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Legal Update
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U.S. Securities and Exchange Commission Adopts Final Say-On-Pay Rules

On January 25, 2011, the Securities and Exchange Commission (SEC) issued Release Nos. 33-9178; 34-631768, “Shareholder Approval of Executive Compensation and Golden Parachute Compensation,”[1] adopting regulations to implement advisory votes giving shareholders:

- A “say-on-pay” vote for executive officer compensation
- Input on the frequency of such say-on-pay vote
- A say-on-pay vote for “golden parachutes” in the context of change-in-control transactions

The rules also contain golden parachute disclosure requirements. The say-on-pay rules are required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[2]

Say-On-Pay

New Rule 14a-21(a) under the Securities Exchange Act of 1934 (Exchange Act) requires a separate advisory vote on executive compensation at least once every three calendar years. The vote must relate to all named executive officer compensation (rather than director or other employee compensation) that is disclosed pursuant to Item 402 of Regulation S-K.

Rule 14a-21(a) does not specify the form or language of the approving resolution, but an instruction to the rule specifies that the registrant’s resolution shall indicate that the advisory vote is to approve compensation of the named executive officers as disclosed pursuant to Item 402 of Regulation S-K and provides the following non-exclusive example of a resolution that satisfies the requirements of this rule:

> RESOLVED, that the compensation paid to the company’s named executive officers, as disclosed pursuant to Item 402 of Regulation S-K, including the Compensation Discussion and Analysis, compensation tables and narrative discussion is hereby APPROVED.

In addition, when a say-on-pay vote is on the agenda, new Item 24 of Schedule 14A under the Exchange Act requires issuers to disclose that they are providing a separate shareholder vote on executive compensation and to explain the general effect of the say-on-pay vote, such as whether the vote is non-binding.

Issuers must address in their Compensation Discussion and Analysis (CD&A) whether, in determining their compensation policies and decisions, they have considered the results of the most recent say-on-pay vote required by either the Dodd-Frank Act or, for companies that have received financial assistance under the Troubled Asset Relief Program (TARP), Rule 14a-20 under the Exchange Act. Companies that have considered the results of such advisory votes must describe in their CD&A how that consideration has affected their compensation policies and decisions. This new CD&A requirement does not cover say-on-pay votes submitted as shareholder proposals pursuant to Rule 14a-8 under the Exchange Act, or as proposals that were previously submitted voluntarily by issuers. Accordingly, for most issuers this disclosure requirement will not apply until next proxy season.

Frequency Vote

New Rule 14a-21(b) requires issuers to provide a separate advisory vote at least once every six calendar years to determine whether shareholders want the say-on-pay vote for executive compensation to occur every one, two or three years. When a frequency vote is on the agenda, Item 24 of Schedule 14A requires issuers to disclose in their proxy statements that this advisory vote is occurring, and to explain the general effect of the frequency vote, such as whether the vote is non-binding. Because the frequency vote is advisory, the say-on-pay rules do not prescribe a standard for determining which frequency has been "adopted."

When neither an advisory vote on executive compensation nor a frequency vote is on the agenda, Item 24 requires issuers to specify in their proxy statements the current frequency of say-on-pay votes and when the next say-on-pay vote will occur.

Rule 14a-4 under the Exchange Act has been amended to require issuers to provide four choices for the frequency vote on their proxy card: one year, two years, three years or abstain. While the SEC expects that the many boards of directors will provide recommendations as to how frequently shareholders should vote on executive compensation, proxy cards cannot be set up as approving or disapproving of the issuer's recommendation. If a company chooses not to make a recommendation as to frequency, it will not be able to vote uninstructed proxy cards. As a transitional matter, if a proxy service provider is unable to program its services to accommodate four choices, the SEC will not take action if shareholders are provided only the choice of one-, two- or three-year frequencies (without the abstention choice), as long as shares are not voted in cases where the shareholder did not select one of these three choices.

Say-On-Pay/Frequency Vote Timing

The Dodd-Frank Act required that proxy statements, whether in preliminary or definitive form, for the first annual meeting (or other meeting in which executive compensation disclosure is required in the proxy statement) taking place on or after January 21, 2011 include separate advisory resolutions for shareholders to approve executive compensation and the frequency of say-on-pay votes, even if final SEC regulations are not yet effective by the date the proxy statement is filed. Therefore, although the SEC's final say-on-pay rules technically become effective 60 days after they are published in the *Federal Register*, the final say-on-pay and frequency vote rules should be treated as though they are immediately effective.

