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SEC Issues Final Rules Regarding Say-On-Pay and Golden Parachute Requirements Under the Dodd-Frank Financial Reform Act

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On January 25, the Securities and Exchange Commission (SEC) issued final rules (the Final Rules) to implement the requirements in the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) that companies provide to their shareholders three advisory votes relating to executive compensation as well as certain disclosures about compensation arrangements upon a change in control of the company. The Final Rules provide guidance with regard to the three separate nonbinding shareholder votes required by the Act: (i) a vote on executive compensation (Say-on-Pay); (ii) a vote on the frequency of presenting Say-on-Pay votes to shareholders (Say-on-Frequency); and (iii) a vote on compensation (Say-on-Golden-Parachutes) together with new disclosure requirements (Golden Parachute Disclosure) associated with compensation arrangements triggered by mergers, consolidations, sales, or other similar transactions and dispositions.

Highlights of the changes made by the Final Rules include the following:

- The Say-on-Pay and Say-on-Frequency requirements will apply with respect to annual shareholder meetings, or other shareholder action, at which directors are elected on or after January 21, 2011. However, smaller reporting companies (companies with a public float of less than $75 million) are not required to comply with the Say-on-Pay and Say-on-Frequency requirements until the first annual shareholder meeting or other shareholder action occurring on or after January 21, 2013.

- A company need only disclose in its Compensation Discussion and Analysis (CD&A) whether, and, if so, how, the compensation committee has taken into account the results of the most recent Say-on-Pay vote and how such results have affected the compensation committee's policies and decisionmaking processes. A company should address its consideration of earlier Say-on-Pay votes to the extent such consideration is material to the compensation policies and decisions disclosed in the annual CD&A.

- A company must disclose its decision on the frequency of Say-on-Pay proposals in an amendment to the Form 8-K in which the company disclosed the results of the Say-on-Frequency vote. The amendment must be filed no later than 150 calendar days after the date of

the meeting at which the shareholders voted, and at least 60 calendar days prior to the deadline for the submission of shareholder proposals.

- A company will be able to seek SEC concurrence with the omission of shareholder proposals on Say-on-Pay and Say-on-Frequency proposals in future proxy statements if the company implements the frequency of future Say-on-Pay proposals in accordance with the vote of a majority of shareholders.

- The Say-on-Golden-Parachutes rules will become effective for initial proxy and information statements and other schedules and forms filed on or after April 25, 2011.

Preparation for the new Say-on-Pay and Say-on-Golden-Parachutes proposals is particularly important since brokers no longer have discretionary authority to vote on any compensation-related matters.

Say-on-Pay

Scope of the Final Rules. The Final Rules require a shareholder Say-on-Pay vote at the first meeting of shareholders, annual or otherwise, at which proxies will be solicited for the election of directors, or a special meeting or a consent solicitation in lieu of such annual or special meeting, occurring on or after January 21, 2011. However, a shareholder Say-on-Pay vote is not required for smaller reporting companies (companies with a public float of less than $75 million) until the first annual meeting or other shareholder meeting occurring on or after January 21, 2013. As specified in the Act, the Final Rules require companies to include this separate advisory vote on the compensation of the named executive officers in their proxy statements at least once every three years.

The Final Rules include a nonexclusive example of a resolution that would be acceptable for the Say-on-Pay vote, but do not require any specific language or form for the Say-on-Pay resolution. The resolution will comply as long as the Say-on-Pay vote is to approve the compensation of the named executive officers as such compensation is disclosed pursuant to Item 402 of Regulation S-K (which sets forth the requirements for the CD&A, the compensation tables, and certain other narrative executive compensation disclosures). Many companies are likely to use resolutions that merely follow the SEC's example.[1]

The Final Rules confirm that the shareholder Say-on-Pay vote need not address director compensation, as disclosed pursuant to Item 402(k) or 402(r) of Regulation S-K. If, as required by Item 402(s) of Regulation S-K, a company discloses information about its compensation policies and practices relating to risk management and risk-taking incentives, these policies and practices also need not be subject to the Say-on-Pay vote because the risk disclosures relate to the company's compensation arrangements for employees generally, and not just to the named executive officers. Nevertheless, if risk considerations are a material component of the company's compensation policies or decisions for named executive officers, the company must discuss them in its CD&A, and shareholders will, therefore, consider the disclosure when voting on executive compensation. The Final Rules do not prohibit a company from

1. The example in the instruction to new Rule 14a-21 provides as follows: "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."

including additional resolutions regarding executive compensation with a shareholder Say-on-Pay advisory vote.

