

PROFESSORS LUCIAN A. BEBCHUK AND ROBERT J. JACKSON, JR.
COMMENTARY ON “SAY ON PAY” RULES

October 11, 2010

United States Securities and Exchange Commission
100 F Street, Northeast
Washington, D.C. 20549-1090
Attention: Ms. Elizabeth M. Murphy, Secretary
Via Electronic Mail

Dear Ms. Murphy:

We are submitting this letter in response to the Commission’s invitation for preliminary comments on the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”) addressing executive compensation. In particular, we understand that the Commission intends shortly to adopt preliminary rules under Section 951 concerning the frequency of “say on pay” votes. We write to comment on this issue.¹

Both of us are academics who have researched and written on executive compensation and corporate governance.² We write solely in our individual capacities; the institutional affiliations listed below are provided for identification purposes only.³

In light of the short timeframe in which the Commission is adopting these proposed rules, we have limited these comments to two issues raised by Section 951. (We may provide additional reactions after rules are formally proposed.) In these preliminary comments, we suggest that the Commission’s rules:

- Provide a **default rule to govern in the absence of a shareholder majority** on any resolution concerning “say on pay” frequency; and
- Provide that resolutions concerning “say on pay” frequency may be brought to a vote more frequently than is mandated by the Act, and that **both the issuer and shareholders may offer such resolutions** in each annual proxy statement.

Default Rules on “Say on Pay” Frequency

Section 951 of the Act amends Section 14 of the Securities Exchange Act of 1934 to require that certain issuers provide shareholders with a “vote to approve the compensation of

¹ In a separate letter filed today, Professor Jackson provides comments in advance of the Commission’s preliminary rulemaking with respect to shareholder votes on “golden parachutes” under Section 951.

² One of us testified before the House Financial Services Committee in support of legislation concerning shareholder “say on pay” votes. See *Empowering Shareholders on Executive Compensation: Hearing Before the H. Comm. on Fin. Servs.*, 109TH CONG. (2007) (testimony of Lucian A. Bebchuk, William J. Friedman and Alicia Townshend Friedman Professor of Law, Economics, and Finance, Harvard Law School).

³ Although Professor Jackson recently served as an advisor to senior officials at the Department of the Treasury on matters related to executive compensation, and Professor Bebchuk recently served as an advisor to the Office of the Special Master for TARP Executive Compensation, the views reflected in this letter are solely our own.

executives” as disclosed pursuant to the Commission’s rules. As amended, Section 14A(a)(1) requires that such a vote be held “[n]ot less frequently than once every 3 years.” Section 14A(a)(2) separately requires that, “[n]ot less frequently than once every 6 years,” shareholders must be permitted to vote on “a separate resolution” “to determine whether [approval votes] will occur every 1, 2, or 3 years.”

Commentators have so far given the Commission widely varying advice on the frequency vote, for example with respect to the appropriate form of resolutions on this question.⁴ We focus instead on a different, and in our view important, question: What should firms do if a majority of shareholders do not support any resolution concerning “say on pay” frequency brought for a vote under Section 951?

In our view, the Commission’s rules should ensure that, *in the absence of a shareholder majority for any resolution establishing the frequency of “say on pay” votes, firms must provide shareholders with an annual “say on pay” vote.* As we explain below, some default rule will be necessary in the event that no frequency alternative is supported by a majority of shareholders, and in selecting this default the Commission should focus on which default rule would best protect the interests of shareholders and serve the purposes of Section 951.

First, a default rule will be needed for cases in which none of the three frequency alternatives is supported by a majority of shareholders. Particularly during the 2011 proxy season, this may be a frequent outcome, as both issuers and shareholders adjust to this novel, and unanticipated, voting procedure. Thus, even the Commission’s preliminary rules should provide a default rule in the event that a frequency vote does not produce a single outcome with the support of a majority of shareholders.

Second, when choosing a default rule, the Commission should consider the fact that, as a practical matter, it is substantially more difficult for shareholders to reverse an arrangement that is disfavored by management than to reverse one favored by management.⁵ If the default rule chosen by the Commission is not the rule that shareholders favor in a particular case, the switch to the rule that shareholders prefer for a particular company is more likely to occur when the switch is also favored by management.

Management can be expected to initiate and bring to a shareholder vote a resolution to switch from the default arrangement to the one preferred by shareholders only when management also favors the switch. We would not, however, expect management to bring a resolution to require more frequent say on pay votes, since these votes subject these decisions to additional shareholder scrutiny. Thus, as long as management has not been able to obtain majority shareholder approval for a resolution establishing less frequent say on pay votes, the Commission’s rules should provide that the firm must conduct an annual say on pay vote.

⁴ Compare, e.g., Letter from the Business Law Section of the American Bar Association to Elizabeth M. Murphy, Sec’y, SEC (Sept. 29, 2010), at 5-6 (suggesting that there is a basis for a number of forms of proposals on say on pay frequency) with Letter from Compensia to Elizabeth M. Murphy, Sec’y, SEC (Oct. 4, 2010) (suggesting that the Commission allow companies to recommend only a choice between two and three years).

