McDermott Will & Emery

SEC Adopts Final Rules on Say-on-Pay, Say-on-Frequency and Say-on-Parachutes

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The SEC recently adopted final rules regarding shareholder advisory votes on executive compensation , the frequency of say-on-pay votes and golden parachute arrangements. Public companies must provide shareholders with a say-on-pay vote and say-on-frequency vote at the first annual or other meeting of shareholders where directors are elected occurring on or after January 21, 2011. The say-on-parachutes vote and enhanced disclosure of golden parachute compensation will be required for initial filings by all public companies on or after April 25, 2011. While the final rules are similar to the proposed rules understanding the differences will assist in preparing for the 2011 proxy season.

On January 25, 2011, the U.S. Securities and Exchange Commission (SEC) adopted final rules regarding shareholder advisory votes on executive compensation (say-on-pay), the frequency of say-on-pay votes (say-on-frequency) and golden parachute arrangements (say-on-parachutes) under Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Except for certain smaller reporting companies, public companies must provide shareholders with a say-on-pay vote and say-on-frequency vote at the first annual or other meeting of shareholders where directors are elected occurring on or after January 21, 2011. The say-on-parachutes vote and enhanced disclosure of golden parachute compensation will be required for initial filings by all public companies on or after April 25, 2011. The full text of the final rules is available at http://www.sec.gov/rules/final/2011/33-9178.pdf. Proposed rules were issued on October 18, 2010, which was described in a McDermott White Paper available at http://www.mwe.com/info/news/wp1010a.pdf. The final rules are in many respects similar to the proposed rules. Important differences between the proposed rules and the final rules, plus a detailed summary of the final rules are provided below.

Key Highlights

- The final rules with respect to say-on-pay and say-on-frequency become effective 60 days after publication in the Federal Register. Nevertheless, we anticipate many public companies will follow the final rules prior to their effective date.
- Smaller reporting companies (companies with public float of less than $75 million) are not required to provide say-on-pay and say-on-frequency votes until 2013; however, all public companies but must comply with the final rules applicable to say-on-parachutes votes on and after April 25, 2011.
- As expected, public companies will not need to file a preliminary proxy with the SEC due to a say-on-pay or a say-on-frequency vote.

- The SEC provided an example of a resolution that will be considered to comply with the final rules applicable to say-on-pay; no example was provided for the say-on-frequency vote.
- Public companies will generally need to disclose their determination with respect to the frequency of future say-on-pay votes within 150 days after the say-on-frequency vote; this reflects a change from the proposed rules, and we anticipate that many public companies will provide this disclosure well before this deadline.
- If a public company adopts a say-on-frequency policy that reflects a *majority* of the votes cast at the most recent shareholder meeting, then it will be permitted to exclude a subsequent shareholder proposal seeking a more frequent say-on-pay alternative.
- The categories of transactions for which golden parachute disclosure will be required has been expanded to include tender offers and going private transactions but this is just a disclosure requirement since no shareholder vote on the golden parachute arrangements in these transactions is required.
- The final rules will require public companies in future years to address in the Compensation Discussion & Analysis (CD&A) whether, and, if so, how they considered the results of their most recent say-on-pay advisory vote, if any, and how that consideration affected executive compensation decisions and policies.

Background

Section 951 of the Dodd-Frank Act includes three shareholder advisory votes which are covered under the SEC's final rules:

- "Say-on-Pay" Vote – voting on whether to approve the compensation of named executive officers as disclosed under federal securities law
- "Say-on-Frequency" Vote – voting at least once every six years on whether the say-on-pay vote should occur every one, two or three years
- "Say-on-Parachutes" Vote – voting on whether to approve so-called golden parachute compensation in connection with a business combination

None of these shareholder votes is binding on the board of directors or the issuer. The results of a say-on-pay vote or say-on-parachutes vote do not overrule prior decisions and does not increase or change the fiduciary duties of the board of directors.

Say-On-Pay Votes

The SEC has adopted rules under new Section 14A(a) of the Securities Exchange Act of 1934, which requires issuers subject to the federal proxy rules to conduct a shareholder advisory vote on executive compensation, beginning with the first shareholders' meeting taking place on or after January 21, 2011, even if the proxy statement for the meeting has already been filed.