Scope of the Disclosure Requirements. The Final Rules require companies to explain the general effect of the shareholder Say-on-Pay vote, such as whether the vote is nonbinding. Footnote 69 in the SEC's release announcing the adoption of the Final Rules (the SEC Release) explains that information about the advisory nature of the vote should be available to shareholders before they vote. Companies may want to indicate in the proxy statement what actions or steps they expect to take in reaction to the outcome of the Say-on-Pay vote, such as to canvass shareholders to identify concerns.

Although a company need not take any specific action in response to a Say-on-Pay vote, the Final Rules require a company to address in its next CD&A (i) whether the compensation committee has taken into account the results of the most recent Say-on-Pay vote and, if so, how; and (ii) how the results of the most recent Say-on-Pay vote have affected the compensation committee's policies and decisionmaking processes. The SEC Release provides that companies should address their consideration of earlier Say-on-Pay votes to the extent such consideration is material to the compensation policies and decisions disclosed in the annual CD&A.

Required Say-on-Pay votes clearly place even greater importance on the analysis of controversial compensation arrangements and the bases for compensation decisions. To increase the likelihood of a favorable Say-on-Pay vote, companies should enhance the explanation in their CD&A of compensation decisions made in the most recent year, including the impact of the companies' performance on those decisions, and why their compensation policies and practices are in the best interests of their shareholders. In addition, the Say-on-Pay vote requirement should lead to more active discussions between companies and significant shareholders about executive compensation practices.

Say-on-Frequency

Scope of the Final Rules. The Final Rules require companies to provide, at the first shareholder meeting at which directors will be elected, annual or otherwise, or in connection with a consent statement regarding the election of directors, occurring on or after January 21, 2011 (or, in the case of smaller reporting companies, meetings occurring on or after January 21, 2013), a separate shareholder advisory vote regarding how often companies should allow shareholders to cast their Say-on-Pay votes: every year, every two years, or every three years. The vote must also give shareholders the option of abstaining from the vote. Under the Final Rules, companies are not allowed to structure a Say-on-Frequency vote to provide shareholders with fewer than the four choices mentioned above. This Say-on-Frequency vote must occur at least once during the six calendar years following the prior frequency vote and will be required only in a proxy statement relating to the election of directors at an annual or other shareholder meeting for which the SEC rules require compensation disclosure.

Votes with respect to Say-on-Frequency will be advisory only and, accordingly, the rules do not specify a required vote for approval. Nevertheless, to avoid including a shareholder proposal that seeks a vote on substantially the same matters as the Say-on-Pay and Say-on-Frequency proposals, the proposal would require a company to have implemented a frequency policy that is consistent with the majority of votes cast in the most recent Say-on-Frequency vote. Footnote 154 of the SEC Release states that a company that wants to exclude a shareholder proposal for this reason must follow the same shareholder proposal

process with the staff of the SEC as would be required for the company to rely on any other substantive basis for exclusion under Rule 14a-8.

The SEC has provided some flexibility for proxy statements for meetings or shareholder action on or before December 31, 2011. In response to companies' concerns that processing systems may be unable to accommodate all four choices for the upcoming proxy season, the SEC said it will not object if the proxy form for the Say-on-Frequency vote only includes a choice among every one, two, or three years. For any company choosing that approach, the transition relief in the SEC Release provides that the proxy must be disregarded for purposes of the vote if no choice is selected on the proxy card. To the extent that a company includes its recommendation in the proxy, it must make clear to the shareholders that their vote is not on the company's recommendation; rather, they must choose from among all the available choices (i.e., one, two, or three years, or abstention).

Scope of the Disclosure Requirements. The Final Rules require each company to disclose in its proxy statement that it is seeking a Say-on-Frequency vote and to explain the general effect of the vote (i.e., that it is nonbinding). Additionally, the Final Rules require disclosure of the current frequency of Say-on-Pay votes and when the next scheduled Say-on-Pay vote will occur, except in the first proxy statement that includes the new proposals.

