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SEC Proposes Rules on Required Say-On-Pay and Golden Parachute Votes

New Votes Required for Meetings Beginning January 21, 2011

The Dodd-Frank Wall Street Reform and Consumer Protection Act[1], signed into law in July 2010, will require public companies to put specific matters to their stockholders for non-binding, advisory votes as early as January 2011.

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Public companies will need to ask their stockholders:

- to approve their executive compensation, no less frequently than once every three years ("*say-on-pay*");
- to indicate how frequently – every one, two or three years – they would like to see the say-on-pay vote reoccur ("*say-on-frequency*"); and
- to approve any so-called "golden parachute" arrangements with executive officers of either party to an acquisition transaction, to the extent not previously approved, whenever they seek stockholder approval of the transaction.

On October 18, 2010, the SEC proposed rules[2] addressing say-on-pay, say-on-frequency and golden parachute votes. The proposed rules remove some obstacles that existing proxy rules would impose on such votes, provide for supplemental disclosure, and provide transitional guidance. Under the Dodd-Frank Act, the say-on-pay and say-on-frequency votes are required at any annual or special meeting held on or after January 21, 2011 for which executive compensation disclosure is required, regardless of whether the SEC has promulgated final rules. The golden parachute disclosure and voting provisions, in contrast, will not take effect until the rules are final.

While the rules are only in proposed form at this stage, public companies should understand how both the statute and the likely rules will apply to their upcoming annual meeting season. There is not likely to be much time, if any, between the final rules and the mailing date for many proxy statements in which the new disclosure and stockholder votes are required. Public comments on the proposals are due November 18, 2010.

Say On Pay

Proposed new Rule 14a-21(a) addresses the required say-on-pay vote. It applies to annual meetings of issuers with a class of security registered under Section 12 of the Exchange Act whose shareholders will be solicited to grant proxies for the election of directors, or at special meetings in lieu of such an annual meeting. Shareholders will need to vote at least once every three years whether to approve the compensation of the company's executives, beginning with the first meeting for the election of directors held on or after January 21, 2011.

The proposed rules do not prescribe language to be used in the shareholder resolution. Companies are free to develop their own proposal language. A number of companies, including those required to do so under the TARP program, are already seeking approval of analogous stockholder resolutions.[3] The SEC proposing release makes clear that the resolution must cover all executive compensation disclosure – the Compensation Discussion and Analysis ("*CD&A*"), the compensation tables, and related narrative disclosure. If golden parachute payments are disclosed, as described below, the vote would likewise cover those payments. A proposal on a different matter, such as to approve only compensation policies and procedures (which is the formulation some companies have used in the past), would not satisfy the requirement.

Director compensation is not subject to a say-on-pay vote. Likewise, if a company makes disclosure relating to its compensation policies and practices as they relate to risk management[4], that disclosure will not be covered by the vote. However, if risk management is a material part of the company's compensation policies, those considerations would need to be discussed in the company's CD&A and so would be covered by the say-on-pay vote.

Say On Frequency

The Dodd Frank Act requires companies to put a say-on-pay vote to its stockholders not less frequently than once every three years. Once every six years, beginning with the first meeting on or after January 21, 2011, companies need to solicit the views of stockholders on how frequently – once every year, two years or three years – the company should include the say-on-pay vote in its proxy statement.

This say-on-frequency vote thus will offer four options to stockholders: they can express a preference for one year, two year or three year voting frequency, or they can abstain. The proposed rules do not prescribe specific language.

Current SEC rules governing the form of proxy require that, other than in the election of directors, stockholders be given the choice between approval of, disapproval of, or abstention from each separate matter.[5] Since the say-on-frequency vote is an expression of preference among three alternatives, and not approval or disapproval of management's recommendation, the SEC has proposed technical changes to Rule 14a-4 that will accommodate the say-on-frequency vote in the form of proxy. Company boards nevertheless may, and in many cases will, make recommendations as to which of the options they recommend.

