

TAX MANAGEMENT

MEMORANDUM

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Say on Pay: It's Coming, Are You Ready?

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INTRODUCTION

Executive compensation and increased communication and transparency for shareholders are among the hot-button issues in economic reform. One need only look to the discussions at the recent G20 London Summit or the responses to Securities and Exchange Commission (SEC) calls for comments to understand that momentum is swinging toward allowing shareholders more access in matters of compensation. This memorandum will address recent legislative and regulatory developments in executive compensation as they relate to Say on Pay Proposals and will analyze ways in which companies can position themselves to

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better prepare for mandatory shareholder input into executive compensation.

SAY ON PAY

What Is a Say on Pay Proposal?

An advisory vote on executive compensation, or Say on Pay Proposal, is a non-binding proposal included in a company's proxy materials that calls for an annual shareholder advisory vote on a company's executive compensation program. Such a vote would permit a company's shareholders to give the company an annual "thumbs up" or "thumbs down" vote on the company's executive compensation program.

What Is the History of the Say on Pay Proposal?

The recent push to require companies to provide shareholders with an advisory vote on executive compensation is the result of the relative success of a similar movement in the United Kingdom, Australia, the Netherlands, Norway and Sweden. The advisory vote initiative originated in the United Kingdom and became mandatory for all companies listed on the London Stock Exchange beginning in 2003.

A concerted effort by activist shareholders and certain large institutional investors brought

the issue to the fore in the United States. Beginning in 2006, several activist shareholders and institutional investors began to pressure certain public companies to include a Say on Pay Proposal in their respective proxy statements. Shareholder resolutions to adopt Say on Pay Proposals were successfully filed at five publicly traded companies in 2006, expanding to more than 50 in 2007, more than 80 in 2008, and exceeding 100 in 2009. In January 2009, the American Federation of State, County and Municipal Employees (AFSCME) and Walden Asset Management (Walden) announced that they were leading a coalition of more than 70 institutional and individual investors in an effort to file Say on Pay Proposals with more than 100 companies.²

With respect to the 2009 proxy season, RiskMetrics reports that, as of December 15, 2009, 76 Say on Pay Proposals have been voted on and have received an average support of 45.6% of votes cast.³

What Benefits Are Associated With Say on Pay Proposals?

Proponents of Say on Pay Proposals claim that implementing an advisory vote on executive compensation will incentivize public companies to think about *how* and *why* they arrived at specific executive compensation decisions and, in turn, will create better disclosure. In particular, some proponents argue that the potential for public censure regarding excessive executive compensation packages will lead directors to restrain excessive executive compensation in response to shareholder sentiment and more directly link pay with performance. Other proponents claim that Say on Pay Proposals will affect executive compensation levels in more indirect ways. For instance, Say on Pay Proposals would promote dialogue with and feedback from shareholders. Also, these proposals would give shareholders a sense of empowerment without binding the company to anything. Furthermore, compensation committees might be able to use advisory votes to their advantage, as a way to provide cover for the committee and the board as a whole when negotiating compensation with managers.

² Press Release, American Federation of State, County and Municipal Employees, Institutional Investors Continue to Press Companies for an Advisory Vote on Executive Pay (Jan. 22, 2009) (available at: http://www.iccr.org/news/press_releases/2009/pr_sayonpay01.22.09.htm).

³ RiskMetrics Group, RiskMetrics Proxy Season Scorecard, available at http://www.riskmetrics.com/knowledge/proxy_season_scorecard_2009 (last visited Jan. 4, 2010). In 2008, there were 74 “Say on Pay” proposals included in proxy materials; supporters constituted an average of 41.5% of votes cast. *Id.*

What Costs Are Associated With Say on Pay Proposals?

Opponents of Say on Pay Proposals claim that an advisory vote on executive compensation will be ineffective, costly and confusing. They believe that Say on Pay Proposals are ineffective because a simple “thumbs-up” or “thumbs-down” vote on executive compensation gives management little information about the specific components of executive compensation to which shareholders object. Opponents argue that such an advisory vote is unnecessary and confusing because shareholders are already receiving detailed information on executive compensation as a result of the SEC’s executive compensation disclosure rules. Opponents also claim that an advisory vote will be costly because it will require companies to spend a significant amount of time engaged with various corporate governance activists and proxy advisory firms each year explaining their executive compensation practices and determinations in order to ensure that the advisory vote is in their favor. Finally, opponents fear that activist groups that support Say on Pay Proposals might use advisory votes as an inroads to promote their own social or political agendas that are not related to the company’s economic growth.

