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corporate alert

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The Dodd-Frank Wall Street Reform and Consumer Protection Act: A Review of the 2011 Proxy Season and a Look Forward to 2012

Proxy Season 2011: Lessons Learned from the Dodd-Frank Act

As the 2011 proxy season draws to a close, it is time to reflect on the lessons learned from this past year – the first year in which the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") affected the proxy season. Dodd-Frank mandated that almost all public companies[1] include two additional proposals in their 2011 proxy materials. The first required companies to conduct a separate stockholder advisory vote to approve the compensation of executives ("say-on-pay"). The second required companies to conduct a separate stockholder advisory vote to determine how frequently a company will conduct say-on-pay votes in the future ("say-on-frequency").

The following is a brief summary of the most important takeaways from the 2011 proxy season, as they relate to say-on-pay and say-on-frequency.

- Public company stockholders overwhelmingly approved present executive compensation practices. Of over 2,000 public companies that have thus far filed results with the SEC, only 37 companies failed to obtain at least majority support for their executive compensation programs, representing less than 2% of all such companies. What's more, a great majority of companies had tremendous support for their executive compensation programs. 71% of public companies received more than 90% stockholder approval, and the average approval rating among all public companies was 91%.

- Although stockholders generally signaled their satisfaction with most companies' executive compensation programs, stockholders also showed a clear preference for engaging in a say-on-pay vote each year. Annual voting on say-on-pay was the top choice by stockholders for 81% of public companies. Stockholders preferred annual say-on-pay votes even in the face of management recommendations of triennial votes.

- Receiving a negative recommendation from proxy advisory firms, including Institutional Shareholder Services ("ISS"), was a significant event for public companies: every company that did not receive a majority of stockholder support on say-on-pay had previously received a negative recommendation from ISS. It was a significant event, even for those companies that eventually received at least a majority of votes supporting say-on-pay: these companies' say-on-pay proposals received an average of 25% less support from stockholders, and, in some cases, companies were forced to expend considerable time and resources to combat the potential negative consequences of unfavorable ISS recommendations.

- ISS received a fair amount of criticism for perceived lack of transparency, factual errors and a one-size-fits-all approach, which led many public companies to vigorously assert that ISS's negative say-on-pay recommendations were unearned.

- Given how high the average support was for most companies' executive compensation programs, companies that received stockholder support of only 70%-80% of the votes cast may wish to reevaluate their current compensation practices.

- Companies should consider drafting additional proxy disclosure tailored to key institutional investors should they receive a negative recommendation from ISS on executive compensation. This additional disclosure can underscore how the compensation of executive officers is indeed aligned with performance of the company, and, if applicable, can pinpoint why a company feels ISS's methodology is flawed.

- Companies that do not receive at least a majority of stockholder support on say-on-pay votes may face litigation risks from stockholders claiming a violation of fiduciary duties by directors. Since say-on-pay votes are advisory in nature, many of these suits appear to be frivolous and without merit, although these risks highlight the need for companies to be focused on say-on-pay proposals and executive compensation practices and disclosure.

Proxy Season 2012 and Beyond: Items for SEC Rulemaking under the Dodd-Frank Act

Dodd-Frank contains additional provisions that will require the SEC to implement new rules that, if and when implemented, will likely affect the 2012 proxy season (or the 2013 proxy season or later, depending

on when implemented). The following is a brief summary of certain of these sections.

August – December 2011 (planned)

- Section 952:
  - Adopt exchange listing standards regarding compensation committee independence. While independence of compensation committee members is already required by the NYSE and NASDAQ, proposed listing standards are likely to be expanded to look similar to the current audit committee independence requirements.
  - Adopt disclosure rules regarding compensation consultant conflicts of interest.
- Sections 953 and 955:
  - Propose rules regarding disclosure of pay-for-performance, which requires each public company to disclose in its annual proxy statement information that shows the relationship between executive compensation actually paid and the financial performance of the issuer.
  - Propose rules regarding pay ratios. Public companies must disclose (a) the median of the annual total compensation of all employees (excluding the CEO), (b) the total annual compensation for the CEO and (c) the ratio of (a) to (b).
  - Propose rules regarding whether employees and directors are permitted to hedge any decrease in the market value of a company's securities.
- Section 954:
  - Propose rules regarding recovery (or clawback) of executive compensation. Companies listed on a national securities exchange will be required to adopt and implement a policy providing that the company can recover incentive-based compensation from current and former executive officers in the event the company prepares an accounting restatement because of "material noncompliance" with financial reporting requirements under federal securities laws. This "clawback" must have a three-year look-back from the date of the accounting restatement, and amounts recovered from the incentive compensation of such executive officers will be the amounts that are in excess of what would have been awarded under the restated financials. No misconduct on behalf of the executive officers is required to recover such amounts.

January - June 2012 (planned)

- Sections 953 and 955:
  - Adopt rules regarding disclosure of pay-for-performance, pay ratios and hedging by employees and directors.
- Section 954:
  - Adopt rules regarding recovery of executive compensation.

Dates still to be determined

- Section 957:
  - Issue rules defining "other significant matters" for purposes of exchange standards regarding discretion of brokers to vote uninstructed shares.

Based on the extensive rulemaking burdens placed on the SEC by Dodd-Frank, do not be surprised if some of the foregoing governance-related rules are postponed beyond 2012. In addition, we have seen efforts in Washington to repeal certain provisions of Dodd-Frank, including Section 953(b), related to pay ratios. Stay tuned.

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[1] The Securities and Exchange Commission ("SEC") granted smaller reporting companies a temporary exemption from say-on-pay and say-on-frequency votes until the first annual or other meeting of stockholders held on or after January 21, 2013.

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