CLEARY GOTTLIEB Alert Memo

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"Say on Pay": Preparing for the Vote and its Aftermath

On July 31, 2009, the House of Representatives passed H.R. 3269, the Corporate and Financial Institution Compensation Fairness Act of 2009,[1] which includes provisions requiring annual shareholder advisory votes on executive compensation (or "say on pay" votes) at all U.S. public companies.[2] The vote would ask shareholders to approve the compensation of the company's "named executive officers" as disclosed under Securities and Exchange Commission ("SEC") rules, including the compensation committee report, the compensation discussion and analysis, the compensation tables and any related materials.[3] In light of the strong support in Congress and the Obama administration for say on pay legislation, it appears all but inevitable that some form of say on pay requirement will be in place by the 2011 (if not the 2010) proxy season. Recipients of assistance under the Troubled Asset Relief Program ("TARP") are already required to hold annual say on pay votes,[4] and a number of non-TARP companies have voluntarily adopted say on pay voting (usually in response to shareholder proposals) and have held votes or promised to do so in coming proxy seasons.[5] Even in the absence of legislation, activists will continue to press

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[1] The text of H.R. 3269 as passed by the House is not yet available, but a copy of the bill as considered on the House floor and a copy of the amendment adopted by the House that amended the bill as reported are attached as Appendices A and B, respectively, to our client alert entitled "House Passes Corporate and Financial Institution Fairness Act of 2009" and our Say on Pay Resource Center.

[2] H.R. 3269 would require a vote at any annual meeting occurring on or after the date that is six months after the date on which the SEC issues rules to implement the requirements. The SEC would be required to issue rules no later than six months after the enactment of the legislation.

[3] H.R. 3269 would also require disclosure of "golden parachute" payments at shareholder meetings for mergers and similar transactions, and to provide for a separate shareholder vote on such arrangements if not previously subject to a say on pay vote. The import of a vote on "golden parachute" payments at the time of a transaction is unclear, insofar as it would relate to arrangements to be triggered by the very transaction under consideration.

[4] Section 111(e) of the Emergency Economic Stabilization Act of 2008 ("EESA"), as amended by The American Recovery and Reinvestment Act of 2009 ("ARRA"). The SEC has proposed rules to implement this requirement Release No. 34-60218 (July 1, 2009) (the "Proposed Rule") and future SEC rulemaking regarding non-TARP companies may follow the approach implemented for TARP companies.

[5] To date, 23 companies have reportedly adopted say on pay voting in some form. Please see our Say on Pay Resource Center for information about experience to date.

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the issue through shareholder proposals, just as they will continue to target changes to specific pay practices.

These developments signal the need for companies to begin now to prepare for a say on pay vote. Other changes affecting corporate governance, such as majority voting for directors, e-proxy, the SEC proposal on proxy access and the elimination of broker discretionary voting for directors in uncontested elections, make the importance of planning more acute.

Although companies may face the prospect of a say on pay vote with concerns about headline risk and other adverse consequences, experience to date suggests that there is a high likelihood of favorable votes.[6] Shareholders have approved executive pay at all of the U.S. companies that have held a say on pay vote to date, including TARP recipients. Indeed, most proposals were approved by a high percentage of the shareholder vote, usually in excess of 90%.[7] The experience has been comparable to that in the UK, where shareholder advisory votes on the Directors' Remuneration Report (an annual report somewhat less extensive than the SEC's Compensation Discussion and Analysis ("CD&A")) have been required since 2002. Since then, there have been only a limited number of votes to disapprove these Reports.

Despite this favorable experience, the risk of a negative vote is perceived to be greater in the current climate. Indeed, of the handful of votes to disapprove Directors' Remuneration Reports in the UK since 2002, five occurred in the 2009 season.[8] Even a close vote signals shareholder discontent and can be a harbinger of activism to come. Whether a say on pay vote will be a constructive development or merely a tool to force implementation of currently favored pay practices – regardless of their suitability for a particular company – is of course far from certain. But it is clear that successful navigation of the say on pay landscape will depend in large part on well-planned engagement with key constituencies. We propose below steps that companies should consider when planning for a say on pay vote and addressing the results.

[6] Under NYSE Rule 452, brokers holding shares in street name that do not receive voting instructions from the beneficial owner of the shares are permitted to vote the shares in their discretion on such a proposal. This increases the likelihood of a positive vote, since brokers often exercise this discretion to vote in favor of management's recommendations.

[7] For information about 2009 votes, please see our Say on Pay Resource Center.

[8] In the UK, the 2009 annual general meeting season saw negative votes at five companies (Bellway plc, The Royal Bank of Scotland Group plc ("RBS"), AMEC plc, Provident Financial plc and Royal Dutch Shell plc). RBS received an unprecedented 90% vote to reject the Directors' Remuneration Report. The RBS vote is generally perceived as a protest against pension payments made to the former CEO. The British government, which held a 57.9% voting stake after stepping in to save the failed bank, led the vote against RBS' pay policies.