SAY ON PAY FOR TARP RECIPIENTS

On June 15, 2009, the U.S. Department of the Treasury (Treasury) released an Interim Final Rule implementing the executive compensation and corporate governance standards under the American Recovery and Reinvestment Act of 2009.⁴ These standards generally apply to all recipients of funds under the Troubled Asset Relief Program (TARP), except for TARP recipients not holding outstanding obligations.

The Interim Final Rule consolidates and supersedes all prior guidance issued by Treasury on this topic, including the initial executive compensation rules issued under the Emergency Economic Stabilization Act in October 2008 and the executive compensation guidelines announced by Treasury in February 2009. As set forth in the Interim Final Rule, TARP recipients will be subject to compensation restrictions on both executive officers and highly paid non-executive officers. TARP recipients will also need to implement compliance reporting and recordkeeping procedures, as specified in the Interim Final Rule, to comply with compensation and corporate governance standards. Additionally, the Interim Final Rule requires that shareholders of any institution that has received or

⁴ P.L. 111-5, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ005.111.pdf.

will receive financial assistance under TARP be provided with an annual non-binding Say on Pay vote to approve the compensation of the institution's executives.

The Interim Final Rule is consistent with prior statements of Treasury Secretary Timothy Geithner in which he outlined the following best practices for a compensation program:

- Compensation plans should properly measure and reward performance;
- Compensation should be structured to account for the time horizon of risk;
- Compensation practices should be aligned with sound risk management;
- Golden parachutes and supplemental retirement packages should be re-evaluated; and
- Compensation programs should promote transparency and accountability in the compensation-setting process.

SAY ON PAY FOR ALL

In an effort to address the public outcry over executive compensation and consistent with the financial regulatory reform initiatives announced by the Obama Administration,⁵ Treasury in July submitted to Congress draft legislation titled the Investor Protection Act of 2009 (the Legislation).⁶ The Legislation would require *all* public companies to put their executive compensation⁷ to a non-binding, advisory vote by such company's shareholders at any annual meeting held after December 15, 2009 (a Say on Pay Proposal). The Legislation also includes a similar provision requiring a non-binding, advisory shareholder vote on any "golden parachutes" to be awarded to a company's executive officers in connection with any business combination transaction. Finally, the Legislation also addresses compensation committee independence, compensation consultant independence, and a compensation committee's use of compensation consultants, legal counsel and other advisers.

The current Legislation is consistent with legislation submitted to Congress in 2007 (2007 Legisla-

⁵ See the Obama Administration's white paper on Financial Regulatory Reform entitled "A New Foundation: Rebuilding Financial Supervision and Regulation" (June 17, 2009) available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf (last visited Jan. 4, 2010).

⁶ The text of the Legislation can be found at <http://www.treas.gov/press/releases/reports/titleixsubt%20d.pdf>.

⁷ The term executive compensation is defined to include the compensation committee report, the compensation discussion and analysis, the compensation tables, and any related materials. *Id.*

tion),⁸ legislation introduced by Senators Charles Schumer and Maria Cantwell in May 2009,⁹ reform initiatives announced by the Obama Administration in June 2009,¹⁰ and requirements imposed on recipients of TARP funds.¹¹ With respect to the 2007 Legislation, then-Senator Barack Obama and Representative Barney Frank, the Chairman of the House Committee on Financial Services, introduced twin bills in both houses of Congress to require a shareholder advisory vote on executive compensation. As with the current Legislation, the 2007 Legislation would have been applicable to all U.S. publicly traded companies.

