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Preparing for the 2011 Proxy Season: What's New

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In preparation for the 2011 proxy season, there are a number of new developments companies must take into account when drafting proxy statements and annual reports in the wake of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and the release of proposed rules by the Securities and Exchange Commission ("SEC"). Principally, companies will now be required to hold shareholder advisory votes on executive compensation ("Say on Pay"), the frequency of say on pay votes ("Say on Frequency"), and golden parachute compensation ("Say on Golden Parachutes"). It is expected that the SEC will issue additional rules throughout the year to implement provisions of the Dodd-Frank Act. While these rules will not be effective for the 2011 spring proxy season, companies should keep apprised of these developments and may want to consider reviewing other policies and practices in anticipation of the new rules.

I. Current Action Required:

On October 18, 2010, the SEC issued proposed rules 14a-21(a)-(c) to implement Say on Pay, Say on Frequency, and Say on Golden Parachutes.

- ***Say on Pay.*** Commencing with annual meetings that occur on or after January 21, 2011, companies are required to provide shareholders with a non-binding Say on Pay advisory vote approving the compensation of its executive officers at least once every three years.
  - While there is no specified language that must be included in the proposal, the SEC's proposed Rule 14a-21(a) requires companies to make clear that the advisory vote is based on the executive compensation disclosures contained in the Compensation Discussion and Analysis ("CD&A"), proxy tables, and narrative disclosures.

- ***Say on Frequency.*** Companies must also provide for a separate non-binding advisory vote at least once every 6 years to determine whether the say on pay advisory vote should be held every 1, 2, or 3 years.
  - There is no specified language that must be used in the proposal. However, the SEC's proposed Rule 14a-21(b) requires that it be clear to shareholders that there is a choice among the following four alternatives: annual, biennial, triennial, or abstain.

- ***Say on Golden Parachutes.*** Companies holding shareholder meetings to approve a merger, acquisition or other business combination on or after January 21, 2011, are now required to

provide for a separate non-binding advisory vote on any transaction related golden parachute compensation arrangements.
    - This vote is not required if the golden parachute payment was previously disclosed and approved in a say on pay advisory vote.
    - Proposed Item 402(t) of Regulation S-K requires disclosures in specific tabular and narrative form of all golden parachute compensation for named executive officers related to or based on the transaction.

It is anticipated that the SEC will issue final rules sometime between January - March of 2011. Say on Pay and Say on Frequency will be effective for shareholder meetings on or after January 21, 2011, regardless of when the SEC issues final rules. Say on Golden Parachutes, however, will not be effective until final rules are issued.

II. Other Considerations for the 2011 Proxy Season:

The SEC is expected to issue proposed rules regarding hedging and clawback policies between April - June 2011 (the Dodd-Frank Act did not mandate an effective date for these rules). Companies may consider including disclosures of the adoption or modification of such plans in their proxy statement.

- ***Hedge Disclosure.*** The rules will mandate disclosure by public companies in its annual proxy statement of whether any employee or director is permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds) designed to hedge or offset any decrease in the market value of equity securities granted to the employee or director as part of their compensation or other securities held by the employee or director.

- ***Executive Compensation Clawbacks.*** The rules will direct national exchanges to prohibit the listing of any securities of a public company that does not have a policy for the recovery of compensation paid to executive officers.
    - The policy must provide for mandatory public disclosure of the company’s policy on incentive-based compensation that is based upon financial information required to be reported under the federal securities laws.
    - The policy must further provide that in the event the company is required to prepare an accounting restatement because of material noncompliance with any financial reporting requirement under the securities laws, it will recover from current and former executives any incentive-based compensation for the three years preceding the restatement that would not have been awarded under the restated financial statements.