Scope of Say-On-Pay Votes and Voting Procedures

New Rule 14a-21(a) requires public companies, not less frequently than once every three calendar years, to provide a separate shareholder advisory vote to approve the compensation of named executive officers described in their proxy statements for annual or special meetings at which directors are elected. The shareholder vote must relate to all executive compensation disclosed under Item 402 of Regulation S-K, including the CD&A, the compensation tables and other required narrative executive compensation disclosures. Neither the compensation of directors nor the compensation policies and practices related to risk management and risk-taking incentives will be subject to the shareholder advisory vote, unless discussed in the CD&A.

The final rule does not require issuers to use any specific language or form of resolution for the say-on-pay vote, but the instructions to Rule 14a-21 provide the following example of a resolution that would satisfy the requirements of Section 14A(a):

"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."

The final rule does not attempt to address the issue of what counting or approval standard should be applied to a say-on-pay vote (except to remind issuers that, as with any matters that involve "executive compensation" brokers may not vote shares as to which they have not received voting instructions from the ultimate beneficial owners). Public companies should follow the counting and approval standards required by the law of their state of incorporation.

Disclosure Related to Say-On-Pay Votes

The adopted rules add new Item 24 to Schedule 14A, requiring issuers to disclose in their proxy statements that they are providing shareholders an opportunity to cast a say-on-pay vote and to briefly explain the general non-binding effect of the vote. In future years issuers will be required to disclose under Item 24 the current frequency of the say-on-pay votes and when the next say-on-pay vote will occur, a requirement added in response to comments on the proposed rules. The final rules amend Rule 14a-6 to exempt issuers from filing a preliminary proxy statement with the SEC due to the inclusion of a say-on-pay vote.

The final rules amend the list of items that public companies are required to discuss in their CD&As under Item 402(b) of Regulation S-K, to include a discussion as to whether and, if so, how the issuer has considered the results of the most recent say-on-pay vote (as well as prior votes, to the extent material) in determining compensation policies and decisions and how that consideration has affected the issuer's compensation policies and decisions. As a practical matter, the addition of this CD&A disclosure obligation, which was not required by the Dodd-Frank Act, puts pressure on the compensation committee to carefully consider how to respond to say-on-pay votes.

Say-On-Frequency Votes

The SEC has adopted rules implementing the requirement under Section 14A(a) that public companies subject to the federal proxy rules provide their shareholders with an advisory vote on the desired frequency of the say-on-pay votes described above, beginning with the first shareholders' meeting taking place on or after January 21, 2011.

Voting Procedures

New Rule 14a-21(b) requires issuers, not less frequently than once every six calendar years, to provide, in their proxy statements for annual or special meetings at which directors are elected, a separate shareholder advisory vote to determine whether the say-on-pay vote will occur every one, two or three years.

If shareholders return proxy cards without indicating a choice, issuers may only vote shares held by those shareholders in accordance with management's recommendation for the say-on-frequency vote if management actually includes such a recommendation in the proxy statement; a choice to abstain is provided on the proxy card; and disclosure is included on the proxy card in bold that informs shareholders how uninstructed shares will be voted.

Additionally, under amended Rule 14a-8, if a public company adopts a say-on-frequency policy consistent with a single choice that received a *majority* of votes cast (*i.e.* one, two or three years) in the most recent say-on-frequency vote, the issuer will be able to exclude from its proxy materials subsequent shareholder proposals related to say-on-pay votes and the frequency of such votes on the basis that any such proposal has been "substantially implemented." The proposed rules had provided for this relief if the say-on-frequency policy was consistent with just a *plurality* of the votes cast.

Disclosure Related to Say-On-Frequency Voting

In addition to disclosure regarding the say-on-pay vote, new Item 24 of Schedule 14A requires issuers to disclose in the proxy statement that they are providing a separate say-on-frequency vote and to briefly explain the general non-binding effect of this vote. Amended Rule 14a-6 exempts issuers from filing a preliminary proxy statement with the SEC due solely to a say-on-frequency vote.

