

Many Companies Will Need to Conduct Say-on-Frequency Votes in 2017

As companies begin to prepare to draft their definitive proxy statements for the 2017 proxy season, it is important to remember that, for many companies, next year also marks the sixth anniversary of their initial shareholder advisory vote to determine the frequency with which they would conduct future shareholder advisory (non-binding) votes on the compensation of their named executive officers (the so-called “Say-on-Pay” vote).

As required by Section 14A(a)(2) of the Securities Exchange Act of 1934, public companies must solicit the preference of their shareholders as to whether future Say-on-Pay votes should be held every one, two, or three years (the so-called “Say-on-Frequency” vote) no later than the annual meeting of shareholders (or other meeting at which directors are to be elected and for which compensation disclosure is required) held in the sixth calendar year after the last Say-on-Frequency vote. Consequently, companies that conducted their initial Say-on-Frequency vote in 2011 (the first year that such a vote was required) must conduct their next Say-on-Frequency vote at their 2017 annual meeting of shareholders. As a corollary, companies that conducted their initial Say-on-Frequency vote after 2011 have until the sixth anniversary of such vote before they must hold their next Say-on-Frequency vote.

Selecting a Frequency Preference

Just as with the initial vote in 2011, each company’s Board of Directors will want to recommend a preference when soliciting shareholder input in 2017 on the frequency of future Say-on-Pay votes. The initial Say-on-Frequency votes conducted in 2011 resulted in the overwhelming majority (approximately 85%) of all Say-on-Pay votes being held annually. Moreover, that choice has remained the predominant practice over the past six years. Thus, it is likely that many companies will continue to recommend – and, in all likelihood – decide to continue with an annual Say-on-Pay vote.

Nonetheless, as with any significant corporate governance decision, the Board may want to evaluate anew the advantages and disadvantages of each potential choice – an annual, biennial, or triennial vote – before making a recommendation to shareholders. Among the key considerations in this evaluation are the following:

- **Say-on-Pay Approval Level** – Consistently over the past six years, approximately 70% of the companies holding a Say-on-Pay vote have received more than 90% shareholder support for their executive compensation program. In the absence of significant opposition to the program or significant design changes, you may want to assess whether your past levels of shareholder support warrant consideration of a periodic, rather than an annual, Say-on-Pay vote.
- **Shareholder Engagement** – Companies with an ongoing shareholder engagement process may decide that, in view of a robust dialogue with large institutional shareholders, there is less need for an annual Say-on-Pay vote to identify and respond to investor concerns.
- **Shareholder Preferences** – Many major institutional shareholders disclose their Say-on-Pay vote preference in their proxy voting guidelines. It may be useful to identify the preferences of your key shareholders. Where an annual vote preference is disclosed, it may be worth exploring whether there is any flexibility in application of this policy. On the other hand, the major proxy advisory firms and many pension funds are aggressive advocates of annual Say-on-Pay votes. Consequently, a thorough understanding of your shareholder base – and their preferences – is warranted.
- **Timing Disconnect** – A troublesome corollary of an annual Say-on-Pay vote is that, in most cases, the vote results are not known until after a company has made its executive compensation decisions for the current fiscal year. Thus, it may take an additional full cycle before any design changes resulting from a problematic vote can be fully implemented. As we have seen, this may

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result in shareholder confusion and the need for additional disclosure to explain this timing disconnect.

- **Incentive compensation Design** – One of the original arguments for a periodic Say-on-Pay vote was its consistency with the design of most long-term incentive compensation plans; that is, that shareholder feedback on program specifics should be aligned with the multi-year view of most programs. While for many companies this argument was ultimately outweighed by shareholders' desire to provide more frequent feedback on pay issues, in view of the "stabilization" of most executive compensation programs over the past five years, such concerns may no longer be as important for many shareholders.

We expect that the impact of these considerations will vary among companies. In addition, they are likely to be further affected by a company's current financial results, its relationship with its largest shareholders, its approach to corporate governance matters, and its executive compensation philosophy. It's also worth noting that Say-on-Frequency votes can be held at any time (although no less frequently than once every six years). Consequently, even where a company isn't prepared to make a change to the frequency of its Say-on-Pay votes at this time, it doesn't have to wait until 2023 to revisit the matter if circumstances change.