In a similar measure, the House of Representatives (House) passed the Corporate and Financial Institution Compensation Fairness Act of 2009 (2009 Legislation) on July 31, 2009, by a vote of 237-185.¹² In a party-line vote, Congress rejected an amendment that would require only an advisory vote once every three years and would allow companies to opt out of advisory votes for five years with the approval of a two-thirds investor vote. The 2009 Legislation generally follows the contours of the Treasury legislation. Notably, however, the 2009 Legislation eliminates the December 15, 2009, deadline for companies to start holding advisory votes, instead directing the SEC to issue final rules within six months of the date of enactment. Provisions with regard to compensation committee independence require the issuance of rules or regulations to implement those provisions within nine months of the enactment of the 2009 Legislation.

GOLDEN PARACHUTES

The Legislation also includes a non-binding shareholder vote on "golden parachutes" at any meeting of shareholders called after December 15, 2009, for the

⁸ H.R. 1257, 110th Cong. (2007); S. 1181, 110th Cong. (2007). The 2007 Legislation passed the House but was stalled in the Senate.

⁹ Press Release, Office of Senator Charles Schumer, Schumer and Cantwell Announce "Shareholder Bill of Rights" to Impose Greater Accountability on Corporate America (May 19, 2009) (available at: http://schumer.senate.gov/new_website/record.cfm?id=313468).

¹⁰ Note 6, above.

¹¹ The U.S. Securities and Exchange Commission in a Compliance and Disclosure Interpretation announced that §111(e) of the Emergency Economic Stabilization Act, P.L. 110-343, Division A (2008), as amended by §7001 of the American Recovery and Reinvestment Act of 2009, P.L. 111-5 (2009), requires companies to allow for a non-binding shareholder vote to approve or oppose executive compensation plans. *See* SEC Staff Responses to Chairman Dodd, SEC Compliance and Disclosure Interpretations [formerly SEC Telephone Interpretations Manual] (CCH) ¶17,000 (Feb. 24, 2009).

¹² H.R. 3269, 111th Cong. (2009). The Bill was referred to Senate Committee on Banking, Housing and Urban Affairs on Aug. 3, 2009.

purpose of approving a business combination. The timing of this measure was changed in the 2009 Legislation to shareholder meetings occurring six months or more after the issuance of SEC final rules. The proxy material for the business combination would be required to disclose in a clear and simple form in accordance with regulations to be promulgated by the Commission any agreements or understanding with either the target company or the acquiring company about any type of compensation that “is based on or otherwise relates” to the business combination. The idea of a non-binding shareholder advisory vote on any new golden parachute compensation is not new. In fact, such an advisory vote was also included in both the House and the Senate drafts of the 2007 Legislation.

COMPENSATION COMMITTEE INDEPENDENCE

The Legislation would insert a new §10B into the Securities Exchange Act of 1934 (Exchange Act) to establish independence standards for members of the compensation committees of the board of directors of public companies. New §10B would mirror the independence standards for audit committees set forth in §10A but would go one step further by addressing independence standards for compensation committee consultants and other compensation committee advisers. New §10B would also provide compensation committees with the authority to hire independent compensation consultants, legal counsel and other advisers and require each public company to fund the engagement of any compensation consultants, legal counsel and other advisers hired by the compensation committee.

The ability to retain and hire consultants, legal counsel and advisers at the company’s expense is already a best practice for the vast majority of compensation committees of public companies and is commonly evidenced in their compensation committee charter. Likewise, although the proposed independence standards (that the members not receive any consulting, advisory or other compensatory fees and may not be an affiliated person of the issuer) may be a bit stricter than the independence standards public companies must currently adhere to under the corporate governance listing standards of the NASDAQ Stock Market, LLC, the New York Stock Exchange or the NYSE Amex, LLC,¹³ such independence standards are familiar territory given that they mirror the

¹³ For example, under §303A.02 of the NYSE Listed Company Manual, a director is considered independent if, among other things, he has not received more than \$120,000 in direct compensation from the listed company during any 12-month period

existing independence standards set forth in §10A of the Exchange Act applicable to audit committee members.

Unlike the compensation committee independence standards, the independence standards for compensation consultants, legal counsel and other advisers to the compensation committee presents a new level of compliance and relationship vetting for public companies. If this independence standard is enacted as currently drafted, public companies will have to treat the engagement of compensation consultants much the same way they treat the engagement of auditors. For example, companies will need to explore a wide variety of relationships that may impair a consultant’s independence similar to the framework set forth in Rule 2-01(c) of Regulation S-X under the Exchange Act, including financial relationships, employment relationships, business relationships, and non-compensation-related services.