The final rules require Form 8-K reporting of a public company's decision regarding how frequently it will conduct say-on-pay votes no later than 150 calendar days after the date of the meeting in which the say-on-frequency vote took place, but no later than 60 calendar days prior to the deadline for submission of Rule 14a-8 shareholder proposals for the subsequent annual meeting. The Form 8-K timing chosen by the SEC is designed to permit boards time to consider the outcome of the shareholders' say-on-frequency vote, but also to give shareholders time, after the issuer has announced its say-on-frequency policy, to submit proposals for the next proxy cycle if they disagree with the issuer's policy or otherwise believe companies are not being sufficiently responsive to shareholder wishes on executive compensation.

Say-on-Parachutes

The SEC has adopted rules regarding disclosure and say-on-parachute advisory votes that must be provided with respect to golden parachute compensation arrangements triggered by certain forms of corporate transaction (as described below). Golden parachute compensation is defined to include any type of compensation (whether present, deferred or contingent) that is based on or related to a covered corporate transaction for the named executive officers of the issuer or of the acquiring person (assuming the person conducting the solicitation is not the acquiring person).

Form of New Disclosure for Golden Parachute Compensation

New Item 402(t) of Regulation S-K expands what must be disclosed regarding golden parachutes. Unlike the termination and change-in-control compensation disclosures currently required by Item 402(j) of Regulation S-K, new Item 402(t) would require:

- A standardized form of table
- All compensation to each named executive officer that is "based on or otherwise relate[s]" to a business combination transaction, including cash severance, the dollar value of accelerated stock awards, pension and non-qualified deferred compensation enhancements, perquisites and tax reimbursements
- Disclosure of all perquisites and other personal benefits, (with no *de minimis* exclusion), and benefits under arrangements that do not discriminate in favor of executive officers (such as group health, life insurance, *etc.*, normally excluded from disclosure of executive compensation)
- A "total" amount of golden parachute compensation for each person in the table

Disclosures must also include a narrative discussion to explain exactly how various payments are triggered, material conditions or obligations applicable to the receipt of payment, how and when payments are to be made for each agreement, and material assumptions related to uncertainties for the provision of payments or the amounts thereof. The compensation disclosed may be limited to that related to the subject transaction only, and need not cover parachute compensation that might be received under other circumstances (unless included in a regular annual proxy statement).

Interplay Between Golden Parachute Disclosure and Say-on-Parachutes

The final rules require disclosure of golden parachute compensation arrangements under Item 402(t) for any transaction at which shareholders are asked to approve an acquisition, merger, consolidation or a proposed sale or other disposition of all or substantially all assets of the company, including Rule 13e-3 "going private" transactions and third-party tender offers. A separate say-on-parachute advisory vote with respect to these golden parachute compensation arrangements will be required pursuant to new Rule 14a-21(c) in connection with shareholder meetings at which shareholders are asked to approve any of the foregoing business combinations *except* a going private transaction or a third-party tender offer (even though the disclosure is required for all such transactions). However, the final rules permit the exclusion of a say-on-parachute advisory vote in connection with such transactions if the same golden parachute arrangements were subject to a previous say-on-pay advisory vote. In order to take advantage of this exception, a company would have to voluntarily include Item 402(t) golden parachute compensation disclosure in a previous regular annual meeting proxy statement.

As noted above, the disclosure required by Item 402(t) is more expansive than the disclosure currently required for termination and change-in-control payments under Item 402(j). If the Item 402(t) information is provided, a public company does not need to include the information regarding potential payments upon a change of control that would otherwise be provided pursuant to Item 402(j), except for disclosure regarding potential payments upon termination of employment. However, a company will need to obtain another approval at the time of a covered corporate transaction if golden parachute arrangements have been changed or a new named executive officer has been hired subsequent to the prior say-on-pay advisory vote (in which case two tables would need to be disclosed, to show what was previously approved and what has changed). Companies will need to weigh the potential benefits of this exception against the risk of higher scrutiny of a say-on-pay vote at an annual meeting, and the burden of complying with Item 402(t).