The New Enhanced Proxy Disclosures – The Final Rules*

* we timed this dinner perfectly …
Speakers

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Overview

Dodd-Frank Wall Street Reform and Consumer Protection Act enacted in July 2010 (the “Dodd-Frank Act”)

Contains several new executive compensation requirements:

- Say on pay, frequency of say on pay and say on golden parachutes
- Eliminates discretionary voting by brokers
- Mandates a tougher incentive compensation clawback policy
- Compensation committee independence
- Compensation committee adviser independence
- Enhanced compensation disclosure (pay versus performance, internal pay equity, director and employee hedging)
- Provisions on proxy access and enhanced whistleblower protections

Effective times vary - waiting for additional SEC and securities exchange rules on many provisions
Non-binding stockholder vote to approve NEO compensation disclosed in the proxy materials
- For each meeting at which directors are elected and where Item 402 disclosures are required

“Named executive officer”:
- The chief executive officer (and anyone in that capacity during the year)
- The chief financial officer (and anyone in that capacity during the year)
- The three other most highly compensated executives
- Up to two additional former executives

Vote is on the information contained in the CD&A, the compensation tables and the related narrative disclosure

In effect, the stockholders are voting on how they feel about what is disclosed in your proxy (plus anything else on their mind ... )
What does non-binding mean?

- It is a tangible expression of stockholder sentiment
- It does not create new or otherwise change the existing fiduciary duties of the company or its board of directors
- It does **not** overrule compensation decisions made by the company or its board of directors
  - You aren’t required to go back and change your existing compensation arrangements …
  - But, you must disclose in your next CD&A how you considered the results of this last vote …
  - And, if the vote fails, be prepared to engage stockholders and take corrective action to avoid adverse votes on your committee members’ re-election next year
Say on Pay

Timing:

- Required for first meeting held after January 21, 2011
  - Delay until January 2013 for smaller reporting companies
- Required to be held thereafter at least every three years
  - Subject to the company’s frequency of say on pay vote
- SEC adopted final rules January 25, 2011
  - Text of final rules not yet released
**Action Items:**

- Review pay history/practices
- Review ISS, Glass Lewis and major institutional investor reports/ratings
  - Confirm accuracy of factual data underlying GRId variables – if any inaccuracies, submit data correction
- Identify any problematic pay practices and consider eliminating
- Identify and consider implementing best practices
- Understand your stockholder base
  - Consider whether to actively engage with shareholders, and if so whether to use a proxy solicitor
- Decide what the company will do with the results of the vote, particularly if the proposal fails
**Action Items:**

- Review and strengthen CD&A:
  - Use a 1 page executive summary
  - Highlight positive corporate performance
  - Highlight best practices
  - Address poor pay practices head on
- Be aware of ISS hot points:
  - Evaluation of *performance metrics*, as discussed and explained in CD&A
  - Evaluation of *peer group benchmarking* used to set target pay
  - Balance of *performance-based v. non-performance-based pay*
    - Time based options are not “performance-based”
    - ISS wants at least 50% of # of shares (not value) granted to be subject to performance vesting conditions
  - Evaluation of “*problematic pay practices*” in addition to “*egregious pay practices*”
ISS’s Egregious Pay Practices

- As defined by ISS, *each of these practices*, on a stand-alone basis, can trigger negative vote recommendations for Say on Pay:
  - repricing underwater stock options without prior stockholder approval (including cash buyouts and voluntary surrender of options)
  - excessive perquisites (perquisites for former /retired executives, extraordinary relocation benefits) or tax gross-ups
  - new or extended agreements that provide for any of the following:
    - change in control payments exceeding 3x base salary and average/target/most recent bonus
    - change in control severance payments without involuntary job loss or substantial diminution of duties
      - may include single trigger vesting (even if awards aren’t assumed in the transaction) and cash payments
    - change in control payments with excise tax gross ups (including modified gross ups)
ISS’s Problematic Pay Practices

As defined by ISS, these practices may contribute toward a negative vote recommendations for Say on Pay:

- Egregious employment contracts -- e.g., multi-year guarantees for salary increases, non-performance based bonuses and equity compensation
- New CEO with overly generous new-hire package
- Abnormally large bonus payouts without justifiable performance linkage or proper disclosure -- includes performance metrics that are changed, canceled or replaced during performance period without adequate explanation of the action and link to performance
- Egregious pension or SERP (deferred compensation) payouts
- Excessive perquisites
- Excessive severance and/or change in control provisions
  - Change in control payments exceeding 3 x base and bonus
  - Single trigger change in control payments (cash or equity) without involuntary job loss or substantial diminution of duties
- New or materially amended agreements that provide for an excise tax gross-up
- Tax reimbursements on income taxes on executive perquisites and other payments (e.g., relocation/housing)
- Dividends or dividend equivalents paid on unvested performance shares or units
- Executives using company stock in hedging activities
- Repricing or replacing underwater stock options without shareholder approval (including cashouts)
Say on Frequency of Say on Pay

- Say When on Say on Pay: a non-binding stockholder vote on how often they would like the “say on pay” vote to occur going forward.
- Stockholders have four choices: one, two or three years or abstain.
- Frequency vote must be held at first meeting after January 21, 2011 and at least every 6 years thereafter.
  - Delay until January 2013 for smaller reporting companies.
- Your board may decide to hold future say on pay votes more or less often than stockholders request, but:
  - Be prepared for consequences if you disregard stockholder preference.
  - You may not exclude stockholder proposals on say on pay/frequency if you do not follow the selection of the majority (not plurality) of votes cast.
  - You must report, in an 8-K, within 150 days post-frequency-vote, the company’s final decision on how often to hold future say on pay votes.
- Research your institutional stockholders to determine what they prefer before making your decision.
Say on Frequency of Say on Pay