Form 8-K

An issuer must include the results of its say-on-pay and frequency votes (detailing the number of votes for each of the alternatives on the proxy card) on the Form 8-K it files pursuant to Item 5.07(b) within four business days after its annual shareholders meeting to report its voting results. In addition, pursuant to new paragraph (d) of Item 5.07 of Form 8-K, the issuer must amend the Form 8-K in which it reported its voting results to disclose its decision as to how frequently its proxy material will include a shareholder vote on the compensation of executives before the next required vote on say-on-pay frequency. This amendment must be filed no later than 150 calendar days after its annual shareholders meeting, but at least 60 calendar days prior to the company's deadline for submission of shareholder proposals under Rule 14a-8. This is a change from the proposed rules, which would have required companies to provide this information in the Form 10-Q for the period in which the vote occurred (or on a Form 10-K for meetings held in the fourth quarter).

No Preliminary Filing

Rule 14a-6(a) under the Exchange Act has been amended so that preliminary proxy filing requirements are not triggered by any shareholder advisory vote on executive compensation or by the frequency vote. As a transitional matter, the adopting release indicates that the SEC will not take action if, before the final rules become effective, companies do not make preliminary filings for proxy statements with say-on-pay proposals or frequency proposals, so long as a preliminary filing is not required as a result of some other proposal contained in the proxy statement.

Shareholder Proposals

Rule 14a-8(i)(10) allows an issuer to exclude from its proxy statement a shareholder proposal to the extent that the proposal has been substantially implemented. A note has been added to this rule to clarify the status of shareholder proposals requesting either advisory votes on executive compensation or frequency of say-on-pay votes. This note specifies that a company may exclude such shareholder proposals as substantially implemented if in the most recent frequency vote required by Rule 14a-21(b) one of the specified intervals (i.e., one, two or three years) received approval of a majority of votes cast on the matter and the company has adopted a policy on the frequency of say-on-pay votes that is consistent with the choice of the majority of votes cast in the most recent frequency vote. This represents a change from rules which the SEC initially proposed, which based such policy on the frequency receiving a plurality of the votes cast.

Golden Parachute Disclosure

The SEC has adopted new Item 402(t) of Regulation S-K. With respect to each named executive officer of the acquiring company and the target company, Item 402(t) requires disclosure of agreements or understandings, whether written or unwritten, between each such named executive officer and the acquiring company or the target company concerning any type of compensation, whether present, deferred or contingent, that is based on or otherwise relates to an acquisition, merger, consolidation, or sale or other disposition of substantially all of the assets of the issuer. If contained in a transactional proxy statement, this disclosure must be provided with respect to each executive officer for whom disclosure was required in the issuer's most recent SEC filing that required a Summary Compensation Table. The golden parachute disclosure needs to be presented in both tabular and narrative formats.

New Item 402(t) is in addition to the existing potential payments upon termination or change-in-control disclosure requirement of Item 402(j) of Regulation S-K, which the SEC determined was not sufficient to satisfy the Dodd-Frank Act mandate. For example, in contrast to Item 402(j), new Item 402(t) requires disclosure concerning the value of arrangements that do not discriminate in favor of executive officers and are available generally to all salaried employees.

Item 402(t) requires a new Golden Parachute Compensation Table in order to present quantitative disclosure of the aggregate dollar value of the following individual elements of golden parachute compensation, as well as total dollar values:

- Cash severance payments (e.g., base salary, bonus and pro-rata non-equity incentive plan payments)
- Accelerated stock awards, in-the-money option awards for which vesting would be accelerated, and payments in cancellation of stock and option awards
- Pension and nonqualified deferred compensation benefit enhancements
- Perquisites and other personal benefits and health and welfare benefits

- Tax reimbursements (e.g., tax gross-ups)
- "Other" additional elements of compensation not otherwise specifically includable

If the golden parachute disclosure is included in a proxy statement for a transaction in which shareholders are to receive a fixed dollar amount per share, golden parachute dollar amounts that are based on stock price must be quantified using that fixed dollar amount. However, if the transaction does not provide for a fixed dollar amount per share, dollar amounts that are based on stock price must be calculated using the average closing market price of the registrant's securities over the first five business days following the first public announcement of the transaction. If the golden parachute disclosure is in an annual proxy statement, dollar amounts that are based on stock price must be based on the closing market price on the last business day of the most recently completed fiscal year.

If there are golden parachute arrangements between the acquiring company and the named executive officer of a soliciting target company, an additional Golden Parachute Compensation Table is required to clarify which compensation is the subject of the golden parachute advisory vote, if such compensation is different from the full scope of the golden parachute disclosure.

Compensation has to be disclosed under Item 402(t) only to the extent that the compensation is based on, or otherwise relates to, the transaction. Separate quantification of the compensation disclosed in the Pension Benefits Table or the Nonqualified Deferred Compensation Table is not needed, nor is there a requirement to disclose previously vested equity awards. The golden parachute disclosure does not have to include post-transaction employment agreements, although such agreements may trigger separate disclosure requirements (e.g., if the future employment agreement constitutes a "substantial interest" in the matter to be voted upon).

