

PROXY AND GOVERNANCE ALERT

A PRACTICAL LOOK AT SAY ON PAY

As expected, the Securities and Exchange Commission last week adopted the final rules concerning shareholder approval of executive compensation ("Say on Pay" and "Say When on Pay") and "golden parachute" compensation arrangements as required under the Dodd-Frank Wall Street Reform and Consumer Protection Act. They did however provide a temporary exemption for smaller reporting companies (public float of less than \$75 million), giving these companies a reprieve from the requirements of Say on Pay and Say When on Pay until January 21, 2013.

Say on Pay (S.O.P)

The SEC's new rules, which effectively apply to all annual shareholder meetings going forward, specify that Say on Pay (SOP) votes must be held at least once every three years.

In essence, SOP allows shareholders to voice their approval or disapproval (by voting For, Against or Abstain) regarding your compensation practices for Named Executive Officers (NEOs). SOP is a non-binding advisory vote, but executive compensation is a very sensitive issue with institutions and proxy advisory firms, and issuers will need to pay attention to the vote results. Even with a 70% favorable vote, for example, you cannot ignore the fact that 30% of your holders that voted find your compensation practices to be problematic.

The difficulty is how to interpret that vote. What is it that holders don't like? The stock performance? The pay-for-performance metrics? And what improvements would they like? **Also, what is your board's appetite for a negative or weakly positive vote?**

A potential benefit, at least in the near term, of SOP to companies and their shareholders is that it provides shareholders with an alternative to withholding votes or voting against directors (particularly members of the compensation committee) as the only means of expressing dissatisfaction with the company's executive pay practices.

ISS and Glass Lewis have changed their policies for the 2011 proxy season. In most cases where they identify executive compensation practices that merit a negative vote recommendation, they will recommend a vote against SOP rather than recommending that their clients withhold votes from or vote against individual directors.

As companies have responded to shareholder pressure to declassify their boards and adopt a majority vote standard for uncontested director elections, the potential consequences of votes against directors have become more serious and may have unintended consequences, compounded by the loss of discretionary voting on directors in 2010 (NYSE Rule 452.)

ISS will continue to recommend votes against comp committee members, but only in rare "egregious" situations or if you are continuing to engage in a problematic pay practice that has already been the subject of a withhold recommendation. Furthermore, there are some

institutions that will vote against comp committee members whenever they determine to vote NO on SOP because they believe that if the compensation practice problem rises to the level of a NO vote on SOP then the directors responsible should be held accountable. If you believe you may be in either of these groups, give us a call and we can review this with you.

A note of caution if you have had SOP on the proxy in prior years or are looking at the high approval results from companies that did –these proposals had been deemed routine under NYSE Rule 452 and benefitted from the broker discretionary vote. However, Dodd-Frank forced the NYSE to change its ruling and SOPs are now non-routine. Issuers with any sizeable retail holder constituency will be impacted the most by this change.

*** This new ban on broker votes on compensation agenda items has already had an impact. One of the first Dodd-Frank mandated SOP votes was at Jacobs Engineering which just announced that it received just 44% approval (53.7 percent opposition) to its SOP advisory vote. Had brokers still been able to vote uninstructed shares, the result would have been a 62% approval!*

Questions remain as to what the proxy advisory firms will do after 2011? Where they identified compensation issues in 2010, and possibly recommended against SOP, what will they do if they perceive that those issues have not been effectively addressed? While they will clearly vote against SOP again, the unresolved question is when will they vote against comp committees.

While on the topic of the advisory firms, an important new development is that ISS will no longer reverse a negative vote based on the “get out of jail free” 8-K filing with some sort of future commitment after they release their recommendation. This may force some of you to make unwanted changes prior to filing your proxy as you no longer have the benefit of “lets see what ISS says and then we can decide”.

Say When on Pay (SWOP)

While SOP must be on the ballot at least once every three years, issuers are now required to hold a vote at least once every six years asking holders to indicate how often they would like to see the SOP vote. Holders will be given the choice of an annual, biannual or triennial vote. Like SOP, this “Say When on Pay” or “frequency” vote is non-binding.

ISS and Glass Lewis have announced their intention to support annual SOP votes at all 2010 meetings. Among the institutions, support for annual votes is strong but hardly universal. A number of firms have publicly noted that they do not have the resources to review all of the necessary disclosure every year. Some also do not believe that a SOP vote is beneficial or informative, and therefore expect to vote for the 3 year option and hold directors directly accountable on the interim years (or vote Against SOP and withhold on comp committee as discussed above).

Management will need to decide what recommendation to make to shareholders on this issue. Early indications are that a majority of companies are recommending a vote every 3 years. The majority of clients we have spoken to are also recommending triennial votes. As one client opined to us “We felt the triennial vote made sense and if we didn’t at least recommend it, we certainly were not going to get it.” However, we expect many large companies to concede to the inevitability of the influence of ISS and recommend an annual vote in the proxy statement. This outlook is strengthened by looking at the first major votes of the new year. Shareholders at Monsanto voted for the 1 year option despite the company’s recommendation of a 3 year option.