III. Future Considerations:

A. Upcoming Rules on Corporate Governance Provisions of the Dodd-Frank Act

- ***Compensation Committee Independence.*** The SEC must adopt, no later than July 16, 2011, rules regarding compensation committee independence, which may impose additional requirements to the definition of “independence” determined by the applicable exchanges.
    - The rules will take into account the sources of compensation paid to members of the compensation committee (consulting, advisory and other fees) and whether the members of the compensation committee are affiliates with the company, a subsidiary

of the company, or an affiliate of a subsidiary of the company.

- ***Compensation Consultants, Legal Counsel and Other Advisors.*** The Dodd-Frank Act requires that the compensation committee, in its sole discretion, be directly empowered to engage or obtain the advice of compensation consultants, legal counsel and other advisors. Any such engagement will be subject to consideration of certain factors that affect the independence of such advisors.
    - The compensation committee is not required to follow the advice or recommendations it receives from any such compensation consultant, legal counsel or other advisor, and must exercise its own judgment in the fulfillment of its duties.
    - The SEC must adopt rules by July 16, 2011.

- ***Pay vs. Performance Disclosures.*** The Dodd-Frank Act mandates that the SEC issue rules under which public companies must disclose in its proxy statement for an annual meeting of shareholders, “a clear description of any compensation required to be disclosed” under Item 402 of Regulation S-K.
    - The disclosure must include information regarding the relationship between executive compensation actually paid and the financial performance of the company, taking into account any change in the value of the shares of stock and dividends of the company and any distributions.
    - Proposed rules are anticipated to be issued between April - June 2011, although the Dodd-Frank Act did not mandate an effective date for these rules.

- ***Internal Pay Comparison.*** The Dodd-Frank Act requires the SEC to amend Item 402 of Regulation S-K to mandate disclosure of: (1) the median annual total compensation of all employees of the company, other than the CEO; (2) the annual total compensation of the CEO; and (3) the ratio between one and two.
    - Proposed rules are anticipated to be issued between April - June 2011, although the Dodd-Frank Act did not mandate an effective date for these rules.

B. Proposed Rules on Shareholder Proxy Access

On August 25, 2010, the SEC approved rules and amendments, including the adoption of a new Rule 14a-11, that would significantly change the nomination and election process for directors of public companies by facilitating the ability of shareholders to nominate their own candidates for election to the board of directors. October 4, 2010, however, the SEC stayed the effective date of the rules pending a judicial review by the U.S. Court of Appeals for the D.C. Circuit. Although the matter will be considered on an expedited basis by the court, the fate of the new proxy rules is unlikely to be resolved prior to the Summer of 2011 and will likely be inapplicable in 2011 for calendar year companies. Here are some key features of the rules:

- ***Ownership Requirements.*** In order to be eligible to take advantage of proxy access, a nominating shareholder (or shareholder group) must:
    - hold at least 3% of the total voting power of the company’s securities that are entitled vote on the election of directors;
    - have owned these securities continuously for at least three years, and
    - must continue to hold the securities through the date of the annual meeting.

- ***Maximum Number of Nominees.*** Companies are not required to include every shareholder nominee in its proxy materials. Rule 14a-11 only requires companies to include the greater of

one shareholder nominee or that number of nominees that represents no more than 25% of the company's board (rounded down if 25% does not result in a whole number).
    - In the event that the company receives shareholder nominations under Rule 14a-11 in an amount that exceeds the maximum it is required to include in its proxy materials, the nominating shareholder group with the highest voting power percentage has priority.

- ***Nominee Requirements.*** A company may exclude a shareholder nominee from its proxy materials if that nominee does not meet specific eligibility requirements under Rule 14a-11. However, there is no requirement under Rule 14a-11 that the nominee be independent of the shareholder that is making the nomination.

- ***Company Procedural Requirements.*** After receipt of a Schedule 14N regarding a Rule 14a-11 nomination, the company must determine whether any applicable circumstances exist that permit exclusion of the shareholder nominee. A company's obligations will depend on the result of its determination.
    - Rule 14a-11 summarizes the relevant procedures and timelines that must be adhered to when company intends to exclude shareholder nominees from its proxy materials.

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