The golden parachute narrative disclosure must identify the specific circumstances that would trigger payment. This disclosure has to state whether the payments would (or could) be lump sum or annual, and has to specify the duration of the payments and by whom they would be provided. The narrative must describe any material conditions or obligations applicable to the receipt of payment or benefits, including but not limited to non-compete, non-solicitation, non-disparagement or confidentiality agreements, including the duration of such agreements and provisions regarding waiver or breach.

The golden parachute disclosure requirement is not limited to transactions requiring proxy statements or a golden parachute advisory vote. To make the disclosure applicable regardless of the form of the extraordinary transaction, the SEC also requires the Item 402(t) disclosure in:

- Information statements filed pursuant to Regulation 14C
- Proxy or consent solicitations that do not contain merger proposals but require disclosure of information under Item 14 of Schedule 14A pursuant to Note A of Schedule 14A
- Registration statements on Forms S-4 and F-4 containing disclosure relating to mergers and similar transactions
- Going private transactions on Schedule 13E-3

Unless the transaction is also a going private transaction, bidders in third-party tender offers do not have to provide the golden parachute disclosure. Target companies will have to provide such information in their Schedule 14D-9. There is an exception for agreements and understandings with senior management of a foreign private issuer.

Golden Parachute Advisory Vote

New Rule 14a-21(c) requires a separate advisory vote on golden parachute compensation in proxy statements for meetings where shareholders are asked to approve an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all of the assets. This advisory vote is needed with respect to compensatory agreements or arrangements that are required to be disclosed pursuant to Item 402(t) of Regulation S-K. As with the executive compensation say-on-pay vote, the rule does not require issuers to use any specific language or form of resolution. A golden parachute shareholder vote is also non-binding.

A golden parachute advisory vote is not required if the compensation was the subject of a prior executive compensation say-on-pay vote, regardless of whether the shareholders approved such compensation. In order to use this exception, however, the proxy statement for the prior say-on-pay vote must have included the golden parachute disclosure required by Item 402(t) of Regulation S-K. Accordingly, some issuers may choose to voluntarily include that disclosure in their annual meeting proxy statements when obtaining an executive compensation say-on-pay vote.

The exception for a prior say-on-pay vote is only available to the extent that the same golden parachute arrangements are in effect without modification. New or revised arrangements, including those resulting from ordinary course equity awards and salary increases, remain subject to a golden parachute advisory vote. In such a circumstance, two separate Golden Parachute Compensation Tables would be required. One table would disclose all golden parachute compensation while a second table would disclose only the new or revised arrangements that are subject to a vote.

Golden Parachute Timing

Companies must comply with the golden parachute disclosure and golden parachute say-on-pay requirements in proxy statements and other schedules and forms initially filed on or after April 25, 2011.

TARP Companies

Companies that have received financial assistance under TARP will continue to provide annual say-on-pay votes under Rule 14a-20 as long as TARP indebtedness is outstanding. Therefore, during such period, they will not also have to conduct an additional say-on-pay or frequency vote under Rule 14a-21. TARP companies are required to include CD&A disclosure of how the result of a previous say-on-pay vote impacted executive compensation policy and decisions. The proxy statement for the first annual meeting after TARP indebtedness has been fully repaid is required to contain the say-on-pay and frequency votes required by Rule 14a-21.

Smaller Reporting Companies

The SEC has granted a two-year exemption for smaller reporting companies so that they will not have to conduct the advisory vote on executive compensation until their first annual meeting (or other meeting at which directors are to be elected and executive compensation is to be disclosed) occurring on or after January 21, 2013. This temporary exemption for smaller reporting companies does *not* apply to shareholder advisory votes on golden parachute compensation.

When the two-year exemption expires, smaller reporting companies will need to comply with most of the disclosure requirements related to executive compensation say-on-pay and frequency votes. However, because such companies do not have to provide a CD&A, the amendments to the CD&A requiring discussion of the impact of the most recent say-on-pay vote on compensation decisions and policies will not apply to them. If consideration of such an advisory vote is material, it should be addressed in the narrative that accompanies the Summary Compensation Table.

No Broker Discretionary Voting

Brokers are not permitted to vote uninstructed shares in the say-on-pay vote or the frequency vote or in connection with merger or acquisition transactions.