Effect of Votes

Each of the stockholder votes addressed by the proposed rules are advisory votes and are not binding on a company or its board of directors. Specifically, all of the votes required by Section 951 of the Dodd-Frank Act, comprising the say-on-pay and say-on-frequency votes and the golden parachute votes described below, may not be construed as overruling a decision by the company or its board or as creating or implying any change in fiduciary duties or any additional fiduciary duties.[6]

Because of their advisory nature, the proposed rules do not specify under what voting standard the results should be evaluated (other than, as proposed, to determine whether say-on-pay proposals have been substantially implemented for purposes of excluding a stockholder proposal under Rule 14a-8, discussed in more detail below). Because of their advisory nature, any voting standards for stockholder approval set forth in state law, charters, bylaws or stock exchange rules should not apply, and as a general matter no bylaw amendments relating to stockholder voting standards should be required (although such amendments could be considered).

Separate from the non-binding nature of the voting, however, is the question of how to interpret the results. It may not be clear from a substantial "no" vote on say-on-pay what the nature of the stockholders' objection is, including whether it was disclosure-based or substantive, or if indeed the stockholders generally shared the same objection, in each case absent meaningful dialogue with major stockholders. In a say-on-frequency vote, if 40% of the stockholders express a preference for annual voting, while 30% vote in favor of each of biannual and triennial voting, a plurality has voted in favor of annual votes, yet at the same time a clear majority has expressed a preference not to vote every year. It will be up to each company and its board to interpret the results of a vote in light of the votes cast and external feedback. In doing so, companies should be mindful of the positions taken by proxy advisory firms and institutional investors on implementation of stockholder preferences.[7]

Disclosure Changes

Disclosure of Effect of Vote. In a new Item 24 to Schedule 14A, companies will need to disclose in the proxy statement that they are providing any such vote as required under the statute and briefly explain the "general effect" of the vote, including "whether each such vote is non-binding." This requirement is presumably meant to elicit a statement that the vote *is* non-binding, by statute, and at least a general statement focusing on how the company will consider the results of a vote. Similar language is used in the disclosure rules applicable to TARP companies.

CD&A Disclosure. A company's CD&A is intended to outline its overall compensation philosophy, policies and practices, and to provide context to the disclosure in the compensation tables. The proposed rules will add a requirement that the company discuss in the CD&A whether, and if so how, it has considered the results of previous say-on-pay votes in determining compensation policies and decisions, and how that consideration has affected its compensation policies and decisions. As proposed, this disclosure would be required regardless of materiality.

Forms 10-K and 10-Q. Following any say-on-frequency vote, the proposed rules would require a company to disclose its decision, in light of the results of that vote, as to how frequently over the next 6 years it will submit a say-on-pay vote. As proposed, this disclosure will be included in the Form 10-Q relating to the quarter in which the stockholder meeting is held (or, in the case of the fourth quarter, the Form 10-K). We believe that this raises issues regarding the ability of boards to have time to formulate a considered response to the stockholder vote and expect this issue to be identified in comments to the SEC.

No Preliminary Filing Requirement

Under existing rules, a company mailing a proxy statement including a say-on-pay or say-on-frequency proposal would need to file a preliminary proxy statement with the SEC no later than 10 days in advance of mailing. The proposed rule changes will add the say-on-pay and say-on-frequency votes to the enumerated list of proposals that, by themselves, will not trigger a preliminary proxy filing requirement.[8]

Rule 14a-8 Changes

The Dodd-Frank Act specifically provided that the votes required under Section 951 of that Act will not restrict or limit the ability of any stockholder to make proposals related to executive pay for inclusion in a company's proxy statement under Rule 14a-8. The SEC is nevertheless proposing changes to Rule 14a-8 that would permit a company to exclude a shareholder proposal relating to an advisory vote on executive compensation, or to the frequency of say-on-pay votes, provided the company has adopted a policy on the frequency of say-on-pay votes consistent with the plurality of votes cast in the most recent say-on-frequency vote. If those conditions are met, the company would be able to exclude the proposal on the grounds that it has been "substantially implemented" under Rule 14a-8(i)(10). As a practical matter, in light of the new required votes, stockholder proposals under Rule 14a-8 on executive compensation matters are likely to become infrequent. Questions are likely to be raised in comments to the SEC whether applying the plurality standard is the best approach to determining substantial implementation, since the meaning of a vote may be subject to various interpretations as noted above.

Broker Discretionary Voting

Under Section 957 of the Dodd-Frank Act, national securities exchanges were required to amend their rules to prohibit discretionary broker voting of uninstructed shares on say-on-pay or say-on-frequency proposals. This is consistent with the general trend toward greater restrictions on discretionary voting on matters that have previously been considered routine (e.g., director elections). The SEC is considering uninstructed voting as part of a wider review of proxy "plumbing",[9] but most observers do not expect SEC action in the area for some time. Companies should be aware that the absence of uninstructed voting on say-on-pay votes will likely lead to a lower stockholder response rate, especially among retail voters who may be apathetic on the matter or who may support the board's recommendation without realizing that their broker is not voting their shares.

