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Implementation of the Dodd-Frank Say-on-Pay Requirements: An Analysis of the SEC's Proposed Rules in Time to Prepare for the 2011 Proxy Season

BY MARY J. MULLANY

Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[1] adds new Section 14A to the Securities Exchange Act of 1934 (the Exchange Act). Section 14A of the Exchange Act sets forth the various ''say-on-pay'' requirements that will be applicable to all companies that file periodic reports under the Exchange Act with the Securities and Exchange Commission (the SEC) beginning on Jan. 21, 2011. This article discusses the Dodd-Frank say-on-pay requirements, including a summary of the SEC's proposed rules issued Oct. 18, 2010, and the comments submitted in response to such proposed rules, to provide companies with insights and suggestions as companies and their advisers prepare for the 2011 annual meeting of shareholders.

[1] Pub. L. No. 111-203 (July 21, 2010).

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Say-On-Pay Requirements

Dodd-Frank, which brings sweeping regulatory changes that will impact many aspects of business and commerce in America, includes significant corporate governance and executive compensation requirements for all public reporting companies. New Section 14A of the Exchange Act adds three ''say-on-pay'' requirements, which are:

(1) *Periodic Say-on-Pay*—At least once every three years, starting in 2011 for most companies, every public reporting company must include in its proxy statement a separate resolution subject to shareholder vote to approve the compensation of the named executive officers (NEOs) as disclosed pursuant to Item 402 of Regulation S-K.[2]

(2) *Say-on-Pay Frequency*—At least once every six years, starting in 2011 for most companies, every public reporting company must include in its proxy statement a separate resolution subject to shareholder vote to determine whether the periodic say-on-pay vote will occur every one, two, or three years.[3]

[2] Exchange Act Section 14A(a)(1).
[3] Exchange Act Section 14A(a)(2).

(3) *Golden Parachute Say-on-Pay*—Beginning in 2011, after the SEC's final rules are adopted, in any proxy or consent solicitation material for a meeting of shareholders at which shareholders are asked to approve an ''extraordinary transaction'' (an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all the assets of an issuer), the person making the solicitation must make disclosure about any compensation agreements or understandings the issuer has with its NEOs (or any NEOs of the acquiring issuer) that is based on or otherwise relates to the extraordinary transaction, including an aggregate total of all such compensation and the conditions under which it may be paid or become payable.[4] These compensation arrangements and understandings will be referred to in this article as golden parachute compensation. Under Section 14A, if the golden parachute compensation has not been subject to a periodic say-on-pay vote, then the proxy or consent solicitation material must include a separate shareholder vote on such golden parachute compensation.

Each of these three say-on-pay votes is advisory—none are binding on a company or its board of directors, nor may they be construed to overrule a decision made by a company or its board of directors, or create or change any fiduciary duties applicable to the company or its board of directors.[5]

In addition to these say-on-pay requirements, Section 14A of the Exchange Act imposes reporting obligations on each institutional investment manager subject to Exchange Act Section 13(f) to report at least annually on how they voted on the say-on-pay resolutions.[6]

SEC's Proposed Rules—Say-On-Pay

On Oct. 18, 2010, the SEC issued proposed rules under the Exchange Act to implement these Dodd-Frank Section 951 say-on-pay shareholder vote requirements (Say-on-Pay Proposed Rules).[7] The comment period on the Say-on-Pay Proposed Rules, which ended on Nov. 18, 2010, was abbreviated given the pending effectiveness of the Dodd-Frank say-on-pay provisions, and the SEC's Dodd-Frank comment process, which includes an unprecedented opportunity to provide comments in advance of the issuance of proposed SEC rulemaking under Dodd-Frank. The SEC received over 50 letters during the comment process from a variety of interested persons, including national and international corporate governance and executive compensation organizations, public reporting companies, pension funds and pension fund administrators, law firms and legal associations, compensation consultants, proxy advisory firms, shareholder communication firms, and individual investors. The principal guidance that can be gleaned from the Say-on-Pay Proposed Rules, and the principal areas of comment are:

Periodic Say-On-Pay Votes. *When periodic say-on-pay votes must be held*. Proposed rule 14a-21(a) specifies how companies must provide a separate shareholder advisory vote to approve the compensation paid to NEOs, as such compensation is disclosed in accordance with the requirements of Item 402 of Regulation S-K, including the Compensation Discussion & Analysis (CD&A), the compensation tables, and other narrative executive compensation disclosures. Although footnotes in the Say-on-Pay Proposed Rules release imply that these votes should be held only in conjunction with an annual or special meeting at which directors are to be elected, the language of proposed rule 14a-21(a) states that this shareholder vote on executive compensation is required when proxies are solicited for an annual or other meeting of securities holders for which the SEC rules require the disclosure of executive compensation pursuant to Item 402 of Regulation S-K. This leaves open the possibility that a proxy statement soliciting votes for approval of an equity compensation plan that requires such Item 402 disclosures would need to include the periodic say-on-pay shareholder vote even if directors are not being elected.

This possibility has caused concern among a number of commenters, with the primary concern raised by companies such as publicly traded partnerships and limited liability companies that do not generally hold annual elections of directors but may submit compensation plans for security holder approval. These commenters ask that the SEC clarify in the final rules that the periodic say-on-pay vote need only be provided in connection with an annual or special meeting at which directors are to be elected.

Format of the periodic say-on-pay resolution. The Say-on-Pay Proposed Rules do not specify the language or form of resolution required to be used for such shareholder vote. However, the release indicates that a vote to approve a proposal on different terms, such as a vote that seeks approval only of compensation policies and procedures, would not be sufficient. Further, the Say-on-Pay Proposed Rules confirm that only executive compensation for NEOs is covered—no shareholder approval is required for director compensation, or for any disclosure regarding compensation policies and practices as they relate to risk management and risk-taking incentive compensation for employees generally. Finally, the Say-on-Pay Proposed Rules add new Item 24 to Schedule 14A to require a brief explanation of the general effect of the vote, such as whether the vote is nonbinding.

While most commenters were supportive of the lack of a specific language requirement for the periodic say-on-pay resolution, concern was expressed that the lack of baseline principles or guidance could make these votes susceptible to legal challenge and/or make it difficult for investors to compare such votes across companies. Some commenters suggested examples for resolution language, and many called for the SEC to provide specific ''safe harbor'' guidance or nonexclusive language for the required elements of the resolution language in the final rules.[8] In addition, many commenters questioned the need for the Item 24 disclosure, expressing concern that the language of the proposed rule, i.e., *whether* the vote is nonbinding, was ambiguous given

[4] Exchange Act Section 14A(b).

[5] Exchange Act Section 14A(c).

[6] Exchange Act Section 14A(d).

[7] SEC Release Nos. 33-9153; 34-63124; File No. S7-31-10, titled ''Shareholder Approval of Executive Compensation and Golden Parachute Compensation'' published in the Federal Register on Oct. 28, 2010.

[8] See, for example, the comment letters of TIAA CREF, dated Nov. 18, 2010; Pearl Meyer & Partners, dated Nov. 18, 2010; Sullivan & Cromwell LLP, dated Nov. 18, 2010; and the Boeing Co., dated Nov. 16, 2010.

the Dodd-Frank mandate that such votes were nonbinding.

Treatment of smaller reporting companies. Although Dodd-Frank Section 951 specifically provides the SEC with the authority to exempt specific issuers or classes of issuers from these requirements, smaller reporting companies[9] are not exempted from compliance with these say-on-pay requirements, and the Say-on-Pay Proposed Rules do not provide any type of staggered effectiveness for smaller reporting companies.

The SEC specifically sought comment on whether smaller reporting companies should be exempted from these say-on-pay requirements, and the comments varied widely. A number were supportive of the application of these say-on-pay requirements to smaller reporting companies, while others questioned the need for smaller reporting companies to comply with these say-on-pay requirements. Many commenters expressed concern that the burden and cost of complying with these requirements would be disproportionately greater on smaller reporting companies, and that, given their relatively simple compensation structure, unnecessary. Suggestions for change ranged from a complete exemption for all smaller reporting companies, to staggered effectiveness for smaller reporting companies, to requirements for triennial say-on-pay votes for smaller reporting companies. A few banking associations recommended exemption of community banks from these say-on-pay requirements, given the increased regulatory oversight on such banks, the nature of their shareholder base, and other factors.[10]

Subsequent CD&A disclosure. Under the Say-on-Pay Proposed Rules, Item 402(b) of Regulation S-K would be amended to include a mandatory CD&A requirement to discuss in future proxy statements whether and, if so, how a company's compensation policies and decisions have taken into account the results of previous shareholder advisory votes on executive compensation.