- **Annual:**
  - Becomes routine, suggests company sees no issues.
  - Provides first line of defense against “no” votes on committee member reelectios
  - ISS and Glass Lewis want annual vote
  - 30% of filers to date**
    - Surveys indicate later filers are inclined to recommend annual over triennial at a rate of about 5:4

- **Biennial:**
  - Seems like an awkward compromise
  - 8% of filers to date

- **Triennial:**
  - May be easier on company
  - Preferred by a few institutional shareholders (Wellington, BlackRock)
  - Gives stockholders time to evaluate effectiveness of long-term compensation programs
  - Makes sense if you follow best practices for compensation and corporate governance
  - 53% of filers to date

- **No Recommendation:**
  - Perhaps if you will abide by the stockholders’ preference or are otherwise inclined to do annual
  - 7% of filers to date

**Statistics as of 1/21/11**
Say on Golden Parachutes

▶ NEO compensation upon a change in control must be submitted for non-binding stockholder vote at meeting held to approve change in control transaction

▶ Exception: no vote required for compensation arrangements that previously were “subject to” a say-on-pay vote
  ▶ Requires higher standard of disclosure than normal “say on pay” disclosure
  ▶ ISS will hold these “exception” votes to a higher standard than normal “say on pay” votes
  ▶ If compensation changes after an “exception - say on pay” vote, company must submit new/changed compensation to a “say on golden parachute” vote at the time of the transaction
  ▶ Unclear why companies would want to take advantage of the exception

▶ Applicable for meetings held on/after April 25, 2011
  ▶ Final rules approved on January 25, 2011
  ▶ No delay for smaller reporting companies

▶ Non-binding, so what’s the practical point/impact of the vote?
  ▶ Possible ramifications for the acquirer in subsequent director elections or say on pay votes?
Action Items:

- Review current parachute arrangements
  - Consider differences between most recent proxy statement disclosure and potential transaction numbers
  - Consider whether packages are within recommended guidelines or constitute egregious or poor pay practices
- Decide whether to eliminate egregious/poor pay practices
- Consider broadening “say on pay” disclosure to take advantage of exception
  - Good corporate citizen?
- Be mindful of future vote when entering into new executive employment agreements
Discretionary Voting By Brokers

- **Rule:** Prohibits brokers from voting on election of directors, executive compensation matters and potentially “other significant matters” on behalf of shares held in street name in the absence of instruction by beneficial owners as to how to vote.

- Discretionary voting on equity incentive plans prohibited since 2003 and discretionary voting in director elections already prohibited beginning in 2010.

- Proposed SEC rules clarify that say-on-pay or say-on-frequency proposals will be considered “other significant matters” for which broker discretionary voting will not be permitted; adoption of final rules not scheduled.

- So, *institutional stockholders and proxy advisory firms have greater influence on the “say on pay” and “frequency of say on pay” votes.*

- **Action items:**
  - Monitor proxy voting guidelines of influential proxy advisory firms and institutional stockholders.
  - Consider whether any special outreach to retail investors necessary.
Clawbacks of Incentive Compensation

- Each exchange listed company must have a policy for recouping incentive compensation received on the basis of erroneous financial information (e.g. prior to a restatement)

- Under the clawback policy, following a restatement, the company will recover any incentive compensation:
  - Based on the erroneous data,
  - Paid to current or former executive officers during the three-year period preceding the restatement,
  - In excess of what would have been paid using the restated numbers

- No culpability or misconduct is required
  - Which may be a good thing given the terms of your D&O insurance policy
Clawbacks of Incentive Compensation

**Timing:**
- Dodd-Frank Act requires SEC to adopt implementation rules
- SEC expects to issue *proposed* rules by July 2011
  - Adoption of final rules not scheduled
- Likely applicable for 2012
Dodd-Frank Act clawback is broader than SOX:
- No requirement of “misconduct”
- Applies to all executive officers – not just the CEO and CFO
- Recoupment period of three years, not one (different periods)

Dodd-Frank Act clawback is narrower than SOX as the recovery is limited to “excess” compensation rather than all incentive compensation

Dodd-Frank Act clawback will be enforced by companies rather than the SEC
Clawback of Incentive Compensation

**Action Items:**

- Most executives don’t like giving back their compensation!
- Does company have a clawback policy or provision in place already? If so, consider:
  - Highlighting in 2011 proxy statement
  - Whether agreements need to be amended to comply with Dodd-Frank Act requirements
- If no clawback policy, consider for 2011:
  - Adopting a policy before required by Dodd-Frank Act for “credit” with proxy advisory firms and institutional investors?
  - Disclosing in 2011 proxy statement the intention to adopt a policy that complies with the Dodd-Frank Act requirements?
  - Adding a provision in all 2011 and future incentive compensation agreements/plans that the compensation will be subject to recovery as mandated by applicable laws, rules and regulations
Clawback of Incentive Compensation

**Action Items cont.:**

- Schedule discussion on Compensation Committee agenda in near future
  - Consider whether to comply with minimum requirements or adopt more comprehensive policy
    - Consult with legal advisors and D&O carrier
  - Take restatement risk into account when setting performance goals?
    - Structure more compensation as “incentive-based compensation” subject to the clawback policy?
  - Structure around definition of “incentive-based compensation”?
    - Tie compensation to other performance measures
    - Award compensation on a discretionary basis?
Clawback of Incentive Compensation

Action Items cont.:

- Start thinking about implementation:
  - How to enforce three year look-back?
    - Hold-backs on incentive-based compensation?
    - Pay back by deducting from future compensation?
  - How to enforce against former executives?
  - How to recover compensation that has been transferred to an estate upon death or an ex-spouse upon divorce?
  - What is the tax treatment for recovered compensation?
  - How do you account for recovered compensation?