Effect on TARP Issuers

Companies that are currently required to hold annual say-on-pay stockholder votes under the federal government's TARP program will not be required to hold an additional say-on-pay vote under new Rule 14a-21, or to hold a say-on-frequency vote, until the first meeting after which they have repaid their TARP indebtedness.

Effect on Smaller Companies

The Dodd-Frank Act gave the SEC the authority to exempt classes of issuers from the new rules. In the past, the SEC has often elected to exempt smaller reporting companies from certain requirements (such as certain executive compensation disclosures) or to defer the implementation of other rules for smaller companies (such as the currently stayed rules on proxy access). However, the SEC has elected not to propose any exemption or deferral for smaller companies under the say-on-pay, say-on-frequency or golden parachute rules, noting that the advisory votes and related disclosures proposed will be material to investors in all companies, including smaller companies.

Smaller reporting companies are still exempt from the CD&A disclosure requirements, of course, and can provide more streamlined executive compensation tables, so a say-on-pay advisory vote for a smaller reporting company will cover the compensation described under the rules applicable to it. Smaller companies that voluntarily provide a CD&A and enhanced disclosure should presumably formulate a vote that covers the more comprehensive disclosure.

Transitional Rules for Upcoming Meetings

Some companies may find themselves filing preliminary or definitive proxy statements for meetings to be held on or after January 21, 2011, but before the effective date of the final SEC rules. Companies with August 31 and September 30 fiscal years in particular may find themselves with annual meetings for the election of directors scheduled for late January or February. These companies will typically mail their definitive proxy materials at least a month before their meetings. The SEC has issued transitional guidance that will apply pending the adoption of final rules:

- The SEC will not object if issuers do not file preliminary proxy materials prior to the adoption of final rules if the only matters that would require the filing of preliminary materials are the say-on-pay and say-on-frequency proposals.
- The SEC will not object if issuers include a say-on-frequency vote offering a choice of one, two or three year intervals for say-on-pay votes, or abstaining from voting, notwithstanding the current language of Rule 14a-4.
- If proxy service providers are unable to complete the system programming necessary to accommodate four voting options under a say-on-frequency vote, the SEC will not object if a form of proxy provides only three boxes, offering one, two and three year options, so long as proxies are not voted if a stockholder does not check any box (rather than being voted in the proxyholder's discretion, as would usually be the case for unmarked items).

Of course, to the extent feasible, companies with meetings otherwise scheduled for late January may benefit from moving the meeting forward, to January 20, 2011 or earlier, in order to avoid the need to include a say-on-pay and say-on-frequency proposal at all this year.

Disclosure and Shareholder Approval of Golden Parachute Arrangements.

Under the Dodd-Frank Act, all persons making a proxy or consent solicitation seeking shareholder approval of an acquisition transaction will be required to provide disclosure of any agreements or understandings that the company has with named executive officers of the company or with the named executive officers of the acquiring company (if the soliciting company is the target company) concerning any type of compensation that is "based on or relates to" the transaction.[10] Further, the proposed rules would require companies to provide a shareholder advisory vote to approve certain golden parachute compensation arrangements in merger proxy statements.

New Item 402(t) Disclosure

The Dodd-Frank Act requires the disclosure to be in a "clear and simple form in accordance with regulations to be promulgated by the Commission" and to include "the aggregate total of all such compensation that may (and the conditions upon which it may) be paid or become payable to or on behalf of such executive officer." While existing rules require disclosures about golden parachute arrangements in annual reports and proxy statements in accordance with Item 402(j) of Regulation S-K, they do not include the detailed requirements for such disclosures that are applicable to proxy or consent solicitations to approve the transaction, as contemplated by the Dodd-Frank Act and the proposed rules. In addition, because golden parachute compensation arrangements may involve agreements between the acquiring company and the named executive officers of a soliciting target company, the proposed rules require this disclosure as well.