Practical Considerations

- Companies should thoughtfully develop the rationale they will provide shareholders to encourage votes in support of their executive compensation policies. While this can be included directly in the say-on-pay proposal, many companies will rely on the CD&A to provide the framework for why executive compensation should be approved. To this end, many companies will be drafting new or revised executive summaries for their CD&A to clearly emphasize the rationale for their compensation decisions and demonstrate their efforts to tie compensation to performance.
- Companies should consider whether to include statements in support of approving executive compensation directly in the section of the proxy statement describing the say-on-pay proposal. Even where a company includes an executive summary in the CD&A, it may be worthwhile for the company to include some discussion of the specific reasons why the company recommends that executive compensation be approved in the section of the proxy statement containing the say-on-pay proposal, especially if it has a large retail shareholder base.
- Because brokers may not vote uninstructed shares on say-on-pay or frequency vote proposals, companies may want their investor relations departments and/or proxy solicitors to actively reach out to large shareholders to garner support for these agenda items.
- The CD&A will need to discuss how compensation decisions were impacted by the result of the say-on-pay advisory votes required by either Rule 14a-21 or Rule 14a-20. TARP public companies will need to prepare that disclosure for their upcoming CD&A sections. Other public companies should consider whether to voluntarily address this question in advance of this year's advisory vote if they know how the compensation committee intends to take the say-on-pay vote into account.
- Companies should check if their voting tabulators can process four choices for the frequency vote proposal on the proxy card, as contemplated by the SEC. Where this procedure cannot be accommodated, companies should implement a policy that precludes voting undirected proxy cards on any of the frequency proposal options.
- Companies should determine what frequency of say-on-pay vote, if any, they will recommend to shareholders. There is already a precedent-base of companies that have filed preliminary or final proxy statements before the SEC's final say-on-pay rules were adopted. A large number of these companies have recommended that the say-on-pay vote be held at three-year intervals, reflecting the fact that performance is typically measured over a multi-year period. On the other hand, quite a few early filers have recommended annual say-on-pay votes. A rationale given for the one-year recommendation is that compensation is disclosed annually. Behind these annual recommendations may also be a belief that an annual say-on-pay vote will make this advisory vote appear routine to investors, in much the same way as accountant ratification, and that an annual vote will provide an outlet for shareholders to express disapproval over compensation practices without voting against members of the compensation committee, or other directors, who are up for re-election. ISS is recommending that its proxy advisory clients vote in favor of an annual frequency. Companies that hold their shareholder meetings later in the season may want to consider the frequency vote results of

companies whose meetings are held earlier when deciding on their recommendation.

- Companies may want to adopt a policy on the frequency of say-on-pay votes that is consistent with a majority of votes cast in the most recent shareholder vote in order to be able to exclude shareholder proposals for say-on-pay or say-on-pay frequency from their proxy statements in the future. However, such a policy can be adopted after the results of the vote are known.
- Newly public companies must conduct say-on-pay and frequency votes at their first annual meeting following their initial public offerings.
- Because a golden parachute advisory vote is not needed at the time of a transaction if the compensation was subject to a prior say-on-pay advisory vote, some public companies may want to expand their potential termination compensation disclosure in their annual proxy statements so that it also complies with the new golden parachute disclosure requirements set forth in Item 402(t) of Regulation S-K. Companies considering this should note that if subsequent changes are made to these arrangements prior to a transaction, those changes will be highlighted by the inclusion of a separate table in the proxy statement for the subsequent transaction and will be subject to a golden parachute advisory vote. For this and other reasons, we believe that issuers may not find incorporation of the golden parachute disclosure into their annual meeting proxy statements to be a generally valuable procedure.
- ISS has indicated that if the golden parachute table is included in an annual meeting proxy statement, with golden parachute compensation becoming part of the advisory vote on executive compensation, the information in the golden parachute table would carry more weight in ISS's overall say-on-pay recommendation. Therefore, it is possible, depending on the nature of the golden parachute compensation disclosed, that incorporating the golden parachute advisory vote into the advisory vote on executive compensation could negatively influence ISS's recommendation on the company's say-on-pay vote.
- Companies should consider adding a disclosure control regarding the need to file an amendment to their voting results Form 8-K to disclose their chosen say-on-pay frequency by the deadline of 150 days after their annual meeting and at least 60 calendar days before the Rule 14a-8 deadline for shareholder proposals. If desired, the Form 8-K disclosure regarding how frequently say-on-pay advisory votes will be conducted may be included in the earlier filed Form 8-K reporting voting results.

Endnotes

1 Available at http://www.sec.gov/rules/final/2011/33-9178.pdf.

2 For more information about the Dodd-Frank Act, see our July 21, 2010 Legal Update "Corporate Governance and Disclosure Implications of the Dodd-Frank Wall Street Reform and Consumer Protection Act," available at http://www.mayerbrown.com/securities/article.asp?id=9371&nid=10707.

If you have any questions regarding the say-on-pay and golden parachute rules, please contact the author of this Legal Update, Laura D. Richman, at +1 312 701 7304, or any of the lawyers listed below or any other member of our Corporate & Securities group.

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