This outcome may have been in part influenced by concerns over the company's compensation practices as evidenced by a 29% Against vote on the SOP proposal (ISS recommended Against). Even at Costco, which received overwhelming support for its SOP proposal, shareholders ignored management's recommendation of a 3 year frequency and supported the annual option.

A relatively small number of companies have decided to make no recommendation and leave it up to shareholders. Realize that if you take this approach, you lose the discretionary authority to vote shares on this proposal if the shareholder returns a proxy with no choice of frequency. We recommend talking to your counsel about the appropriate language in the proxy as to how unmarked cards are handled. We're hearing of a number of situations where the transfer agent is handling unmarked cards as abstentions and Broadridge is not counting them on that proposal, period. An interesting dilemma that will eventually be resolved, but don't ignore it.

Interestingly, the SWOP vote created some concerns early on as this was the first issue that allowed four choices (1 year, 2 year, 3 year and Abstain). The tabulation and proxy card processing systems of the transfer agents and Broadridge were all programmed for the typical three options of For, Against and Abstain. The SEC even acknowledged the potential system problems in their early proposals. Thankfully these concerns have proven unfounded. Broadridge and the major tabulators have reprogrammed their cards and systems to accommodate the frequency vote. We recommend that companies using smaller, less sophisticated transfer agents should confirm that they can accommodate this change.

Resolution of questions regarding 14a-8 proposals

The SEC final rules also revised how companies will be required to deal with shareholder sponsored proposals under Rule 14a-8 that recommend a frequency vote different from the one management adopts.

As adopted, the SEC will permit exclusion of a shareholder proposal on SOP and frequency if, in the most recent shareholder vote on frequency, a single frequency (i.e. one, two or three years) received the support of a majority of the votes cast and the issuer has adopted a policy consistent with that choice.

This creates a slightly higher hurdle for exclusion than had been contemplated by many who felt that the standard should be a plurality of votes cast, rather than a majority. In other words, you cannot exclude the proposal if you adopt the choice that just got the most votes among the three choices, it has to have received the approval of over 50% of the votes cast.

Say on Parachute

Under the SEC's new rules, companies are required to provide additional disclosure regarding "golden parachute" compensation arrangements with NEOs in connection with merger transactions and to have a separate non-binding advisory vote on such arrangements if they have not already been the subject of an SOP vote. Note that there is no requirement for the SOP vote to have passed. Also bear in mind that SOP is only considered "pre-approved" to the extent that it has not been revised in the interim.

We are already getting questions from clients involved in transactions as to whether or not a negative vote on the parachute arrangements will impact their vote on the merger.

Voting disclosure issues

The new rules also require that companies now need to disclose how frequently they will conduct say-on-pay votes (in addition to the disclosure of voting results already required). This new 8-K filing is required no later than 150 calendar days after the annual meeting in which the vote took place, but in any event no later than 60 calendar days prior to the deadline for submission of Rule 14a-8 shareholder proposals for the next annual meeting.

In addition, a new requirement under Dodd-Frank is that any institution filing Form 13F has to publicly disclose how it voted on every SOP, SWOP and golden parachute compensation vote. (Note, this is a wider group than the filings required under the NP-X standard). While this greater transparency may sound like a good thing, it will likely create a tougher environment for lobbying a particular holder to support a proposal that it might otherwise have voted against.

Planning for Say on Pay

We offer below a few additional key pointers from the proxy solicitation perspective for issuers, particularly for those that suspect they may have compensation concerns:

1. Know your shareholder base.
 - a. What is the institutional, retail, hedge fund mix.
 - b. How many shares will be heavily influenced by ISS or Glass Lewis.
 - c. What are the voting policies of the top holders and how do they view SOP and SWOP
2. Determine early on if you may have compensation concerns.
 - a. **Read the last few ISS and Glass Lewis reports.** There may be issues that were raised that have not been resolved. These points may not have been significant enough to lead to a vote against director nominees at the time, but could now result in a recommendation Against SOP.
3. If you believe you have a significant issue, you should engage with your holders before the proxy is filed and be prepared to do so on a broader scale once you are soliciting proxies.
 - a. This should not be a casual outreach. Target who you should contact and go in with a team that is prepared and can discuss compensation knowledgeably.
 - b. Know which firms are open to this type of governance and compensation related engagement.
 - c. Know who you should be talking to – it may not be the portfolio manager or analyst that investor relations departments usually talk to.
 - d. Know the voting process and spheres of influence at each firm.
 - e. Come out of the call or meeting with notes on any concerns and keep these organized. This is key for ongoing discussion, and particularly important when trying to discern what a negative vote on SOP means.

A few cautionary words about the shareholder outreach however. **Don't waste your bullets if you don't need to.** Going hat in hand to a large holder when there really isn't a concern may make it harder to get them when you need to on another matter. Also, be aware of the consequences of getting feedback that you don't act on and then having to answer to "Well why the heck did you ask me for my input on this then?"

If you have any questions, please do not hesitate to call us at (212) 929-5500.