Proposed Item 402(t) contains both tabular and narrative components:

- *Tabular Disclosure*. The new table would present quantitative disclosure of the separate elements of compensation that an executive would receive that are based on or otherwise related to the acquisition transaction. These elements would include: cash severance; the dollar value of accelerated equity and payments in cancellation of equity; pension and non-qualified deferred compensation enhancements; perquisites and other personal benefits and health and welfare benefits; 280G tax reimbursements; and any other elements not specifically included in the foregoing. The table would also require separate footnote identification of amounts attributable to "single-trigger" arrangements (*i.e.*, amounts payable solely upon consummation of an acquisition transaction) and amounts attributable to "double trigger" arrangements (*i.e.*, amounts payable only upon a termination of employment following a transaction). The disclosure will not need to cover previously vested equity awards or amounts payable pursuant to bona fide post-transaction employment arrangements with the acquiring company, although such amounts may be disclosable under existing proxy requirements.
- *Narrative Disclosure*. The accompanying narrative disclosure would require issuers to describe any material conditions or obligations applicable to receipt of payment, including but not limited to non-compete, non-solicitation, non-disparagement or confidentiality agreements, their duration, and provisions regarding waiver or breach. In addition, modeled on existing disclosure requirements with respect to termination and change-in-control agreements of Item 402(j) of Regulation S-K, the proposal requires the issuer to provide a description of the circumstances that would trigger payments, the form and manner of the payments, and by whom the payments would be provided.

This golden parachute disclosure also would be required in connection with going-private transactions and third-party tender offers, so that the information is available for shareholders no matter the structure of the transaction.

Shareholder Vote Requirements

Section 951 of the Dodd-Frank Act requires a separate, non-binding shareholders' advisory vote on golden parachute arrangements in connection with an acquisition transaction. Under proposed Rule 14a-21(c), issuers would be required to provide a separate shareholder advisory vote in proxy statements for meetings at which shareholders are asked to approve such a transaction. This vote would be required with respect to golden parachute arrangements required to be disclosed under Item 402(t). However, a vote on arrangements between a target issuer's named executive officers and the acquiring company is not required, even though such arrangements are covered under the proposed disclosure rules.

While the disclosure requirements are extended to third-party tender offer documents and other arrangements outside of the proxy statement context, the shareholder vote on golden parachute arrangements is required only where stockholders are asked to vote to approve an acquisition transaction.

Exemption for Disclosure Subject to a Prior Say-On-Pay Vote

Issuers would not be required to include a separate shareholder vote on golden parachute compensation in the merger proxy if Item 402(t) disclosure of that compensation had been included in the executive compensation disclosure that was subject to a prior say-on-pay vote of shareholders under proposed Rule 14a-21(a). Note that there is no requirement that such arrangements have actually been approved by stockholders, only that they were subject to a vote.

For issuers to take advantage of this exception, however, the executive compensation disclosure subject to the prior say-on-pay vote would need to have included Item 402(t) disclosure of the same golden parachute arrangements. Even if the annual meeting proxy statement provides some disclosure with respect to golden parachute arrangements, the annual meeting proxy statement would need to include the disclosure required by Item 402(t) in order for the annual meeting shareholder vote to satisfy the requirement. The Item 402(t) table in an annual meeting proxy statement would assume that the triggering event took place on the last day of the most recent fiscal year. Issuers should consider whether to voluntarily include Item 402(t) disclosure with their other executive compensation disclosure in annual meeting proxy statements soliciting the shareholder vote required by proposed Rule 14-21(a) so that this exception would be available to the issuer for a potential subsequent merger or acquisition transaction. In some respects, the new disclosure required by proposed Item 402(t) appears to be only incrementally more than what is currently provided under Item 402(j) with respect to change of control transactions generally.

The foregoing exception would only apply to the extent that golden parachute arrangements previously subject to annual meeting shareholder vote remain in effect, and the terms of those arrangement have not been modified. If such arrangements are modified after being subject to a say-on-pay vote, then only the modification would need to be subject to a vote in the merger proxy. Issuers providing for a vote on new or modified arrangements would provide two separate tables under Item 402(t) in merger proxy statements so that shareholders could clearly see what is subject to shareholder vote. Issuers whose change in control arrangements are likely to change over time or in connection with a specific transaction may decide against including such disclosure in an annual meeting proxy statement.

