiveness of the new rules.

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