September 23, 2010

Preparing for the 2011 Proxy Season: Action Plans and Open Issues

2011 will be a transition year for key proxy-related governance matters. The SEC's new proxy access rules, as we discussed in a recent memo, will be effective as of November 15, 2010, and so 2011 should see the first wave, however modest, of shareholder-nominated director candidates. Other governance provisions of the Dodd-Frank Act will be effective to varying degrees, depending in part on the timing of rulemaking.

The SEC has an enormous queue of rulemaking projects in the wake of Dodd-Frank, and has recently posted a timetable suggesting how it plans to manage that queue. Here are the implications for the 2011 season:

- Companies will be required to conduct two advisory votes: say-on-pay on executive compensation plus a separate "frequency" vote as to whether say-on-pay votes should be held every one, two or three years.[1] .The SEC's stated plan is to issue rules concerning these votes between October 2010 and March 2011, but since the Act requires say-on-pay to be effective for companies with annual meetings on or after January 21, 2011, we will likely see rulemaking in the near future. These rules will also cover compensation committee and advisor independence matters, as well as the separate say-on-pay votes for the approval of golden parachutes in M&A transactions.
- Several other Dodd-Frank requirements, however, are not scheduled for rulemaking until April to July 2011. These include rules clarifying the requirement for clawback policies, and disclosure rules concerning pay-for-performance, pay ratio and hedging policies. We expect that these disclosures will thus not be required in the 2011 proxy statement, at least not for calendar companies.

Pending the outcome of any rulemaking, companies should consider the following as they begin preparing for the 2011 proxy season.

Develop a response plan for proxy access and shareholder proposals

Our prior memo suggests an action plan for anticipating proxy access. In this initial year for proxy access most companies are unlikely to receive Rule 14a-11 nominations, but an awareness and response plan will guard against being caught short if the unexpected happens. An internal team created in advance can quickly evaluate any Schedule 14N filed by a nominating shareholder or group.

The exact dates of the 150-120 day window period for receiving access nominations are now calculable (see a sample timeline here). Once the rules become effective on November 15, Schedule 14N filings to form shareholder groups may be filed even before the window period begins.[2] Remember, though, that

[1] It is not at all clear how the frequency vote should be conducted. Do shareholders get to choose one of three frequencies, or do they get yes/no votes on all three? The frequency vote itself has to be presented at least every six years; does this mean companies can ask the same question each year until they get the answer they want? SEC rulemaking will answer these and other questions. The larger question is whether institutional investors and their advisors will be content to vote every two or three years. Early indications are that the activist community is leaning strongly toward annual votes.

[2] For companies where the 120-150 day window straddles the November 15 effective date, note that nomination notices received prior to November 15 are not effective. In such cases the window in year one will be less than 30 days.

shareholders can solicit interest in forming a nomination group without any public notice by using existing exemptions, such as Rule 14a-2's exemption for solicitations of fewer than ten persons.

Companies should now be revising their advance notice bylaws so that they align with Rule 14a-11 (our sample bylaw is here). Some companies are also likely to be considering director qualification bylaws. We are skeptical that director qualification bylaws will be advisable for most companies, but in any case these issues are best analyzed and discussed based on your individual circumstances.

As for traditional Rule 14a-8 proposals, it is worth remembering that although a majority voting requirement was eliminated from the final version of the Dodd-Frank Act, the momentum in favor of majority voting is still strong. We expect that shareholder proposals seeking adoption of majority voting will especially be on the rise in the mid-cap sector, where majority voting has been much less widely adopted than at larger companies.

Shareholder proposals are subject to the same 120-day deadline as proxy access nominations, although Rule 14a-8 does not have a "window" concept. We believe that the SEC staff may issue yet another staff legal bulletin this fall clarifying and possibly eliminating some current Rule 14a-8 exclusions. The SEC is also likely to take action on the evidentiary requirements for proof of share ownership, which led to private litigation last season.

Anticipate compensation issues that could affect say-on-pay votes

Companies need to identify, and to ensure that their compensation committees are focused on, compensation practices that are considered particularly sensitive and that could trigger negative recommendations by the influential proxy advisory services. Now that mandatory say-on-pay applies to all public companies this advice is more important than ever. Companies with lower total shareholder returns are always more vulnerable to the criticisms of proxy advisory services, and one or two hot button compensation elements could cause the loss of majority support for say-on-pay. This is especially true for new and amended agreements, which may attract *de novo* review by proxy advisors even if the amendments themselves are shareholder-friendly.