Frequency Vote Practices Among Technology and Life Sciences Companies

Our review of the frequency of Say-on-Pay votes among the companies in the Bay Area Tech 120 (that is, the most prominent technology companies headquartered in the San Francisco Bay Area (primarily in Silicon Valley)) indicates that these votes have followed the broader trend. Nearly 88% of the companies surveyed (92 of 105 companies) conduct their Say-on-Pay votes on an annual basis.

Among the companies in the Life Sciences 80 (that is, the most prominent companies in the life sciences sector (many of which are headquartered in the San Francisco Bay Area)), the practice is largely the same. Just over 82% of the companies surveyed (64 of 78 companies) hold annual Say-on-Pay votes.

Compliance Tips

In preparing for your Say-on-Frequency vote, it is important to remember the following points:

Form of Proposal and Voting Choices. Exchange Act Rule 14a-21(b) does not require that companies use a specific form of resolution when preparing the Say-on-Frequency proposal. While the Say-on-Frequency proposal can be in the form of a formal "resolution," the SEC Staff has indicated that it need not be so as long as it is clearly stated. Pursuant to Exchange Act Rule 14a-4, on its proxy card and voting instruction form for the Say-on-Frequency proposal, a company must provide shareholders with four voting choices: "every one year," "every two years," "every three years," or "abstain."

Frequency Recommendation. While the SEC rules do not require that a company include a recommendation with respect to the Say-on-Frequency vote as part of its proposal, to ensure that uninstructed proxy cards are voted in accordance with management's recommendation, it is necessary that the company specify how proxies will be voted on this proposal in the absence of instructions from the shareholder. In 2011, the vast majority of companies disclosed the preference of the Board of Directors as to the frequency of future Say-on-Pay votes as its recommendation on the matter. We expect that this approach will continue to be used in 2017.

Reporting of Vote Results. Section 5.07(b) of Form 8-K provides that, within four days following the annual meeting of shareholders, public companies must file a current report disclosing the results of each matter voted upon at the meeting, including the results of the Say-on-Frequency vote. Such disclosure must state the number of votes cast for each of "one year," "two years," and "three years," as well as the number of abstentions.

Disclosure of Board Decision on Say-on-Pay Vote Frequency. Since the Say-on-Frequency vote is merely "advisory" in nature, public companies must disclose the decision of their Board of Directors with respect to the frequency of future Say-on-Pay votes. Item 5.07(d) of Form 8-K provides that companies have up to 150 calendar days after their annual meeting (but no later than 60 calendar days prior to the deadline for shareholder proposals for the next year) to decide and disclose their decision on Say-on-Pay frequency.

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In the case of the initial votes in 2011, many companies disclosed their decision on frequency at the same time that they disclosed the results of their initial Say-on-Pay vote. That approach can be used once again in 2017. Where a company does not make a frequency decision right away, it will need to amend the Form 8-K reporting the voting results of its annual meeting to disclose this information. We note that although many companies overlooked this requirement in 2011, generally the SEC Staff forgave this oversight. It's unlikely that the Staff will be so generous the second time around, so companies need to make sure that they disclose their frequency decision in a timely manner.

Exceptions to Frequency Requirement

While companies that were required to hold their initial Say-on-Pay and Say-on-Frequency votes at their 2011 annual meeting of shareholders must include a Say-on-Frequency vote (along with their Say-on-Pay vote) at their 2017 annual meeting, smaller reporting companies and emerging growth companies will not need to worry about this requirement in 2017. Since smaller reporting companies were not required to conduct their initial Say-on-Frequency vote until 2013, the sixth anniversary of such vote will not occur until 2019.

In addition, emerging growth companies are not required to comply with Section 14A of the Exchange Act (and, thus, hold any shareholder advisory votes on executive compensation) as long as they maintain "emerging growth company" status. Notably, while Section 14A(e)(2)(B) provides that a company that loses its emerging growth company status within two years of its initial public offering may postpone its initial Say-on-Pay vote until the third year following its IPO, there is no corresponding relief for the Say-on-Frequency vote. Thus, such a company will be required to hold its initial Say-on-Frequency vote before it has to conduct its initial Say-on-Pay vote.

Need Assistance?

Compensia has extensive experience in helping companies draft the executive compensation disclosure in the proxy materials for their annual meetings of shareholders and analyze the potential impact on the Dodd-Frank Act shareholder advisory votes on their executive compensation programs. If you would like assistance in preparing your executive compensation disclosure for the required

shareholder advisory vote on executive compensation, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact Mark A. Borges. ■

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