

PROXY UPDATE

October 14, 2010

The Dodd-Frank Act Implications for the 2011 Proxy Season

Now that the SEC has released a tentative schedule for implementation of the Dodd-Frank Act (which can be accessed [\(here\)](#)), there is greater certainty as to what companies will face in the 2011 proxy season. In helping you prepare, we have outlined a summary of what you need to know, followed by some practical implications for 2011.

WHAT YOU NEED TO KNOW NOW

- All issuers will be required to submit a non-binding, management Say on Pay proposal to shareholders at their 2011 annual meeting.
- A Say on Frequency (or When on Pay) proposal will also be required, giving shareholders a choice of whether they prefer a Say on Pay vote every one, two, or three years. The details of how this proposal will work mechanically are not known at this time, but we believe it will be presented as one proposal with three boxes – one, two, or three years (with no abstain box).
- A Say on Severance vote may be required in M&A situations.
- Broker discretionary voting is eliminated on all compensation issues (including Say on Pay and 162m proposals).
- Disclosure of pay-for-performance, pay ratios, hedging by employees and directors, and compensation consultant conflicts will not be required in proxy statements for meetings during the 2011 proxy season.
- The lead time for preparing for the 2011 Annual Meeting will be earlier than ever, and a more aggressive and/or targeted solicitation effort may be necessary.
- Since it was not included in the final iteration of the Dodd-Frank bill, we expect to see numerous shareholder proposals on majority voting in the election of directors.

SAY ON PAY AND SAY ON FREQUENCY

Say on Pay vote is mandatory. All issuers with annual meetings after January 21, 2011 will be required to include a non-binding proposal on executive compensation (Say on Pay) on the ballot. Since every public company will be required to offer a Say on Pay proposal, there is a potential for a significant logjam in recommendations by proxy advisors and in voting by institutional shareholders. In fact, a number of large institutional investors have concluded that in order to handle the burden of so many Say on Pay votes, they will need to employ a checklist approach in their review of the proposal.

In addition, Say on Pay is no longer a discretionary voting item for brokers. As a result, the approval percentages that management Say on Pay proposals received in the past are likely to drop (in some cases precipitously).

Advanced planning, clear disclosure, and a sound solicitation strategy that includes communicating with major shareholders early in the solicitation period will be important in the coming environment.

Say on Frequency vote is also mandatory. Issuers also must include a non-binding proposal on the agenda giving shareholders a choice of whether future Say on Pay votes should be submitted to shareholders every one, two or three years; and the Frequency vote will need to be repeated at least every six years. The board will be able to make a recommendation as to whether shareholders should approve one, two, or three years.

The mechanics of the Say on Frequency proposal are unclear at this time, but we have heard that it will be presented as one proposal with three boxes: one, two, or three years (we do not believe there will be an abstain box as has been rumored). Shareholders would be allowed to check only one box for their vote to count on that proposal. It is also unclear at this point how unmarked proxies will be treated on the Frequency proposal (i.e., voted as recommended by the board or not voted at all on the proposal).

The SEC has indicated that they expect to have rules in place for Say on Pay and Say on Frequency as soon as possible. In any case, votes on these proposals will begin at annual meetings occurring after January 21, 2011 “with or without the rules in place”.

Institutional preferences. We have heard mixed reaction among shareholders as to the preferred frequency of the Say on Pay vote. This is not surprising since even among various labor groups there has been disagreement as to the required frequency in the past. (Last year, the Carpenters were submitting triennial Say on Pay shareholder proposals)

While we expect a number of large mutual funds will support biennial and triennial approaches, we suspect that will be offset by a great number of shareholders that will lean towards annual Say on Pay votes. As evidence of that, Walden Asset Management, State of Connecticut, AFL-CIO, AFSCME, and others have sent letters asking companies to come out publicly in support of annual Say on Pay votes. Additionally, both TIAA-CREF and the Council of Institutional Investors have indicated a preference for annual Say on Pay votes.

While we don't expect a one size fits all guideline from the advisory firms, we believe firms like ISS will support annual advisory votes more often than they will support biennial or triennial approaches. For example, companies with staggered boards may find strong resistance to anything other than an annual vote since compensation committee members may not be up for election in a given year. Additionally, if the advisory firm recommends against your Say on Pay proposal they will probably not support a two or three year frequency.

We expect ISS will update their guidelines for the 2011 proxy season some time in November of this year.