- **How should the company prepare for a vote?**

➢ ***Be proactive in preparing for the vote and identifying issues.*** Companies should consider who should participate in the planning and communications process, and a key focus for that group should be the identification of potential shareholder concerns or areas of vulnerability. The company should be aware of "hot button" issues and of the experiences of its peers whose pay practices have been criticized.[9] Consultation with the company's proxy solicitor and, if possible, with the principal proxy advisory firms should help to identify flashpoints. These discussions may also neutralize issues if they lead to better understanding of the reasons for the pay practice in question or to a change in the practice, if appropriate. At a minimum, they will sharpen the company's communications about compensation issues and help ensure that there are no surprises. If effectively and timely executed, they should also reduce the risk of a negative vote.

➢ ***Communicate with shareholders in advance of the vote and keep communication channels open.*** Engagement with shareholders is likely to make the difference between a positive process and a combative one. Concerns of key shareholders should have been discussed with them, or at least considered by management and the compensation committee, long before the vote takes place. Companies should ensure that channels remain open for shareholders and others to express concerns.

➢ ***Tailor the consultation process to reflect the company's circumstances and investor mix.*** Individual meetings with shareholders may be appropriate for companies with concentrated institutional ownership, and meetings with investors at "analyst days" and other investor conferences may provide ready opportunities to surface investor concerns. But individual meetings may be less practicable for companies with a high proportion of retail ownership. An alternative or supplementary approach could involve a framework for ongoing dialogue. For example, GlaxoSmithKline plc instituted biannual shareholder roundtables following a shareholder vote to reject its Directors' Remuneration Report in 2003.[10] Other possibilities include shareholder surveys and discussions with prominent investor advocates on compensation issues (*e.g.*, members of the Working Group on the Advisory Vote on Executive Compensation). Details about these approaches can be found in "Shareholder

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[9] For examples of pay practices that may present a risk of investor disapproval, see the AFL-CIO's 2009 Executive PayWatch Highlights 10 of the Worst CEO Pay Practices.

[10] S. Davis and J. Lukomnik, "Create Meaningful, Effective Say-on-Pay Plans," *Compliance Week* (April 14, 2009).

Input on Executive Pay: Summary of Approaches," which accompanies this memorandum and is available at our Say on Pay Resource Center.

- ***Consider changes to compensation policies, practices and plans if appropriate and in the best interests of the company and its shareholders.*** Ultimately the board – in particular the compensation committee – is responsible for guiding compensation policy and has the familiarity with the company's particular circumstances that is necessary to inform complex decisions about compensation. One risk of increased shareholder input is that companies may move towards pre-packaged compensation "best practices" favored by proxy advisory firms and investor advocates. Adoption or abandonment of practices based on a template ill-adapted to the company's situation or on "flavor of the day" trends may not serve the interests of the company or its shareholders. The compensation committee must balance openness to shareholder concerns with its fiduciary responsibility to exercise its own judgment. The committee's compensation consultant should play a role in placing shareholder concerns in context and in suggesting alternative compensation design features. Of course, TARP companies are subject to various compensation limitations by law, but they will face important questions about compensation design once their TARP obligations are discharged.[11]

- ***Refine the company's compensation disclosure, especially the CD&A, to clarify the rationale for compensation and how it is linked to performance.*** The CD&A is the primary vehicle for the company to explain to shareholders what drives its compensation programs. The SEC has stressed that a key function of the CD&A is to explain why the company compensates the way it does, and this will be all the more important under a say on pay regime. If investors or proxy advisory firms have raised concerns about a practice, does the CD&A explain why the practice is appropriate for the company and what justifies it? Does the CD&A clarify the connection between pay and performance? Has the company explained how the compensation program is designed to avoid encouraging excessive risk-taking?[12]

[11] The TARP compensation regime was implemented by the Interim Final Rule on TARP Standards for Compensation and Corporate Governance (Treasury Regulation 1505-AC09) published in the Federal Register on June 15, 2009 (31 CFR Part 30). Please see our client alert entitled "New Regulations Implement EESA and ARRA Restrictions."

[12] The SEC recently proposed amendments to its compensation disclosure rules (Release No. 33-9052 (July 10, 2009)) which would, inter alia, amend Item 402 of Regulation S-K to require all public companies (not just TARP recipients) to discuss and analyze in the CD&A their broader compensation policies and overall actual compensation practices for employees generally, including non-executive officers, if the related risks may have a material effect on the company. Disclosure would also be required concerning the role of the board of directors in the company's risk management process. In addition, H.R. 3269 would impose enhanced

- **Who should participate in the process?**

  ➢ ***Management, including the HR head, should lead the communications effort.*** Management should generally be expected to lead the communications effort. The investor relations team has not only the experience, but also the opportunity to engage in the first instance with shareholders and others and to facilitate follow-on discussions with the company's human resources head, compensation committee chair or other personnel appropriate in the circumstances. The corporate secretary and general counsel may also be valuable participants in planning communications, given their expertise in governance and public disclosure matters. It may also be appropriate for the most senior members of management, including the CEO, to speak directly to investors on pay matters. Participation by senior management demonstrates that the company's leaders are alert to shareholder concerns and, where appropriate, directing responsive steps at the highest level.[13]

