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Corporate Governance Update: Focus in 2011 Will Remain on Executive Compensation

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This has been an eventful year in corporate governance. As companies prepare for the 2011 proxy season, it is important to review some of the legislative and regulatory events and key trends of 2010 that are expected to have an impact over the next year. Data from the last proxy season and the revised proxy policies of Institutional Shareholder Services (ISS) for 2011 both indicate that executive compensation will continue to be the main focus for shareholders in the New Year.

2010 Highlights

Executive compensation dominated the corporate governance landscape in 2010. Most significantly, provisions in the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[1] will require shareholder "say-on-pay," "say-when-on-pay" and "say on golden parachutes" votes.[2] The Securities and Exchange Commission (SEC) has released proposed rules relating to these requirements.[3] Though the proposed rules have not yet been finalized, the initial say-on-pay and say-when-on-pay votes must be included in all proxy statements relating to an issuer's first annual or other shareholder meeting occurring on or after January 21, 2011. The "say on golden parachutes" votes will not be required until the effective date of the final SEC rules implementing those provisions. All three votes are non-binding, so the impact of a negative vote will be difficult to measure. The Dodd-Frank Act also eliminated broker

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[1] H.R. 4173, 111th Cong. § 2 (2010).

[2] Section 951 of the Dodd-Frank Act required the SEC to promulgate rules implementing these provisions.

[3] "Shareholder Approval of Executive Compensation and Golden Parachute Compensation," Securities Act Release No. 9153 (Oct 18, 2010) *available at* www.sec.gov/rules/proposed/2010/33-9153.pdf. At the same time, the SEC proposed rules that would require institutional investment managers to report annually proxy votes relating to executive compensation matters. *See* "Reporting of Proxy Votes on Executive Compensation and Other Matters," Exchange Act Release No. 63123 (Oct. 18, 2010) *available at* www.sec.gov/rules/proposed/2010/34-63123.pdf.

discretionary voting on executive compensation matters,[4] which will give even greater power to institutional shareholders and corporate governance activists.

In 2010, management say-on-pay proposals garnered slightly more shareholder support, on average, than in 2009. ISS reported that the average level of support for such proposals was 89.6 percent, as opposed to 87.4 percent last year.[5] There were three high-profile instances of management say-on-pay proposals that did not win majority support from shareholders: KeyCorp, Motorola, and Occidental. The primary reason for these three negative votes appeared to be a perceived misalignment, in some form, between pay and performance.

With all public companies having to implement say-on-pay proposals in 2011, directors should try to develop executive compensation packages that appear reasonable in both description and operation and are clearly performance-related, particularly when executive compensation includes a large base pay increase or there appears to be an unusually large gap between the pay of the chief executive and the next-highest-paid executive. Increases in salary labeled as "excessive" by ISS and a perceived disconnect between pay and performance were two of the most-cited reasons for ISS recommendations against management say-on-pay proposals in 2010.[6]

A major issue in 2010 that is not likely to affect the upcoming proxy season is proxy access. New SEC Rule 14a-11 was scheduled to become effective on November 15, 2010, and would have required public companies to permit shareholders who met certain criteria to include director nominees in company proxy materials. However, in October the SEC issued a stay[7] of Rule 14a-11's effectiveness pending resolution of a challenge to the proxy access rules filed with the U.S. Court of Appeals for the D.C. Circuit by the U.S. Chamber of Commerce and the Business Roundtable.[8] Mandatory proxy access therefore is not expected to be required until the 2012 proxy season at the earliest. Companies should continue to prepare for proxy access but refrain from adopting any bylaw amendments or other corporate governance policy changes until the legal issues are resolved.

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[4] In September 2010, the SEC approved amendments to New York Stock Exchange Rule 452 and NASDAQ Rule 2251, which now provide that executive compensation matters are non-routine; brokers therefore cannot vote without instructions from the beneficial owner.

[5] Institutional Shareholder Services, 2010 Postseason Report (Nov. 12, 2010) ("ISS 2010 Postseason Report") at 6.

[6] Pay-for-performance disconnects resulted in ISS "withhold" or "against" vote recommendations at 69 "underperforming" companies in 2010. ISS 2010 Postseason Report at 6-7.

[7] "Order Granting Stay" Securities Act Release No. 9149 (Oct. 4, 2010) *available at* www.sec.gov/rules/other/2010/33-9149.pdf.

[8] *Business Roundtable v. SEC*, No. 10-1305 (D.C. Cir., filed Sept. 29, 2010).

An issue that appears to be fading from prominence is the separation of the positions of chairman of the board and chief executive officer. ISS reports that shareholder proposals seeking an independent board chair declined in support from 33.7 percent in 2009 to 28.5 percent in 2010.[9] ISS itself had proposed a policy revision for 2011 requiring companies to demonstrate both the presence of a "counterbalancing governance structure" (such as a lead independent director) *and* "compelling company-specific circumstances that challenge the efficacy of appointing an independent chair" to avoid an ISS recommendation in favor of a separation proposal. The ISS 2011 policy updates do not contain this change, however, and ISS has determined to continue to focus on the presence of a counterbalancing structure and the absence of "problematic" performance, governance or management issues when considering proposals relating to the separation of chairman and CEO positions.

As a general matter, shareholder activists continued to press for a stronger voice in corporate governance matters. One item that has reappeared on the activist agenda in 2010, after a decade of absence, was shareholder proposals requiring companies to allow for written consent by shareholders. ISS reports that resolutions proposing the right of a majority of shareholders to act by written consent obtained an average of 54 percent approval in the last proxy season.[10] Similarly, resolutions seeking to eliminate supermajority voting rules were very popular, averaging 73.7 percent, a slight increase over 2009's 70.5 percent.[11] Given the popularity of these proposals, it is likely that they will gain increased prominence in the 2011 proxy season.

