Alert 10-181

ReedSmith

Corporate & Securities Alert

Dodd-Frank Say on Pay

Today, the U.S. Senate passed the "Dodd-Frank Wall Street Reform and Consumer Protection Act," or "Dodd-Frank," which is scheduled to be signed into law by the president next week. This memorandum will focus on one of the statute's provisions: requiring that companies periodically hold nonbinding shareholder votes to approve executive compensation. This requirement, which is applicable to all U.S. public companies, will be effective for the 2011 season of annual shareholders' meetings.

Required Shareholder Votes. Dodd-Frank adds a new section 14A to the Securities Exchange Act of 1934 ("Exchange Act"). It provides that a proxy for a meeting of shareholders for which Securities and Exchange Commission ("Commission") proxy rules require compensation disclosure[1] must include, not less frequently than once every three years, a resolution subject to shareholder vote to approve the compensation of executives as disclosed pursuant to Item 402 of Regulation S-K. The statute is effective for the first meeting of shareholders occurring after mid-January 2011 (six months after the statute's enactment) for which compensation disclosure is required, and the initial executive compensation approval resolution must be included at such meeting.

The statute specifies that the resolution must be to approve compensation of executives as disclosed pursuant to Item 402 of Regulation S-K. This means only those executives ("named executive officers") described in Item 402(a)(3).[2] A vote to approve compensation of other executives and employees is not required. And, although director compensation is disclosed pursuant to Item 402, a vote to approve director compensation (other than directors who are named executive officers) is not required by the statute. When including the resolution in the proxy materials, companies may wish to make reference to the portions of the document that contain the Item 402 executive compensation disclosure, so as to make it clear what compensation is being voted upon. This would include the various compensation tables and also the compensation discussion and analysis. It would not need to include the compensation committee report, which is furnished pursuant to Item 407, not 402.

In addition, new section 14A requires that, not less frequently than once every six years, a proxy for a meeting of shareholders for which the proxy solicitation rules of the Commission require compensation disclosure must include a resolution subject to shareholder vote, to determine whether shareholder votes to approve executive compensation will occur every one, two or three years. The first such vote is required at the first meeting of shareholders occurring after mid-January 2011 for which compensation disclosure is required. Such votes could be held more frequently than every six years. For example, if in the initial vote shareholders indicate that shareholder executive compensation approval should be sought every year, the board may wish to submit the same issue to shareholders in the following year, seeking a vote at that time that a two- or three-year frequency should be the practice. And, if in the subsequent year a three-year frequency is approved, the board may decide to not present the issue of frequency determination for six years. Alternatively, under the statute, the board would be permitted to opt not to follow the shareholders' initial preference as to the frequency of votes (see "Nonbinding Nature of Votes" below) and determine not to resubmit the question for another six years.

Nonbinding Nature of Votes. Paragraph (c) of new section 14A provides that the shareholder vote on executive compensation will not be "binding" on the issuer or its board, and that such vote may not be construed as overruling a decision by the issuer or the board, creating or implying any change to the fiduciary duties of the issuer or board, or creating or implying any additional fiduciary duties for the issuer or board. This provision is consistent with state corporation laws, which generally vest the power to manage the affairs of the corporation, including decisions about compensation, in the board rather than in the shareholders.[3] In accordance with this provision, the board would not be obligated as a legal matter, by virtue of a shareholder vote disapproving executive compensation, to make any change in its executive compensation decisions.

The statutory language also characterizes the vote on how often shareholder executive compensation votes should be sought as "nonbinding,"[4] and likewise not creating or implying any change in fiduciary duties of the board, or any new fiduciary duties. This means that the board is not legally required to follow an expressed shareholder preference as to the frequency of executive compensation approval votes, subject to the statutory requirement that a shareholder vote to approve executive compensation be held not less frequently than once every three years.[5] There may be complications in determining whether shareholders have in fact approved a particular frequency.[6]

The statute also provides that the statutorily required shareholder votes may not be construed to restrict or limit the ability of shareholders to make proposals for inclusion in proxy materials related to executive compensation. Such proposals will continue to be subject to the requirements of Rule 14a-8.