The Final Rules require a company to disclose its decision about how frequently it will hold its Say-on-Pay vote in light of the Say-on-Frequency voting results no later than 150 calendar days after the date of the end of the annual or other meeting in which such vote took place, but in no event later than 60 days prior to the deadline for the submission of shareholder proposals for the subsequent meeting. The Final Rules require this disclosure in an amendment to the company's prior Form 8-K filing under Item 5.07 in which the company disclosed the results of the Say-on-Frequency vote, which is required to be filed within four business days of the vote. Given this timing, companies will have ample time to consider how to take into account the Say-on-Frequency vote in determining how frequently to submit Say-on-Pay proposals to shareholders. The Final Rules revised the reporting requirements with respect to the results of the Say-on-Frequency vote to provide for disclosure of the number of votes cast for each of one year, two years, and three years as well as the number of abstentions.

Companies should consider whether to make a recommendation with respect to the Say-on-Frequency vote. Although the SEC Release states that the SEC would expect such a recommendation, a company will want to consider its shareholders' preferences when deciding what to recommend. Then, the company will want to balance a number of relevant factors, including input from shareholders and shareholder advisory groups such as Institutional Shareholder Services (ISS) (which recently recommended annual Say-on-Pay votes); whether an annual vote might reduce the importance of the vote; whether the Say-on-Pay vote should be coordinated with other votes, such as equity plan approvals; whether the company wants to try to get off cycle with other companies or to follow the crowd; whether a particular frequency for Say-on-Pay votes would be more consistent with the company's compensation arrangements; and whether the company wants Say-on-Pay approval in advance of a change in control.

If a company decides not to recommend a frequency, however, the company will be unable to vote uninstructed shares. To vote uninstructed shares, the company must include a recommendation in the proxy statement on the frequency of Say-on-Pay votes, permit abstention on the proxy card, and disclose in bold on the proxy card how uninstructed shares will be voted.

Say-on-Golden-Parachutes

Scope of the Final Rule. Existing rules require a target company soliciting shareholder approval in connection with an acquisition, merger, consolidation, or proposed sale or disposition of all or substantially all of a company's assets (Business Combination) to describe briefly any, direct or indirect, substantial interest, by security holdings or otherwise, in any matter to be acted upon, of any person who has been an executive officer or director since the beginning of the last fiscal year. As a result, target companies often disclose in their proxy statements compensation arrangements of their executive officers and directors that are triggered by the Business Combination. Companies must also disclose information about payments that may be made to named executive officers upon termination of employment or in connection with a Business Combination.

The Final Rules require, in any proxy or consent solicitation in connection with a Business Combination, disclosure (both tabular and narrative) of additional information regarding executive officers' golden parachute arrangements. In addition, this disclosure will also be required in proxy and information statements that include disclosures pursuant to Item 14 of Schedule 14A, registration statements for merger and similar transactions, third-party tender offers, and going private transactions.

New Tabular Disclosure. The Final Rules add new section (t) to Item 402 of Regulation S-K requiring companies to include a specified table quantifying, for each named executive officer, the value of the following:

(i) Cash severance payments (e.g., base salary, bonuses, pro rata nonequity incentive plan compensation payments)
(ii) Dollar value of accelerated vesting of equity awards (for options, this amount will equal the "spread" inherent in the option and, for other equity awards, the full value, each as of the latest practicable date) and payments made in cancellation of equity awards
(iii) Enhancements to pension or nonqualified deferred compensation benefits
(iv) Perquisites and other personal benefits, including health and welfare benefits (even if *de minimis*)
(v) Tax reimbursements (e.g., Internal Revenue Code Section 280G gross-ups)
(vi) Any other elements of compensation triggered by the Business Combination and not specifically includable in the other columns of the table
(vii) The total of all such payments and benefits

Compensation previously disclosed in the Pension Benefits Table and Nonqualified Deferred Compensation Table or compensation related to previously vested equity awards is not required in the table because it is not compensation "that is based on or otherwise relates to" the Business Combination. *De minimis* perquisites and arrangements that do not discriminate in scope, terms, or operation in favor of executive officers and are available to all salaried employees must, however, be included in the table if they are triggered by the Business Combination.

The Final Rules require footnotes disclosing which benefit enhancements are single-trigger enhancements (i.e., triggered by the covered transaction) or double-trigger enhancements (i.e., contingent upon conditions in addition to the covered transaction, such as termination of employment within a given period of time) and providing additional explanatory information about the benefits.