This proposal engendered numerous comments, most of them negative. The comments included: (1) concern that the mandatory nature of the requirement will lead to boilerplate language, particularly in the presence of overwhelming approval of the say-on-pay votes by shareholders; (2) recommendations that this disclosure obligation be captured under the existing CD&A requirement to discuss all factors that have an impact on the company's compensation decisions only if material; and (3) recommendations, if the requirement remains mandatory, to limit the discussion to only the most recent shareholder advisory vote, or to the most recent two votes.

Say-on-Pay Frequency Votes. *Frequency vote*. Under proposed Rule 14a-21(b) and amended Rule 14a-4, shareholders must be given four choices on the company's proxy card—whether the shareholder vote on executive compensation should occur every one, two, or three years, or to abstain from voting on the matter. The SEC staff noted that any other variation would not meet the requirements of Dodd-Frank. The Say-on-Pay Proposed Rules contemplate that a company will provide—in the proxy statement—the board of directors' recommendation as to the frequency of the say-on-pay vote. In the Say-on-Pay Proposed Rules release, the SEC staff expressed concern as to whether shareholder voting systems, which are designed to handle votes with three alternatives (for, against, or abstain), would be able to be adapted in time to handle this four alternative vote, and suggested a temporary fix for 2011 that would remove the ''abstain'' alternative and count unvoted proxies as abstentions. The Say-on-Pay Proposed Rules also contemplate that the say-on-pay frequency vote would be a plurality vote.

While some commenters, including Broadridge,[11] expressed confidence that the shareholder voting systems would be able to be adapted in time, the majority of the comments focus on concerns regarding the plurality nature of the vote, including the impact the ''fix'' would have on the return of proxies signed in blank. Many commenters expressed the view that, while plurality voting might lead to a ''winner,'' it would be possible that a majority of shareholders voted for a different frequency alternative. Some of such commenters suggested allowing a company to select either the plurality frequency or a more frequent vote.[12]

Subsequent disclosure requirements. The Say-on-Pay Proposed Rules also add new disclosure requirements to the Form 10-Q and Form 10-K. These amendments will require disclosure, in the periodic report covering the period during which the shareholder advisory vote occurs, of the company's decision on how frequently it will conduct shareholder advisory votes on executive compensation in light of the results of the shareholder vote on say-on-pay frequency.

This proposed rule received almost universal criticism from commenters. Many commenters pointed out that, due to a number of factors, including the timing of the annual meeting of shareholders, the scheduled board and committee meetings, and the potential for a close say-on-pay frequency vote, it might not be possible for a company to adequately evaluate the say-on-pay frequency vote and reach a decision before the due date for the next periodic report. Such commenters also pointed out that the disclosure requirement had the effect of changing the nonbinding nature of this advisory vote. Recommended changes included requiring such notice in the next year's proxy statement, posting the board determination on the company's website, or providing more time for such periodic report disclosure.[13]

Amendment to Shareholder Proposal Rules. Rule 14a-8 (which covers shareholder proposals) is proposed to be amended to add a note to Rule 14a-8(i)(10) to permit a company to exclude a shareholder proposal that would

[9] A smaller reporting company is generally a company with a public float of less than $75 million. Smaller reporting companies are subject to scaled down disclosure requirements and do not have to provide CD&A. The Say-on-Pay Proposed Rules release makes clear that the proposed rules will not require CD&A disclosure by smaller reporting companies, but many commenters questioned the practical reality of whether CD&A disclosure would be necessary to obtain shareholder approval.

[10] See the comment letters of the American Bankers Association, dated Nov. 18, 2010, and the Independent Community Bankers of America, dated Nov. 18, 2010.