No Specific Resolution Language Required. New section 14A is similar to section 111(e) of the Emergency Economic Stabilization Act of 2008 ("EESA"), as amended by section 7001 of the American Recovery and Reinvestment Act of 2009, February 17, 2009, applicable to recipients of financial assistance under the Troubled Asset Relief Program ("TARP"). This statute required a TARP recipient to permit an annual shareholder vote to approve the compensation of executives, as disclosed pursuant to compensation disclosure rules of the Commission, for so long as its TARP obligations remained outstanding.

The Commission adopted Rule 14a-20, effective February 18, 2010, to implement section 111(e) of EESA. In the adopting release,[7] the Commission indicated that it was not requiring that a specific form of resolution be used when presenting the required executive compensation vote to shareholders, in order to afford some flexibility in this regard.

New section 14A of the Exchange Act enacted by Dodd-Frank also does not mandate any particular text for the required shareholder resolutions. Section 14A does not require the Commission to adopt rules to implement its provisions.[8] If the Commission should engage in rulemaking, the experience under EESA 111(e) makes it reasonable to assume that no specified resolution language will be required for the resolution to approve executive compensation.[9] It is possible, however, that the Commission could by rule require that the registrant explain the effect of the required shareholder votes, such as the fact that the votes are nonbinding, as is currently required by Item 20 of Schedule 14A for TARP recipients with respect to the required vote to approve executive compensation. Presumably, companies would want to include such disclosure even if not mandated by rule.

EESA 111(e) required annual nonbinding shareholder votes to approve executive compensation, and thus did not contemplate a shareholder vote to determine the frequency of executive compensation approval votes, as does new section 14A. Section 14A does not mandate particular language for the frequency resolution. The same considerations of flexibility that led the Commission to refrain from mandating particular resolution language for the executive compensation approval resolution under EESA 111(e) make it unlikely that the Commission will by rule impose required language for the frequency resolution.

No Additional Compensation Disclosure Required. New section 14A does not require additional compensation disclosure.[10] It would appear unlikely that the Commission would by rule impose additional compensation disclosure requirements by virtue of the shareholder votes now required by the statute. When EESA 111(e) was enacted, the Commission declined to adopt any additional disclosure requirements for executive compensation in connection with the required shareholder vote, noting that the existing compensation disclosure requirements of Item 402 of Regulation S-K should result in sufficient disclosure to enable an informed vote on the compensation of named executives.

No Broker Discretionary Voting. Under section 957 of Dodd-Frank, broker discretionary voting is not permitted with respect to the shareholder votes on executive compensation and on the frequency of shareholder approval of executive compensation. Section 957 amends section 6(b) of the Exchange Act to require national securities exchanges to prohibit discretionary broker voting of uninstructed shares with respect to the election of directors, executive compensation[11] or any other "significant matter" as determined by the Commission by rule. To the extent that discretionary broker voting might have tended to favor positions recommended by the company, this amendment could make shareholder approval of executive compensation, or of a frequency of approval recommended by the company, more difficult to obtain.

Preliminary Proxy Materials. Currently, under Rule 14a-6, the inclusion in the proxy materials of the shareholder resolutions newly required by section 14A would necessitate filing preliminary proxy materials with the Commission not less than 10 days prior to the date definitive materials are to be distributed. The Commission, in connection with its rulemaking to implement section 111(e) of EESA, amended Rule 14a-6 to provide that inclusion of a shareholder resolution to approve executive compensation as required by section 111(e) would not require filing of preliminary proxy materials. The Commission noted that commenters had pointed out that the need to make a preliminary filing could require accelerated timelines and additional costs for some companies. Other commenters argued that the disclosure provided would be straightforward and unlikely to require staff intervention, which the requirement of a preliminary filing is intended to facilitate. Given this history, it is possible that the Commission will take similar action to provide that inclusion of the new section 14A shareholder resolutions will not require filing of preliminary proxy materials.

