The Dodd-Frank Act: Non-Binding “Say-on-Pay” at Public Companies

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Among the many elements of the massive Dodd-Frank Wall Street Reform and Consumer Protection Act are provisions applicable to public companies requiring defined “say-on-pay” votes. These are shareholder votes on

- executive compensation generally, and
- executive compensation relating to business combinations, known as “golden parachutes”.

In the United States, say-on-pay is advisory and not binding on a company’s board of directors. However, thus far in 2010, at least three companies have received negative say-on-pay votes from shareholders. Public companies would be wise to review their compensation programs with a view to how those programs will be perceived, particularly as explained in the Compensation Discussion and Analysis section of their proxy statements. We doubt that compensation committees will be happy to receive even a non-binding “no” vote on their compensation strategies and implementation. A “no” vote could also result in shareholder advocacy organizations deciding to recommend “withhold” votes for compensation committee directors who are running for election to the board.

Say-on-Pay for Regular Compensation of Executives

Under the Act public companies must, in proxy materials for their first shareholders’ meeting that

- occurs more than six months after July 21, 2010 (the date of enactment of the Act), and
- is required to include compensation disclosure under SEC regulations,

offer shareholders the opportunity to vote on two resolutions. The first resolution will be to approve the compensation of executives as disclosed in the proxy materials for that meeting, and the second resolution will be to determine whether, going forward, the say-on-pay vote by shareholders to approve compensation will occur every 1, 2 or 3 years. A new vote regarding the frequency of the compensation approval vote must be taken by shareholders not less often than once every 6 years.

While no SEC rule-making is needed to put this new requirement into place, the Act gives the SEC authority to exempt, by rule, classes of issuers, particularly small issuers who may be disproportionately burdened.

Say-on-Pay for Golden Parachute Agreements

The second type of say-on-pay vote deals with golden parachute agreements, which are broadly defined to include any agreements or understandings that the issuer has with any “named executive officers” – that is, executive officers whose compensation is required to be disclosed in proxy statements, known as “NEOs” – concerning any type of compensation (present, deferred or contingent) that is based on or relates to a business combination transaction that is being presented to shareholders for approval.

Public company proxy materials for a meeting at which shareholders are being asked to approve a business combination or the sale of all or substantially all the company’s assets must

- contain disclosures, “in a clear and simple form in accordance with regulations to be promulgated” by the SEC, about golden parachute agreements with any NEO of the company (or, if the company is not the acquirer, any NEO of the acquiring company),
- describe the aggregate total of parachute payments that may be paid to any NEO, and
- provide for a separate, non-binding vote to approve any such parachute payments, unless the related golden parachute agreements were subject to an earlier non-binding vote on executive compensation.

This new requirement will apply to any proxy solicitation occurring more than 6 months after July 21, 2010. As noted, SEC rule-making will be necessary in order to put this type of say-on-pay into effect. The SEC may adopt rules to exempt particular classes of issuers from these requirements as well.

The Act says that neither type of say-on-pay vote is binding. Moreover, such votes cannot be construed to

- overrule a decision by the board of directors or the company,
- create or imply any changes or additions to the fiduciary duties of the board or the company, or
- restrict or limit the ability of shareholders to make proposals for inclusion in company proxy statements regarding executive compensation.

Finally, the Act obligates any large institutional investment manager to report at least once a year on how it voted on any say-on-pay shareholder vote under the new las (unless such vote is otherwise required to be reported under SEC rules).

It is worth noting that the Act also has the effect of preventing brokers holding shares on behalf of beneficial owners from voting on compensation matters without instructions from those owners.

Pros and Cons

While “say-on-pay” has become a popular rallying cry among activist shareholders, critics of say-on-pay assert that the practice, which is non-binding in any event, is reactionary rather than pro-active, and is therefore not especially effective at monitoring or regulating compensation. Proponents argue that say-on-pay helps to assure that directors fulfill their fiduciary duties and more closely aligns the interests of shareholders and the board.

Institutional investors with large equity portfolios will have a significant influence on the frequency of say-on-pay votes for regular compensation of NEOs. Prior to passage of the Act, some investor groups expressed concern that annual votes would be excessive, but as adopted, the law lets shareholders chose every other year, or every third year, as alternatives to an annual vote. Institutional investors may try to fine tune their positions on voting frequency, and issuers will likely try to persuade investors that biennial or triennial votes will be enough.