

Client Alert

August 4, 2011

Proxy Access Struck Down by Courts

Additional Dodd-Frank Act Compensation and Governance Provisions Delayed

As we reached the first anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), a federal appeals court struck down implementation of the “proxy access rule” – a provision in the Dodd-Frank Act directing the SEC to issue rules designed to make it easier for shareholders to get their own nominees onto Boards. While the court’s actions rendered universal proxy access dead for 2012, recent amendments to the securities laws would allow shareholders to file individual proxy access bylaw proposals in the upcoming proxy season.

Within a week of this ruling, the SEC announced a delay in final rulemaking for five other Dodd-Frank compensation and governance provisions, including:

- Pay vs. Performance Disclosure
- Ratio of Median Employee Pay to CEO Pay Disclosure
- Clawback Implementation and Disclosure
- Hedging Policy Disclosure
- Regulation of Incentive Pay at Financial Institutions

The rulemaking delay announced by the SEC on these five compensation issues could defer implementation of these provisions until the 2013 proxy season.

This Client Alert discusses the above provisions in further detail and provides insight as to what we can expect on these items going forward.

Proxy Access Rule

Background

Under current rules, a company’s sitting Directors nominate a slate of Directors and the company sends that information to shareholders in the proxy materials. While shareholders can attend the annual meeting and nominate different candidates, the proxy votes have usually been cast by that point. The only alternative for shareholders is to launch a proxy fight by mailing out their own ballots, which can be costly and administratively burdensome. For many years, shareholder activists have argued that this system entrenches existing Directors and management and deprives outside shareholders of their rights as owners. The concept of “proxy access” – which was first offered by the SEC in proposed form in 2003 – is intended to open up the process by allowing certain outside shareholders access to the proxy by nominating their own members in advance of the annual meeting, with information on the alternative slate of Directors distributed by the company to all shareholders.

Dodd-Frank, SEC Rules and Litigation

Despite years of shareholder activism, the concept of proxy access did not gain real momentum until, in the aftermath of the financial crisis, Section 971 of the Dodd-Frank Act provided the SEC with authority (but not a mandate) to issue rules which allowed specified shareholders to include Director nominees in a company's proxy materials. Final proxy access rules were issued by the SEC on August 25, 2010 in the form of Exchange Act Rule 14a-11, with an implementation date scheduled for November 15, 2010 (which would have rendered proxy access applicable to the 2011 proxy season). These final rules generally provided that qualifying shareholders or groups holding at least three percent of the voting power of a company's securities and who have held their shares for at least three years, would have the right to include Director nominees in proxy materials upon meeting certain other requirements.

However, the implementation of the proxy access rule was stayed due to litigation challenging the rules. The Business Roundtable and Chamber of Commerce filed a petition on September 29, 2010 with the U.S. Court of Appeals for the District of Columbia Circuit (the D.C. Circuit) seeking judicial review of the changes to the SEC's proxy access and related rules as well as a request to stay the effective date of proxy access. The SEC granted the request for a stay of the rules on October 4, 2010 pending resolution of the petition for review by the court.

Court Strikes Proxy Access

On July 22, 2011, a three-judge D.C. Circuit panel struck down the SEC's proxy access rule, concluding the SEC violated the Administrative Procedure Act by acting "arbitrarily and capriciously" in approving Rule 14a-11 because the agency failed to properly consider the costs and benefits of the rule. The court's opinion contained unequivocal criticism of the rule, stating the SEC's rule failed to:

- adequately quantify and explain the rule's costs, particularly when a shareholder nominee is not ultimately elected;
- support its predictions of shareholder cost savings or benefits;
- respond to substantial problems raised by commentators in the rulemaking process;
- sufficiently support its conclusion that proxy access would improve Board and company performance or shareholder value;
- address how the rule would take the place of traditional proxy contests; and
- adequately evaluate the costs that companies could face from use of the rule by special interest groups to pursue self-interested agendas unrelated to shareholder value.

What to Expect Going Forward

The court's action means that the SEC's market-wide proxy access rule will not be in place for the 2012 proxy season. While the SEC has 45 days to consider whether it will seek appeal of the ruling before the entire D.C. Circuit, it is unlikely that a majority of the nine-member D.C. Circuit will vote to hear the case in the face of an opinion issued with such a definitive rejection of a high profile initiative. If the SEC does not seek an appeal, it will likely propose a revised and presumably narrower Rule 14a-11. However, a new proposal is unlikely in the near term given the SEC's heavy workload under Dodd-Frank in other areas.