Anticipating the concerns of the proxy advisory services is the best way to avoid the fire drill of responding to an unfavorable report. Companies that have previously faced questions about their compensation practices should be prepared to fully explain any changes made in response. In addition, all companies should review the ISS policy update that will be issued later this fall for any changes that may affect its recommendation.

Ensure that your proxy statement clearly tells your compensation story

The noticeable bloat in Compensation Discussion and Analysis sections in recent years has tended to obscure that real change is underway: most companies are reviewing and revising their compensation programs to align them more closely with desired performance. Particularly in 2011 the emphasis should be on communication, not just compliance. Don't overestimate the reader's stamina: preface your CD&A with an executive summary that hits the highlights in bullet points:

- pay-for-performance for senior executives
- recent changes that may respond to the evolving expectations of advocates
- defenses of sensitive pay practices, such as gross-ups

This sort of summary might be especially compelling as the supporting statement for the say-on-pay vote.

While shareholder engagement is always recommended, this could be a difficult season for getting investor attention. Investors who file Form 13Fs will for the first time be casting thousands of say-on-pay votes and publicly reporting on how they voted. Form 13F filers include banks, insurance companies, and corporations and pension plans that manage their own portfolios, a much broader set of filers than the

group of mostly mutual funds who until now have been required to disclose their voting[3]. This will put a premium on clear and forceful proxy disclosure, as the proxy statement will be the primary, and perhaps the only, communication tool on compensation issues.

Review the composition of the compensation committee and engagement with consultants and advisors

SEC rulemaking this fall and winter will elaborate on the meaning and implementation of Dodd-Frank's requirement that compensation committee members be independent and not be affiliates. In the meantime you can review the current committee composition for potential trouble spots, such as members representing large shareholders.[4] You should also look for factors that may bear on the independence of compensation consultants and other advisors, such as other work they perform for the company, and business and personal relationships with committee members.

Evaluate internal complaint procedures

Subject to SEC rulemaking, the Dodd-Frank Act provides significant incentives for whistleblowers to lodge complaints with the SEC by offering a bounty of from 10 to 30 percent of any fines eventually imposed over $1 million. A risk of this approach, of course, is that it can create perverse incentives for employees to bypass internal compliance systems in favor of the larger payday on offer from the federal government. Companies should examine their internal compliance systems and policies and procedures for handling complaints of any kind, including the treatment of individuals who bring forward the complaint, so that employees will continue to be motivated to use internal channels.

Keep the board informed

Companies that are in the habit of providing annual governance updates to the board should consider more frequent updates over the next year, since we are likely to see a continuous stream of developments: new SEC rules, revised disclosure models, changing governance practices among companies, and early indications as to how shareholders are exercising their increased influence under Dodd-Frank. Companies should continue to educate their boards as these issues progress, to allow sufficient time for careful deliberation of possible adjustments to existing compensation programs, responses to access nominations or shareholder proposals, adoption of new policies and possible revisions to public disclosure.

Consider contributing to the rulemaking dialogue

The SEC has been tasked with translating substantial portions of Dodd-Frank into rules that can be understood and complied with. Consider, for example, the clawback provisions of the statute, which requires that companies adopt policies under which, in the event of a restatement, they will reclaim excess incentive compensation going back three years. The implications for compensation plan design are significant, as are the challenges that boards will face in applying the clawback requirement. The SEC has sought guidance from companies and other participants as to how to craft rules that will carry out congressional intent while at the same time preserving the appropriate place of boards of directors in

[3] The requirement in 2003 that mutual funds disclose their voting was followed by a noticeable shift in voting patterns, with the funds being less likely to reflexively support management. We may see this phenomenon repeated in 2011.

[4] On this issue we hope that the compensation committee independence standards will not simply be imported wholesale from the comparable audit committee rules. It would be odd if substantial shareholders, having been given a say on pay at the annual meeting, were to be disqualified from the more influential role of being represented on the compensation committee.

using their business judgment to preserve shareholder value. We think that the voices of companies can be highly influential here, and we are in dialogue already with a number of our clients as to how they can play a productive role in the process.

There are no prizes for being an early adopter

Our overall advice is that there is a short list of things companies should be doing now, a longer list of potential developments to keep your eyes on, and a lot of areas where you should just let the dust settle for a while. Most companies should not now, for example, be amending or adopting clawback policies that are consistent with what might be required under Dodd-Frank, or attempting to calculate an internal pay ratio. The rulemaking process, especially if companies become involved in the comment process, can shed light on a lot of what appears ambiguous and complex. For now we think the focus should be on what is already clearly required.

If you would like to discuss these matters, please contact any of us or your regular Davis Polk lawyer.

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