[11] See Broadridge Financial Solutions Inc. comment letter dated Nov. 19, 2010. Broadridge is a leading provider of technologies and outsourcing services for shareholder communications and voting.

[12] See, for example, comment letter of Sullivan & Cromwell LLP, dated Nov. 18, 2010.

[13] See, for example, comments letters of Pfizer Inc., dated Nov. 18, 2010; Business Roundtable, dated Nov. 18, 2010; and Frederic W. Cook & Co., dated Nov. 17, 2010.

provide for a say-on-pay vote at a particular shareholder meeting, or at future shareholder meetings, or that relates to the frequency of say-on-pay votes, as long as the company has adopted a policy on the frequency of say-on-pay votes that commits the company to select a say-on-pay vote frequency that is consistent with the results of the shareholder vote at the most recent meeting. This proposed note elicited many comments, including many that were supportive of the proposal. The majority of commenters, however, indicated that because of the rapidly changing dynamics at public companies, including changes in the shareholder base, and likely changes in executive compensation programs, shareholders should be able to propose a different say-on-pay frequency vote, particularly if there has been a material change in NEOs or in the executive compensation program.[14]

Golden Parachute Say-on-Pay Shareholder Votes. *Golden parachute compensation*. The proposed rules would implement the requirements regarding say-on-pay golden parachute votes through new Item 402(t) of Regulation S-K. Proposed Item 402(t) disclosures regarding golden parachute payments in connection with an extraordinary transaction must be presented in a clear and simple form in both tabular and narrative format. The tabular disclosure would require quantification with respect to any agreements or understandings, whether written or unwritten, between each NEO and the company soliciting the shareholder vote, concerning any type of compensation, whether present, deferred, or contingent, that is based on or otherwise relates to the extraordinary transaction. The table would quantify cash severance, equity awards that are accelerated or cashed out, pension and nonqualified deferred compensation enhancements, perquisites, tax reimbursements, and any other compensation related to the extraordinary transaction. This would not include bona fide post-transaction employment agreements to be entered into in connection with the extraordinary transaction. These nonbinding shareholder votes will also need to be included in a number of other solicitations seeking shareholder approval of an extraordinary transaction, including going-private transactions and third party tender offers. Bidders in a third party tender offer would need to provide information about a target's golden parachute arrangements, but only if the bidder has made a reasonable inquiry into the golden parachute arrangements and has knowledge of such arrangements.

A company would not be required to include this golden parachute say-on-pay vote in a merger proxy statement if disclosure of its golden parachute compensation had been included in the Item 402 disclosure that was subject to a prior periodic say-on-pay vote. This exception would be available only if the same golden parachute compensation arrangements remained in effect and had not been modified. Modified arrangements or new portions of such an arrangement would be subject to the separate golden parachute say-on-pay shareholder vote. The company would need to provide two separate tables—disclosing all golden parachute compensation in one table and only the new or modified arrangements in the second table.

Comments on this portion of the Say-on-Pay Proposed Rules focused on: (1) request for more clarity and guidance as to whether ongoing compensation awards, such as annual equity grants given under an unchanged compensation program or other routine matters unrelated to changes in the compensation program, would make the merger proxy statement exception inapplicable; (2) suggestions for expansion or clarification of the tabular disclosure, including differentiation of ''single trigger'' and ''double trigger'' compensation arrangements; and (3) agreement or disagreement with the proposal to exclude previously vested compensation from the tabular disclosure.[15]

Other Issues Addressed in the Say-On-Pay Proposed Rules. The Say-on-Pay Proposed Rules release propose the following: (1) broker discretionary voting of uninstructed shares would not be permitted for these say-on-pay votes; (2) companies would not be required to file a preliminary proxy statement because of the inclusion of these say-on-pay shareholder votes; and (3) a company that has received financial assistance under the Troubled Asset Relief Program (TARP), which itself mandates annual say-on-pay shareholder votes, would not be required to comply with the process required by these proposed rules regarding annual meeting say-on-pay votes until that company has repaid all indebtedness under TARP. Commenters were generally supportive of these proposals.