ISS Policy Changes for 2011

ISS recently published its 2011 Corporate Governance Policy Updates, which indicate changes in ISS' voting recommendations to clients in the upcoming proxy season. The most significant changes concern executive compensation, reflecting the effect of the Dodd-Frank Act and the resulting changes to the proxy rules.

The ISS updates include a new policy regarding the frequency of say-on-pay votes. While the Dodd-Frank Act requires companies to provide shareholders with four choices of say-when-on-pay voting mechanics—annually, biennially, triennially or abstain—ISS will recommend that shareholders approve only of annual votes.[12] Annual

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[9] ISS 2010 Postseason Report at 16.

[10] *Id*. at 15.

[11] *Id*.

[12] ISS' U.S. Corporate Governance Policy 2011 Updates (Nov. 19, 2010) ("ISS Policy 2011 Updates") at 16.

votes may not be appropriate for all companies, particularly those that structure their pay around multi-year incentives. Companies that do not want to be pressured to adopt annual say-on-pay votes should communicate with their institutional investors, through direct outreach as well as discussion in proxy materials, to explain their reasoning and listen to any significant concerns from major shareholders. ISS supports annual votes in order to maximize "accountability and direct communication"; presumably, if a company can provide these with a less frequent vote, the underlying rationale for the vote recommendation could be satisfied.

ISS also has adopted a new policy of case-by-case recommendations on golden parachute compensation arrangements. The evaluation will take into account the degree to which a company's compensation arrangements include any "problematic pay practices" relating to severance. Features that may increase the likelihood of a negative vote recommendation include: excise tax gross-up provisions, certain single and "modified single" trigger payments or vesting of equity, "excessive" severance, and golden parachutes that may influence change in control transactions (either because they provide an undue incentive to the executive or because the company purports to condition a proposed transaction on approval of the golden parachute arrangement in the advisory vote). ISS may give higher weight to golden parachute arrangements in its say-on-pay analysis when companies seek to satisfy the golden parachute vote requirement by including the specified disclosure in an annual meeting proxy featuring a say-on-pay vote.[13]

With respect to perceived problematic pay practices, the 2011 ISS policy updates include a shortened list of the "egregious" pay practices that could, individually, trigger an ISS recommendation to vote against a management say-on-pay proposal or an equity compensation plan, and, under certain circumstances, a recommendation for a "withhold" vote against compensation committee members or the full board. The revised list of these problematic practices includes repricing underwater options without prior shareholder approval, "excessive" perks, and new or extended agreements that provide for change-in-control payments that are single-trigger, exceed three times salary and bonus, or include an excise tax gross-up. Amending auto-renewing ("evergreen") agreements that contain problematic features may "receive particular scrutiny" under ISS analysis. A related change for 2011 is that ISS will no longer consider a company's commitment to eliminate problematic pay practices in the future as a way of forestalling or reversing a negative vote recommendation.[14]

In other areas, the ISS policy updates continue the trend of incremental encroachment on directorial discretion. ISS will generally support proposals to enable

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[13] *Id*. at 19-20.

[14] *Id*. at 17-19.

shareholders to act by written consent but will make case-by-case recommendations with respect to companies that already have an “unfettered” right for 10 percent of the shareholders to call a special meeting (assuming the company also has an unclassified board, majority voting in director elections and no rights plan that has not been approved by shareholders).[15] Companies should be cautious in this area; the 10 percent threshold may not be appropriate in most cases and, in our experience, is too low a threshold. In particular, companies that have existing thresholds of 20 percent or 25 percent of the outstanding shares to call a special meeting should consider resisting ISS-generated pressure to conform to an arbitrary, “one size fits all” guideline.

The policy updates contain a relatively minor adjustment with respect to action on majority-supported shareholder proposals. ISS will now recommend an across-the-board “withhold” or “against” vote on the board of directors if they do not act on a shareholder proposal that was approved by a majority of shares outstanding in the previous year or a majority of votes cast in the previous year and one of the two preceding years (as opposed to just the immediately preceding year).[16] It is not clear how ISS will evaluate situations in which similar, but not identical, proposals were approved by shareholders in two out of three years. Regardless, the underlying point remains unchanged; ISS wants to see increased company responsiveness to majority-supported shareholder proposals and will try to hold boards of directors accountable in situations where boards are not perceived to be responsive. The best defense against a withhold vote recommendation is for companies to take the offensive: managements should do their best to engage with significant shareholders to avoid majority shareholder votes on the underlying shareholder proposals.

Looking Ahead

In 2011, we are likely to see companies, investors, and regulators continue to focus on issues relating to executive compensation and activists will continue to press for greater shareholder involvement in corporate governance and the narrowing of director discretion. 2011 also will see the initial application of 2010 legislative and regulatory efforts, with the finalization and implementation of SEC rules pursuant to the Dodd-Frank Act, probable resolution of the proxy access challenge, and companies working through the issues involved in complying with a host of new disclosure and corporate governance requirements.

Corporate governance issues rise and fall in prominence, but certain fundamentals remain constant. Directors should stay focused on creating long-term value for shareholders, using performance-related pay to attract and retain senior management,

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[15] *Id*. at 11.

[16] *Id*. at 7.

and exercising sound business judgment to evaluate opportunities and manage risk. Communication with key shareholders remains an important element of corporate governance; companies and investors alike would do well to remember that they have nothing to lose, and everything to gain, by working together to create lasting corporate success. In addition, with the results of the 2010 congressional elections, it is an open question whether Congress will dismantle or lessen its focus on mandatory corporate governance requirements for public companies.