Nonetheless, when the SEC adopted Rule 14a-11, it also adopted amendments to Rule 14a-8. This amendment requires companies to include shareholder proposals in their proxy statements which would amend company bylaws to provide for expanded proxy access. While the amendments to Rule 14a-8 were stayed by the SEC in connection with the litigation, it is likely the

SEC will lift the stay as to these amendments and make the rules operative in the near future. The revisions to Rule 14a-8 could prove to be a powerful arsenal for activist investors and potentially create more issues than the now vacated proxy access rule, as it does not have any ownership or length of holding thresholds. Under Rule 14a-8, a shareholder need only own \$2,000 worth of stock and have held it for one year, although such thresholds may be augmented by more vigorous state law requirements.

Even if Rule 14a-8 amendments are effective for the 2012 proxy season, it is unclear to what extent shareholders will submit access bylaw proposals. If access resolutions are widespread, the argument against the SEC's enactment of a market-wide access rule could be strengthened. The argument against proxy access may also be bolstered if such individual proxy access proposals receive low levels of support. Widespread resolutions may result in many companies trying to exclude such proposals by offering their own management resolutions with very high ownership thresholds.

PM&P Observation: The fallout from suspension of a universal proxy access rule could be a proliferation of individual company proxy access rules not likely to have consistency across the investor landscape. Individual company Boards may need to develop their own proxy access rules in reaction to proxy proposals on this matter from their shareholders. We anticipate that Board-developed proxy access rules will most likely be fairly stringent, creating potential conflict with shareholder advocates who are generally in favor of a more liberal proxy access.

Delayed Rulemaking for Five Key Compensation-Related Dodd-Frank Provisions

While most of the other compensation and governance-related Dodd-Frank provisions have either been implemented or are likely to be effective for the 2012 proxy season (see Implementation Appendix for status of other provisions), on August 1, the SEC announced further delays for final rules in five key areas. The delay in final rulemaking could result in postponing the effective dates of the provisions to a point beyond 2012, particularly if final rules are not ready prior to the beginning of the 2012 proxy season.

Disclosure of Pay versus Performance

Section 953(a) of the Dodd-Frank Act directs the SEC to adopt rules mandating the disclosure of the relationship of the compensation actually paid to a company's executive officers versus that company's financial performance, taking into account changes in the value of stock and dividends or distributions. This disclosure may be presented graphically or in narrative form. The Dodd-Frank Act did not specify implementation dates, but the SEC expects to propose rules between August and December, 2011, with final rules being issued between January and June, 2012.

Disclosure of CEO Pay versus Median Employee Pay

Section 953(b) of the Dodd-Frank Act directs the SEC to adopt rules mandating disclosure of the median annual total compensation of all employees (except the CEO), the annual total compensation of the CEO, and the ratio of the median employee total compensation to the CEO total compensation. Total compensation is determined by reference to the "total compensation" column of the Summary Compensation Table. This item has been the most controversial of the compensation disclosure items, and has generated harsh criticism regarding the difficulty of gathering such data compared to the usefulness such data will provide to potential investors and existing shareholders.

Debate has continued in Congress on the question of whether this provision should be repealed or modified, and on June 22, the House Financial Services Committee voted to recommend H.R. 1062, the "Burdensome Data Collection Relief Act," a bill that would eliminate this requirement. The bill still must be approved by the full House and then the Senate before repeal or amendment would be official. While it could pass in the House, we understand that it is highly unlikely to gain Senate approval. The Dodd-Frank Act did not specify implementation dates, but the SEC expects to propose rules between August and December of 2011, with final rules being issued between January and June of 2012.

Compensation Recovery and Disclosure (Clawbacks)

Section 954 of the Dodd-Frank Act requires that stock exchange listing standards be amended to require companies to adopt a policy providing for recovery from any current or former executive officer who received incentive-based compensation (including stock options awarded as compensation) during the three-year period preceding the date on which the company is required to prepare an accounting restatement. The recovery policy would apply in cases where a company is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws, and the recovery amounts would be based on value received due to the erroneous data, in excess of what would have been paid under the restatement. Again, the Dodd-Frank Act did not specify implementation dates, but SEC expects to propose rules between August and December of 2011, with final rules being issued between January and June of 2012.

Disclosure of Employee or Director Hedging Policies

Section 955 of the Dodd-Frank Act directs the SEC to adopt rules mandating disclosure of whether any employee or Director is permitted to purchase financial instruments, such as prepaid variable forwards, equity swaps, collars, and exchange funds, any of which are designed to hedge or offset any decrease in the market value of equity securities granted as compensation or held directly or indirectly by the employee or Director. The Dodd-Frank Act did not specify implementation dates, but SEC expects to propose rules between August and December of 2011, with final rules being issued between January and June of 2012.