Reporting Requirements for Institutional Investment Managers

On Oct. 18, 2010, the SEC also issued proposed rules to implement Exchange Act Section 14A(d) regarding the proxy voting reporting requirements for institutional investment managers [16] subject to Section 13(f) of the Exchange Act (Proxy Reporting Proposed Rules).[17] Proposed Rule 14Ad-1 would require institutional investment managers to file reports on Form N-PX under Section 13(f) of the Exchange Act to disclose annually how they voted on say-on-pay resolutions proposed by companies in which the institutional investment managers have voting authority.

Under the Proxy Reporting Proposed Rules, an institutional investment manager would be required to report on these votes only if the institutional investment manager possesses, directly or indirectly, through any

[14] See, for example, comment letters of Boston Common Asset Management LLC, dated Nov. 16, 2010; Walden Asset Management, dated Nov. 9, 2010; and the State Board of Administration of Florida, dated Nov. 22, 2010.

[15] See, for example, comment letters of the Center on Executive Compensation, dated Nov. 18, 2010; Compensia, dated Nov. 18, 2010; and Glass Lewis & Co., dated Nov. 18, 2010.

[16] The term ''institutional investment manager,'' as defined in Section 13(f)(6)(A) of the Exchange Act, is an investor who is not a natural person, investing in or buying and selling securities for its own account and any person exercising investment discretion with respect to the account of any other person if the investor is required to file reports under Section 13(f) of the Exchange Act because it, he, or she exercises investment discretion with respect to accounts holding Section 13(f) securities with an aggregate fair market value of at least $100 million on the last trading day of any month.

[17] SEC Release Nos. 34-63123; IC-29463; File No. S7-30-10, titled ''Reporting of Proxy Votes on Executive Compensation and Other Matters'' published in the Federal Register on Oct. 28, 2010.

contract, arrangement, understanding, relationship, or otherwise, sole or shared voting power with respect to these votes. If the institutional investment manager does not have such voting power, it, he, or she need not report such votes, even if the institutional investment manager has voting power over other matters. This is a facts and circumstances test. Under current rules, institutional investment managers reporting on Form 13F is based on investment discretion rather than voting power; so discrepancies may arise between securities reported by an institutional investment manager on Form 13F and securities for which votes are reported on Form N-PX. The institutional investment managers would need to report these say-on-pay votes annually on Form N-PX not later than Aug. 31 of each year, for the most recent 12-month period ending on June 30. This is the same schedule on which funds currently are required to report their complete proxy voting records on Form N-PX under the Investment Company Act.

The Proxy Reporting Proposed Rules provide for the following:

■ *A transition period*. An institutional investment manager would not be required to file a Form N-PX report for the 12-month period ending on June 30 of the calendar year in which the manager's initial filing on Form 13F is due.

■ *A defined date for termination of reporting obligations*. The institutional investment manager would not be required to file a report on Form N-PX with respect to any applicable vote at a meeting that occurs after Sept. 30 of the calendar year in which the manager's final filing on Form 13F is due. Instead, the manager would be required only to file a report on Form N-PX for the period between July 1 through Sept. 30 of that calendar year. Such final report would be due by Feb. 28 of the next calendar year.

■ *Joint reporting*. A single institutional investment manager that shares voting power would be able to meet its reporting requirements by identifying and incorporating by reference to the Form N-PX filed by the institutional investment manager or fund that actually reports the voting results.

■ *Form N-PX amendments*. Form N-PX would be amended to provide for the additional disclosures. Most notably, for each proxy vote that must be included on a Form N-PX, the form must provide specific information identifying the security voted, the matter with respect to which the vote occurred, and how the reporting person voted. This information would need to be included in a standardized format and would specifically include the number of shares the reporting person was entitled to vote, solely or with shared voting power, and the number of shares voted, the identity of the institutional investment managers whose votes were shared, and standardized descriptions of the votes. These new requirements will also apply to the proxy voting reporting by funds.

■ *Confidential treatment*. Information filed on Form N-PX would be publicly available, but an institutional investment manager could request confidential treatment of information reported on Form N-PX. However, confidential treatment protections are narrowly defined in this context.