PROXY ACCESS

The SEC in May voted to propose changes to the proxy rules under the Exchange Act.¹⁴ The proposed amendment would “remove impediments to the exercise of shareholders’ rights to nominate and elect directors to company boards of directors.”¹⁵ Specifically, shareholders meeting specified requirements would include their nominees for director in the company’s proxy materials (unless otherwise prohibited by state law or a company’s bylaws from nominating candidates for election as a director). This would allow shareholders to propose their own directors for election alongside the company’s board slate. Currently, shareholders wishing to nominate opposition candidates must do so using their own proxy materials.

The SEC received more than 550 comment letters on its proposed Rule 14a-11.¹⁶ Most of the letters were from businesses that opposed the proposed rule

within the last three years. Under new §10B, a member of the compensation committee would not be permitted to receive any compensation from the company. In other words, a director who receives a small consulting fee in an amount less than \$120,000 a year may be considered an independent director with respect to service on the board but would not be considered an independent director with respect to service on the compensation committee.

¹⁴ The text of the proposed rule is available at <http://www.sec.gov/rules/proposed/2009/33-9046.pdf>.

¹⁵ For more information on the proposed Proxy Access rule, see Sutherland Asbill & Brennan July 9 legal alert, available at <http://www.sutherland.com/files/News/7b216c45-e54e-4c0a-87e9-1cb1a0ecd803/Presentation/NewsAttachment/06ae69c1-919c-4327-a1ff-1d60dc71af85/CORPALert7.9.09.pdf>.

¹⁶ Broc Romanek, *Parsing the Proxy Access Comment Letters*, TheCorporateCounsel.net, available at <http://www.thecorporatecounsel.net/Blog/2009/10/-with-the-comment->

and from individuals who objected to increased government involvement in business. Notably, institutional investors, governance service providers and academics wrote in strong support of the proposed rules. A final vote on the measure had been scheduled for November, but recent reports indicate the SEC has delayed the vote in order to give its staff more time to review the comment letters.¹⁷ This means the provision is unlikely to be in place for the 2010 board elections. Nonetheless, proxy access has been championed by SEC Chairman Mary Schapiro, and the momentum created by the debate over its adoption is likely to spill over into executive compensation.

WHAT SHOULD A PUBLIC COMPANY DO NOW IN PREPARATION?

Say on Pay currently applies to companies that received TARP funding and there is support for widespread Say on Pay requirements among key regulators, including SEC Chairman Mary Schapiro.¹⁸ Given the increased momentum on multiple fronts — from non-profit groups, regulators and legislators — it is likely that some form of Say on Pay measure will

letter.html.

¹⁷ Jesse Westbrook, “SEC Said to Delay Proxy-Access Rule, Giving Banks Reprieve,” *Bloomberg* (Oct. 2, 2009).

¹⁸ See, e.g., Ian Katz, “New SEC Chief Backs Say-on-Pay,” *Washington Post* (Jan. 24, 2009); Press Release, Chairman Schapiro Statement on Executive Compensation (June 10, 2009) (available at <http://www.sec.gov/news/press/2009/2009-133.htm>).

be enacted in time for the Spring 2010 proxy season. As such, companies and investors should take the time now to prepare for mandatory Say on Pay votes in the future.

Public companies and their compensation committees should evaluate their responses to the following questions in preparing for the implementation of Say on Pay proposals:

- What metrics are used to evaluate performance? How are those metrics related to business strategy? Is there a clear link between compensation and performance?
- Is the process used by the company reasonable in relation to other companies of the same size or in the same industry?
- Are there techniques employed to align pay and shareholder value?
- Is the pay program disclosed to shareholders in a clear and understandable fashion? Is the company able to show that their board is overseeing executive compensation?
- Is the company responsive to shareholder input? How could the company improve communication with its investors?

It is also advisable that public companies evaluate the professional advisors their compensation committees engage as well as the actual composition of their compensation committees so as to ensure they meet the applicable independence standards.