What should your company do? Each company will have to make a decision on the Frequency recommendation based on their particular shareholder profile and their compensation and governance practices. Companies seeking a biennial or

triennial Frequency vote will need a persuasive argument as to why these timeframes work for their particular circumstances (such as explaining how a biennial or triennial vote corresponds with the company's compensation scheme). This explanation should be separate from the CD&A or in a summary at the beginning of the CD&A, where it is more likely to be read.

Issuers that don't provide annual Say on Pay votes should be aware the advisory firms like ISS have demonstrated in the past that Say on Pay proposals will be their primary avenue for negative recommendations on compensation issues, so not providing annual Say on Pay votes could make the compensation committee members more vulnerable during years when Say on Pay is not offered.

Companies may want to survey some of their large holders in advance of the proxy to get a sense for how they may approach this issue.

SAY ON SEVERANCE

At shareholder meetings where holders are asked to approve an acquisition, consolidation, or proposed sale or disposition of all or substantially all assets of the issuer, it would be required that issuers have a separate vote to approve any type of compensation (present, deferred, or contingent) that is based on or relates to the acquisition, consolidation, or proposed sale or disposition of all or substantially all assets of the issuer. This vote would not be required if the Golden Parachutes had been approved in advance as part of a Say on Pay vote.

BROKER DISCRETIONARY VOTING AND THE SWORD OF DAMOCLES

The Act also provides that brokers cannot vote without instructions from underlying shareholders on executive compensation issues or "any other significant matter, as determined by the Commission". This will eliminate broker discretionary voting privileges for management Say on Pay proposals. In practice, this can mean lower favorable votes on Say on Pay as a percentage of the voted, since a negative institutional vote will be magnified with the reduced turnout (this is similar to the impact the elimination of broker voting has had on director elections during 2010).

On September 9, the SEC approved an amendment to NYSE Rule 452 that eliminates broker discretionary voting on all compensation related proposals; including approval of 162m proposals (approval of cash compensation plans in order to obtain favorable tax treatment).

The wording in the Act allowing the SEC to determine "any other significant matter" provides the SEC with a virtual Sword of Damocles. This will allow the SEC to eventually do away with broker discretion on any or all matters they decide are "significant". We would not be surprised to see certain issues that have historically been discretionary, such as increases in the authorized common stock for general corporate purposes, to be deemed "significant". For that reason, companies with high retail ownership or supermajority voting requirements may want to review their common stock needs over the next few years and consider increasing their authorized common shares in 2011 while the proposal is still discretionary.

The good news is that it appears the Sword will remain in its sheath for the 2011 season because the SEC's schedule for

implementation indicates that they will not act on the determination of “any other significant matter” until April, 2011, at the earliest.

MAJORITY VOTING FOR DIRECTORS

Noticeably absent from the bill was a mandate for all public companies to adopt majority voting in the election of directors. While a majority of the S&P 500 has already adopted majority voting, many have not, and the vast majority of small and mid-cap companies still maintain a plurality voting standard. We suspect that a number of corporate governance activists initially expected majority voting to be mandated prior to the 2010 season, which may have led to a smaller than expected number of shareholder proposals on the issue in 2010. We expect to see a sharp increase in the number of such shareholder proposals during 2011.

Underscoring the importance of majority voting for some investors, The Florida State Board of Administration has begun sending letters to companies in the Russell 2000 that have not adopted a majority vote standard for directors. They view the election of directors as a fundamental right of shareowners under state corporate law, and view the absence of a majority voting standard as undermining the legitimacy of the director election process.

CONCLUSION

As noted before, the lead time for preparing for the 2011 Annual Meeting will be longer, and a more aggressive and/or targeted solicitation in 2011 may be necessary. To prepare for the significant changes for the 2011 Annual Meeting season, it is imperative that issuers understand the composition of their shareholder profile well in advance of the meeting, and the views of their investors, especially institutional investors, on these and other significant issues.

As we discussed in our [July 2010 update](#), now is the best time to consider a coordinated outreach program to engage with major investors, so you have an understanding of their views well before your proxy is filed. We are prepared to assist you in setting up this approach to your investors.

Morrow & Co. is available at any point to answer your questions or assist you as you move toward the 2011 proxy season. Please feel free to contact your Morrow representative with any questions you may have. You may also contact Tom Ball, Fred Marquardt or John Ferguson at 203-658-9400.

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