■ *Compliance dates*. Institutional investment managers would be required to file their first reports covering these say-on-pay votes for a meeting that is held on or after Jan. 21, 2011, and prior to June 30, 2011. Such initial Form N-PX is due no later than Aug. 31, 2011. Funds must also comply with these proposed rules for the period of July 1, 2010, through June 30, 2011, but do not have to report say-on-pay votes at meetings held prior to Jan. 21, 2011.

The comment period for the Proxy Voting Proposed Rules also ended on Nov. 18, 2010. The SEC received approximately 20 comment letters, primarily from funds, pension administrators, institutional investor organizations, law firms and proxy advisory firms. The comments generally focused on: (1) criticism of the expanded disclosure regarding how many shares were eligible to be voted, rather than just those voted; (2) concern that the proposed rules dramatically expand the obligations under Dodd-Frank Section 951 and require the collection and reporting of information that will be difficult to collect and of questionable utility to investors; (3) calls for an extended transition period to allow data collection systems to be adapted to the new requirements; (4) requests to narrow the reporting to only those shares the institutional investment manager or fund actually voted without instruction; and (5) application of the same de minimis thresholds under Form 13F to Form N-PX reporting.[18] Some commenters were also critical of these expanded reporting obligations prior to release of ''proxy plumbing'' rules following the July 2010 SEC Concept Release on U.S. Proxy Voting.

What Should Companies Do Now?

While the SEC has committed to issuance of final rules on these say-on-pay topics prior to the effectiveness of Dodd-Frank Section 951 on Jan. 21, 2011, there are some practical things companies can begin to do now as they prepare for the 2011 annual meetings of shareholders:

■ *Determine the scope and language of the periodic say-on-pay resolution*. While the resolution language must comply with the baseline requirements of Dodd-Frank, each company should consider whether it will expand the resolution to include more specific approvals. For guidance, companies can look to the resolutions of TARP companies and those public companies that voluntarily included say-on-pay shareholder votes in 2010 proxy statements. Also as noted above, some of the comment letters provide some guidance and suggested language as well.

■ *Review CD&A*. Each company should review its executive compensation disclosures with a fresh eye to evaluate whether the disclosure adequately describes the analysis and determinations made with respect to NEO compensation.

■ *Determine the company's say-on-pay frequency vote recommendation*. As each company evaluates its alternatives, it should consider factors such as whether it: has a staggered board (i.e., recommend against a frequency recommendation that would have the periodic say-on-pay arising with the same class of directors); is considering or anticipating significant changes in its executive compensation programs or NEOs; has received prior say-on-pay shareholder proposals and, if so, the results of such vote; and the makeup of its shareholder

[18] See, for example, comment letters of Seward & Kissel LLP, dated Nov. 18, 2010; Fidelity Investments, dated Nov. 18, 2010; Mayer Brown LLP, dated Nov. 18, 2010; and Investment Advisor Association, dated Nov. 16, 2010.

base. On Nov. 19, 2010, Institutional Shareholder Services Inc. released its 2011 updates to its proxy voting guidelines and, in line with overall client feedback, is recommending a vote for annual advisory say-on-pay votes on executive compensation.[19]

■ *Evaluate inclusion of golden parachute say-on-pay disclosures in the 2011 proxy statement*. This is one area in which it may be advisable to wait for the final rules because, based on the Say-on-Pay Proposed Rules, there is substantial uncertainty as whether inclusion of such disclosure will qualify a company for the exemption from including a golden parachute say-on-pay resolution in a subsequent merger proxy statement or other solicitation material regarding an extraordinary transaction.

■ *Assess the company's shareholder base*. Many commentators believe that one of the biggest impacts of the say-on-pay votes will be to increase communications between a company and its shareholders on the topics of executive compensation and corporate governance. If a company anticipates that issues will arise related to these say-on-pay resolutions, it may be more helpful than in years past to reach out to the corporate governance and voting representatives of the company's shareholders as the company makes the foregoing assessments and evaluations.

[19] ISS, U.S. Corporate Governance Policy, 2011 Updates, published Nov. 19, 2010, at 16.