Vote Required to Approve Resolutions. The statute does not specify the vote required to approve the shareholder resolutions required by new section 14A. This will be determined by the law of the corporation's jurisdiction of incorporation. The resolution with respect to approval of executive compensation will be cast in terms seeking a yes or no vote on executive compensation as disclosed. Under Delaware law, unless a contrary requirement is specified in the corporation's certificate of incorporation or bylaws, approval of this resolution will require the affirmative vote of a majority of the shares present in person or represented by proxy at the meeting and entitled to vote on the matter.[12] Under Pennsylvania law, except as otherwise provided in a bylaw adopted by shareholders, approval of this resolution will require the affirmative vote of a majority of the votes cast by all shareholders entitled to vote thereon.[13]

Section 14A also requires a nonbinding shareholder vote to determine whether shareholder nonbinding votes to approve executive compensation will occur every one, two or three years. The simplest approach would be to request shareholders to express a single preference through checking a box or a similar mechanism among each of the three alternatives. However, the preference receiving the most votes would not necessarily be considered as representing the collective choice of shareholders. The requirements as to the necessary vote for valid shareholder action will apply, even though the vote is not binding upon the board. And typically, state corporation law provides that only in the case of the election of directors does a plurality vote suffice for valid shareholder action.[14] For other matters, approval requires some type of "majority" vote as described above. In the case of a resolution where shareholders are provided three choices, if the preference receiving the most votes does not receive a majority of the votes,[15] it could be concluded that the shareholders have not validly expressed even a nonbinding preference.

Sample Resolutions. The following examples can serve as indicative text for the portions of the proxy statement responsive to the requirements of new section 14A:

Nonbinding Vote Regarding the Compensation of the Company's Named Executive Officers

The Company's named executive officers are identified on page___, and the compensation of the named executive officers is described on pages ___to___, including the "Compensation Discussion and Analysis" on pages____to___. As discussed in the Compensation Discussion and Analysis, we believe that our compensation policies and decisions are focused on pay-for-performance principles and are strongly aligned with the long-term interests of our shareholders. Compensation of our named executive officers is designed to enable the Company to attract and retain talented and experienced senior executives to lead the Company successfully in a competitive environment.

[Here, add highlights of such elements of named executive officer compensation as are deemed desirable.]
We are requesting your nonbinding vote on the following resolution:

"Resolved, that the compensation of the Company's named executive officers as described on pages ___to_____of the proxy statement is approved."

The board of directors recommends a vote FOR the resolution.

The shareholder vote on this resolution will not be binding on the Company or the board, and will not be construed as overruling any decision by the Company or the board. The vote will not be construed to create or imply any change to the fiduciary duties of the Company or the board, or to create or imply any additional fiduciary duties for the Company or the board.

Nonbinding Vote Regarding the Frequency of Voting on the Compensation of the Company's Named Executive Officers

Not less frequently than once every three years, the Company will include in the proxy materials for a meeting of shareholders where compensation disclosure is required, a resolution subject to a nonbinding shareholder vote to approve the compensation of named executive officers.

We are requesting your nonbinding vote to determine whether a vote on the type of resolution described above will occur every one, two, or three years.

The Company believes that the shareholder nonbinding vote to approve executive compensation should occur every three years. The Company's compensation policies and procedures are developed with long-term objectives in mind, which is consistent with a multi-year shareholder approval cycle. More frequent shareholder votes could result in additional distractions at annual shareholder meetings. Shareholder votes every three years will permit shareholders to express their collective view on approval of compensation on a frequent basis, while allowing the votes to be based on a longer-term perspective.

The board of directors recommends a vote FOR a three-year frequency for nonbinding shareholder votes to approve executive compensation.

The shareholder vote on the frequency of nonbinding shareholder votes to approve executive compensation will not be binding on the Company or the board, and will not be construed as overruling any decision by the Company or the board. The vote will not be construed to create or imply any change to the fiduciary duties of the Company or the board, or to create or imply any additional fiduciary duties for the Company or the board.