⁵ See, e.g., Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 Nw. U. L. Rev. 489, 490-91 (2002) (identifying the asymmetry between the costs of reversing rules that favor corporate insiders and those that favor shareholders); see also Lucian A. Bebchuk & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 Bus. Law. 329, 345 (2010) (applying this insight to the proxy access debate).

It might be argued that, in the absence of a shareholder majority for a particular outcome, management should be able to choose, and follow, its preferred frequency. Those holding this view may contend that, in the absence of a clear shareholder majority for a particular outcome, management might be in the best position to choose the most efficient frequency. We think that this argument overlooks the fact that the interests of management and shareholders may diverge with respect to the frequency of the say on pay vote. Because the vote subjects management's decisions on compensation to heightened scrutiny, management may prefer that this scrutiny be applied less frequently than is in shareholders' interests. Indeed, Section 951 mandates say on pay votes at public firms that have long been free to adopt these votes voluntarily, but have commonly chosen not to do so. Thus, Section 951 itself is based on a recognition that, left free to follow their own preferences, management may prefer to have fewer say on pay votes than is desirable for the protection of investors.

Given this possibility, the Commission's rules should not give management either formal or effective power to determine the frequency of the vote where no resolution setting the required frequency has obtained the support of a majority of shareholders. Instead, the proposed rules should provide that, where a resolution establishing a less frequent vote has not drawn the support of a majority of shareholders, firms must provide shareholders with an annual vote.

Facilitating Shareholder-Initiated Resolutions on "Say on Pay" Frequency

Section 14A(a)(2) provides that a frequency vote must be held "[n]ot less frequently than once every 6 years." The statute expressly leaves open the possibility that a frequency vote may be held more often than every 6 years. As discussed above, there may be cases in which further frequency votes will be needed to ascertain shareholders' preferences. Moreover, and importantly, the desirable frequency for any particular firm's shareholders may change over time. During the six-year period following the passage of a frequency resolution, a change in circumstances may make it desirable to change the frequency of the say on pay vote.

Thus, the Commission's proposed rules should explicitly address whether frequency resolutions may be brought more frequently than once every six years. In particular, the Commission's rules should *expressly permit proposals in each annual proxy, by both management and shareholders, concerning the frequency of say on pay votes.*

Specifically, shareholders' ability to offer such proposals could continue to be governed by Rule 14a-8.⁶ The Commission's proposed rules under Section 951 should make clear that, like management, shareholders will be permitted to place on the proxy proposals related to the frequency of the say on pay vote subsequent to the proposals required to be included in 2011 under Section 14A(a)(3)(B). The Commission should make clear that any such proposals will not be excludable pursuant to any of the exceptions to Rule 14a-8.

Of course, to make votes on management or shareholder proposals to change the prevailing arrangement on say on pay frequency at a particular company meaningful, the Commission's rules should make clear that, notwithstanding any previous vote, a subsequent proposal adopted by a majority of shareholders will govern the frequency of say on pay votes in the future. Thus, the rules should make clear that, whether or not a subsequent proposal is offered by management or shareholders, if such a proposal is supported by a majority of

⁶ See Shareholder Proposals, 17 C.F.R. § 240.14a-8 (2010).

shareholders, that proposal will supersede prior votes and will govern the frequency of future say on pay voting.

It may be argued that Section 951's statutory language counsels against this outcome. In particular, Section 14A(a)(3)(B) provides that the votes required in 2011 will "*determine* whether votes . . . will occur every 1, 2, or 3 years." Thus, it might be argued, once the appropriate frequency is determined, it may not be altered again until the 6-year term specified in Section 14A(a)(2) has expired. This argument, however, is inconsistent with the explicit language of the statute. Section 951 could, for example, have required firms to hold a vote on say on pay frequency in 2011 and, following that vote, every six years thereafter. Instead, by specifying that resolutions concerning frequency be brought to a vote "[n]ot less frequently than once every 6 years," Section 951 clearly contemplates that such resolutions may be brought before shareholders more frequently than once every 6 years.

The Commission's rules should make clear that, during the 6-year period until another frequency resolution must be brought to a vote, shareholders (using Rule 14a-8), and not only management, may bring such resolutions to a vote.

* * * *

We appreciate the opportunity to provide comments in advance of the Commission's proposal of rules on "say on pay" frequency under Section 951 of the Act. If further discussion of these matters could be useful to the Commission or the Staff, we would be pleased to have such discussions, and we may be reached at the telephone numbers listed below.

Lucian A. Bebchuk

Robert J. Jackson, Jr.

William J. and Alicia Townshend Friedman
Professor of Law, Economics, and Finance
Harvard Law School
(617) 495-3138

Associate Professor of Law
Columbia Law School
(212) 854-0409

cc: Mary L. Schapiro, Chairman
Luis A. Aguilar, Commissioner
Kathleen L. Casey, Commissioner
Troy A. Paredes, Commissioner
Elisse B. Walter, Commissioner
Meredith Cross, Director, Division of Corporation Finance
Thomas J. Kim, Chief Counsel and Associate Director, Division of Corporation Finance