  ➢ ***Participation by directors may be appropriate to emphasize the company's commitment to good pay practices***. It may be appropriate, particularly where a company is embattled, for the lead director or a member of the compensation committee to be directly involved in external communications, and activists have been quick to point out when the board has been absent from the process. Institutional investors with a significant stake in the company may also expect to have the opportunity to speak with a board member and, if denied that chance, may take it as a signal that their concerns are not a high priority. By being actively involved where appropriate, the committee can demonstrate its commitment to exercising stewardship over compensation issues.

  ➢ ***The company's compensation consultant and other advisors play important supporting roles.*** Outside advisors play an important role in preparing for a say on pay vote. The committee's compensation consultant can offer insights not only into practices of the company's peers, but also perspectives about the experience of other public companies facing pressure on compensation matters. The company's proxy solicitation firm should also be involved in the process well in advance of the vote to provide insight into the manner and intensity of solicitation that may be appropriate. Outside counsel may have useful input,

regulatory scrutiny on the relationship between compensation structures and arrangements and risk at covered financial institutions and would prohibit certain arrangements deemed to encourage inappropriate risks.

[13] As an example of senior management involvement, Lloyd Blankfein, the CEO of Goldman Sachs Group, Inc., spoke to shareholders at the 2009 meeting before management's proposal to approve executive compensation (which passed overwhelmingly) was put to the vote. Mr. Blankfein presented Goldman's new Compensation Principles, presumably to demonstrate the company's leadership and commitment to thoughtful pay practices.

particularly to ensure that communications are consistent with law and the company's SEC filings, but care should be taken to avoid a communications approach that is unduly defensive or legalistic.

- **How should the form of resolution be drafted?**

  ➢ ***Consider the approaches used to date and other alternatives to determine which is suited to the company's situation.*** None of the legislative or regulatory initiatives to date specifies the form of resolution, other than to require consideration of the compensation of the named executive officers,[14] and a variety of proposals have been used to date.[15] Each company should consider all of the alternatives in selecting a resolution that reflects its own perspective about the vote. For example, a company might choose to draft a multi-part vote on both overall compensation and specific aspects of the compensation program in order to obtain more granular feedback from shareholders. The company could also vary the resolution in successive years as appropriate in light of changes to its compensation practices.

- **How should the company respond to a negative or close vote?**

  ➢ ***Consider addressing the vote at the annual meeting.*** Companies are generally aware of likely voting results for most annual meetings well before the meetings occur. Where a company is expecting to face a negative or close vote, it should consider addressing the vote directly at the meeting, including steps it plans to take to address shareholder concerns. In these circumstances, a statement from the CEO or the chair of the compensation committee may be appropriate, even where the board or the committee may not have had sufficient opportunity to consider potential changes to executive compensation design in response to the vote.

  ➢ ***Focus on dialogue and, if appropriate, changes to the practices that triggered shareholder concerns.*** The principles outlined above apply equally, or perhaps to a greater degree, in the event of a negative or close vote. While

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[14] Section 111(e) of EESA requires a vote to approve "the compensation of executives, as disclosed pursuant to the compensation disclosure rules of the [SEC] (which disclosure shall include the compensation discussion and analysis, the compensation tables, and any related material)." The formulation is the same as that under H.R. 3269, except that H.R. 3269 also includes the compensation committee report in the list of compensation disclosure items. The Proposed Rule would not specify the form of resolution for TARP recipients, leaving registrants flexibility within the parameters of the statute. The SEC did, however, state that the requirement under EESA would <u>not</u> be satisfied by a vote to approve "only compensation policies and procedures." The SEC invited comment on whether it should specify the presentation of the say on pay vote under EESA.

[15] The accompanying memorandum, "Shareholder Input on Executive Pay: Summary of Approaches," includes examples of these resolutions.

voting results may attract unwanted press attention in the near term, it is unlikely that they will blindside the company. For this reason, companies should not wait until the next proxy season to address shareholder concerns. If changes to pay practices are made, companies should not neglect the need for a proactive communications plan to ensure public awareness not only of the changes, but also the company's responsiveness to shareholder concerns.

- ***Consider the vote results in light of the company's engagement with shareholders generally.*** Say on pay voting will be most instructive – and most constructive – when looked at as part of a long-term commitment to transparency and good governance. In this light, a "no" or close vote should not viewed in isolation. It is likely not only a reflection of concern about executive pay, but a signal that the company should redouble its efforts to promote a sustained, well thought out engagement with shareholders more generally.

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Please contact any of the lawyers listed in the Corporate Governance or Employee Benefits section of our website (www.cgsh.com) or any of your other regular contacts at the firm for further information about the matters discussed above.

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