* * *

Proxy card text for frequency vote

Nonbinding preference as to frequency of nonbinding shareholder votes to approve executive compensation. The Board of Directors recommends a vote FOR a Three-Year frequency.
Check one:

_____Every Three years
_____Every Two years
_____Every year

Proxies checking more than one box will be considered to have selected Every Three years.

We are providing this memorandum as a client service. However, it is not intended to constitute legal advice for any particular situation. For advice on your situation, please contact Bob Morris at 215.851.8176 or 412.288.3126 or by email at rmorris@reedsmith.com, or your own Reed Smith contact.

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1. The proxy rules generally apply to the solicitation of proxies with respect to any security registered under section 12 of the Exchange Act (securities traded on a national securities exchange or nonexempted equity securities held of record by 500 or more persons, where the issuer has total assets of more than $1 million). Under Rule 3a12-3(b), foreign private issuers are exempt from the proxy rules. Item 402 compensation disclosure is required if action is to be taken with regard to the election of directors, or to approve certain compensatory plans or securities grants.

2. These are: all individuals serving as principal executive officer during the last completed fiscal year; all individuals serving as principal financial officer during the last completed fiscal year; the three most highly compensated executive officers, other than the principal executive officer and principal financial officer who were serving as executive officers at the end of the last completed fiscal year; and up to two additional individuals for whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer at the end of the last completed fiscal year.

3. It is possible that a board may feel the need to request a formal opinion of counsel that the shareholder vote on executive compensation is not binding. If so, counsel should ordinarily be able to provide such opinion based on the applicable state corporation law and the language of section 14A.

4. Section 14A(c) specifies a nonbinding character for the shareholder votes referred to in subsection (a), which includes both the vote on executive compensation in subsection (a)(1), and the vote to determine whether shareholder votes on executive compensation will occur every one, two or three years in subsection (a)(2).

5. Although section 14A(a)(2) states that this vote is "to determine" whether votes to approve executive compensation will occur every one, two or three years, the words "to determine" should be interpreted (given the express "nonbinding" language of 14A(c)) to contemplate a precatory shareholder resolution, with the ultimate decision resting in the board.

6. See "Vote Required to Approve Resolutions."

7. Release No. 34-61335.

8. The only reference to Commission rulemaking in section 14A authorizes (but does not require) the Commission to exempt by rule or order an issuer or class of issuers from the requirements of a shareholder compensation vote, and a shareholder vote on the frequency of shareholder approval of compensation. The statute authorizes the Commission to take into account whether these requirements disproportionately burden small issuers.

9. The Commission pointed out in adopting Rule 14a-20 pursuant to EESA 111(e) that, although no particular language for the resolution was specified, the resolution must relate to approval of compensation itself, and not to policies and procedures used to determine compensation. This is consistent with the language of both EESA 111(e) and new section 14A, and should be observed by companies under the new statute, even if the Commission engages in no additional rulemaking. Additionally, although section 14A indicates that the compensation subject to approval is that disclosed pursuant to Item 402 of Regulation S-K, it is clear from the statutory language that the vote is on the compensation, not on the adequacy of disclosure of the compensation.

10. Other sections of Dodd-Frank do require additional compensation disclosure. Section 953 enacts a new section 14(i) of the Exchange Act directing the Commission to issue rules requiring issuers to disclose information showing the relationship between executive compensation and the issuer's financial performance. Section 953 also directs the Commission to amend S-K Item 402 to require disclosure of the median of the annual total compensation of all employees of the issuer except the CEO, the annual total compensation of the CEO, and the ratio of those two amounts.

11. Both the vote on approving executive compensation directly and the vote to determine how often approval of executive compensation should be sought would appear to be votes "with respect to" executive compensation, and thus would fall within the statutory language.

12. Delaware General Corporation Law, § 216.

13. Pennsylvania Business Corporation Law, § 1757(a).

14. Delaware General Corporation Law, § 216, Pennsylvania Business Corporation Law, § 1758(b).

15. Present, or cast, depending upon the state law.

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