Regulation of Incentive Pay at Financial Institutions

Section 956 of the Dodd-Frank Act directed banking regulators and the SEC to examine and impose restrictions on incentive-based compensation arrangements of certain financial institutions. Under this provision, such institutions are required to disclose to their appropriate regulator the structures of all incentive compensation to enable the regulator to determine whether such structures (i) provide any executive officer, employee, Director or principal shareholder with excessive compensation, or (ii) could lead to material financial loss. In addition, the Act required the regulators to jointly issue rules prohibiting arrangements that they determine encourage inappropriate risks by providing any of the individuals noted above with excessive compensation, or that could lead to material financial loss.

By the end of first quarter, 2011, all relevant regulators, including the SEC, had issued proposed rules on this topic, with such guidance indicating the provision would become effective within six months after publication of the final rules. The first annual reports were scheduled to be due within 90 days of the conclusion of each firm's fiscal year. As of August 1, the SEC announced that final rules would not be issued until between January and June of 2012, possibly delaying implementation and reporting under Section 956 until 2013 for calendar year filers.

Conclusions

While Directors will have a reprieve from market-wide proxy access for the 2012 proxy season, their companies are still at risk of shareholder proposals for individual proxy access. With the Dodd-Frank Act tackling many compensation and governance related issues at once, it is not surprising that agencies required to drill down into the details of such provisions have continually delayed rulemaking schedules. We will continue to track the feasibility of implementation for any of the other delayed provisions discussed herein during the 2012 proxy season.

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About Pearl Meyer & Partners

For more than 20 years, PM&P has served as a trusted independent advisor to Boards and their senior management in the areas of compensation governance, strategy and program design. The firm provides comprehensive solutions to complex compensation challenges through the development of programs that align rewards with business goals to create long-term value for all stakeholders: shareholders, executives and employees. The firm maintains offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, Los Angeles, San Francisco and San Jose.

Implementation Appendix As of August 4, 2011

Provision	Effective Dates in DFA	Current Known Status or Scheduled Action
Say on Pay and Say on Frequency	Proxy statements for meetings on or after 1/21/2011	SEC issued Final Rules 1/25/2011 Effective for 2011 proxy season
Say on Golden Parachute	Effective on or after 4/25/2011	SEC issued Final Rules 1/25/2011 Effective for 2011 proxy season
Financial Institution Excessive Compensation Rules	Rules to be issued by 4/21/2011	Proposed Rules Issued by Joint Regulators Feb & Mar., 2011 Final Rules scheduled for Jan. – June 2012 Unclear if effective for 2012 proxy season
Compensation Committee & Advisor Independence; Committee's Oversight Authority	Effective by 7/16/2011	SEC issued Proposed Rules Mar. 30, 2011 Exchanges to issue Proposed Rules by Oct., 2011 SEC to issue Final Rules Aug. – Dec., 2011 Likely to be effective during 2012 after final exchange rules released
Disclosure of Compensation Consultant Conflict of Interest	Proxy statements for meetings occurring on or after 7/21/2011	SEC issued Proposed Rules Mar. 30, 2011 SEC to issue Final Rules Aug. – Dec., 2011 Likely to be effective for 2012 proxy season
Clawback Policy	None stated	SEC to issue Proposed Rules Aug.– Dec., 2011, and Final Rules Jan. – June 2012 Unclear if effective for 2012 proxy season
Pay-for-Performance Disclosure	None stated	SEC to issue Proposed Rules Aug.– Dec., 2011, and Final Rules Jan. – June 2012 Unclear if effective for 2012 proxy season
Internal Equity Ratio Disclosure	None stated	SEC to issue Proposed Rules Aug.– Dec., 2011, and Final Rules Jan. – June 2012 Unclear if effective for 2012 proxy season
Disclosure of Hedging	None stated	SEC to issue Proposed Rules Aug.– Dec., 2011, and Final Rules Jan. – June 2012 Unclear if effective for 2012 proxy season
Disclosure of COB/CEO Roles	None stated, but it is so similar to 2010 rule that most companies have complied in the 2011 proxy	SEC did not commit to dates for guidance; Most companies discussed in 2011 proxies
Proxy Access	SEC issued final proxy rules August 25, 2010; effective 60- days from publication in Federal Register, but delayed implementation pending Court of Appeals review	Rule 14a-11 struck down by U.S. Court of Appeals on July 22; Rule 14a-8 may still allow investors to file access bylaw proposals as to individual companies for 2012 proxy season
Broker Non-Vote on Executive Compensation	Effective 7/21/10	SEC to issue clarifying Final Rules TBD; but effective for 2011 proxy season

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