Institutional Investor Reporting

In a separate companion release[11], the SEC also proposed a rule in response to the Dodd-Frank Act requirement that every institutional investment manager subject to Section 13(f) of the Exchange Act report at least annually how it voted on say-on-pay, say-on-frequency and golden parachute votes. Institutional investment managers required to file quarterly reports on Form 13F – generally those exercising investment discretion over accounts holding more than $100 million of publicly traded equity securities – will be required to report annually their voting record on these votes on Form N-PX. The reports will be filed not later than August 31 of each year, for the twelve month period ending June 30 of each year. This is the same timetable on which mutual funds and other registered management investment companies currently report their proxy voting on the same form.

Suggested Actions

- First and foremost, companies should start planning now. The say-on-pay and say-on-frequency requirements apply to meetings beginning January 21, 2011, regardless of the status of final SEC rules.
- Companies should be aware that large institutional investors will be making voting decisions on multiple companies, many of them at about the same time of year. Companies should pay close attention to the executive summary or overview portion of their CD&A, which may be the primary basis on which voting decisions are made.
- Smaller reporting companies that do not include a CD&A in their proxy statements might consider including a general overview of their compensation policies under the say-on-pay proposal or otherwise highlight their case for a vote in support of their compensation in an easy to understand format.
- Boards should consider whether to recommend an interval for the say-on-frequency vote, and if so, what interval they will recommend. Factors to consider may include the tenor of any prior discussions with stockholders over compensation matters, the general nature of the shareholder base, and whether the company has a staggered board (i.e., in a triennial vote the same directors would be up for election at each meeting where a say-on-pay vote is taken, and such directors may not be on the compensation committee). At least some institutional stockholders have suggested that three years is a more appropriate interval, as it suggests a long-term view and gives a company time to address any issues identified through prior votes. Others promote an annual vote to enhance director accountability. What interval will be best for a particular company will depend on a variety of factors and its circumstances.
- Companies should give some thought as to how they will interpret various plausible results. Despite the votes being merely advisory, the new disclosure requirements will require discussion of whether and how the shareholder expressions of preference are being addressed.
- Companies should consider how to implement or improve the effectiveness of their shareholder outreach programs, both before a vote (in order to address any outstanding issues) or after the vote (in order to assist in interpretation of voting results).
- Companies in early stages of merger negotiations today may want to evaluate whether any arrangements with executives will be subject to the golden parachute votes based on likely transaction and rulemaking schedules.
- Companies will want to consider whether to include the more detailed disclosure on golden parachute arrangements in their annual meeting proxy. Factors to consider are whether this would signal (accurately or not) that the company is considering a sale; whether stockholders are more likely to be receptive to such arrangements in hypothetical or real

situations; the degree to which the disclosure to be provided is already presented in the company's proxy statement under Item 402(j); whether a separate vote at the time of a transaction would prove distracting to the goal of attaining stockholder approval of that transaction; and the likelihood that existing arrangements would remain in effect and be implemented without modification in a likely transaction.

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[1] Dodd-Frank Act, Pub. L. No. 111-203 (July 21, 2010). Section 951 of the Act adds a new Section 14A to the Exchange Act of 1934, as amended, covering most of the matters discussed in this alert.

[2] SEC Rel. 33-9153 (Oct. 19, 2010).

[3] A common formulation is: "Resolved, that the shareholders approve the compensation of XYZ Corp's executives, as disclosed pursuant to the compensation disclosure rules of the Securities and Exchange Commission (which disclosure shall include the compensation discussion and analysis, the compensation tables and any related material) in this proxy statement."

[4] See Regulation S-K Item 402(s).

[5] Rule 14a-4(b)(1).

[6] See new Exchange Act Section 14A(c).

[7] RiskMetrics, for example, considers "failure to respond to concerns raised in connection with significant [say-on-pay] proposals" in evaluating board communication and responsiveness, and will recommend withholding votes from compensation committee members (or the board as a whole if appropriate) on a case by case basis if the board fails to respond to concerns raised.

[8] Companies with indebtedness outstanding under the federal government's TARP program are required to submit say on pay proposals annually. Those proposals are already exempted from the preliminary proxy filing requirements under Rule 14a-6(a)(7).

[9] See SEC Concept Release No. 62495 (July 14, 2010).

[10] Under the proposed implementing rules, disclosure would not be required with respect to named executive officers who were not serving as executive officers at the end of the most recent fiscal year.

[11] SEC Rel. 34-63123 (Oct. 18, 2010).

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