The Item 402(t) table will quantify all agreements or understandings, whether written or oral, entered into between any named executive officer of either the acquiring or the target company and the acquiring or target company concerning present, deferred, or contingent compensation that relates to a Business Combination. The Final Rules require disclosure of the full scope of golden-parachute compensation applicable to the transaction because the SEC believes that shareholders will find this additional information useful when deciding how to vote on the transaction. Arrangements or understandings with former executive officers, other than a former chief executive officer or former principal financial officer, need not be included in the Item 402(t) table when it is disclosed other than in connection with a Business Combination.

Because the Say-on-Golden-Parachutes vote is limited to arrangements between the target and its named executive officers, as discussed more fully below, the additional disclosure required by Item 402(t) may result in the use of two tables: (i) a table showing the aggregate amounts related to all agreements and understandings between any named executive officer and the acquiring or target company and (ii) a table showing only amounts arising from the target company's agreements and understandings with its named executive officers.

Narrative Disclosure. In addition to the new table, the Final Rules also require companies to describe any material factors necessary to understand the compensation arrangements and the payments included in the table, including the following:

(i) Any material obligations or conditions to the receipt of payments or benefits (including restrictive covenants such as noncompete, nonsolicitation, nondisparagement, or confidentiality agreements and their duration, and provisions regarding the waiver or breach of such covenants)
(ii) The specific circumstances that will trigger payment
(iii) Whether payments will be made as lump sums or annually
(iv) The duration of such payments
(v) By whom the payments will be made
(vi) Any other material factors regarding each arrangement (including modification of outstanding options to extend the vesting period or posttermination exercise period, or to lower the exercise price)

Scope of the Shareholder Vote. The Final Rules require a separate Say-on-Golden-Parachutes advisory vote of a company's shareholders when the shareholders are asked to approve a Business Combination. The Say-on-Golden-Parachutes vote is to approve any compensation arrangements that will be triggered by the Business Combination, which are required to be disclosed as discussed above. The vote required by a target company's shareholders, however, must only relate to the compensation arrangements provided by the target company itself to its named executive officers. The SEC-required vote, like the Say-on-Pay and Say-on-Frequency votes discussed above, is nonbinding.

Under the Final Rules, a company need not include a separate advisory Say-on-Golden-Parachutes shareholder vote in the merger proxy to the extent that the compensation has previously been included in the company's executive compensation disclosures that were subject to a prior Say-on-Pay vote.

To satisfy this exception, the executive compensation disclosure subject to the prior Say-on-Pay vote must have included the new Item 402(t) disclosure of the golden parachute arrangements in effect at the time of the solicitation of approval of the particular Business Combination. The SEC notes that it expects some companies to voluntarily include Item 402(t) disclosures with their other executive compensation disclosures in annual meeting proxy statements in connection with their Say-on-Pay votes to avoid having to include a Say-on-Golden-Parachutes proposal in the event of a future Business Combination or to provide information in which investors are interested.

The exception for golden parachute arrangements that have been subject to a prior Say-on-Pay vote will not apply with respect to any changes or modifications to the company's golden parachute arrangements, or any new golden parachute arrangements, that are provided to executive officers after the company's Say-on-Pay vote. The new arrangements and any revisions to existing arrangements must be subject to a new Say-on-Golden-Parachutes vote.

The Final Rules indicate that if the only changes to the disclosure provided previously pursuant to Item 402(t) would be changes in the amounts shown to reflect price movements in the company's securities or to reduce the total value of the compensation package, no Say-on-Golden-Parachutes vote will be required. If, however, the terms of such agreements have changed after the prior Say-on-Pay vote, a separate Say-on-Golden-Parachutes vote will be required. For example, any change that results in a Section 280G tax gross-up becoming payable will be a change in terms that will trigger the obligation to have a new Say-on-Golden-Parachutes vote. Similarly, the SEC Release mentions changes in compensation because of a newly named executive officer, additional grants of equity compensation in the ordinary course, and increases in salary as also triggering the new vote requirement. Presumably, "ordinary course" changes such as higher bonuses (e.g., if reflected in the applicable severance formula) will also require this additional disclosure and Say-on-Golden-Parachutes vote.

A company seeking a Say-on-Golden-Parachutes vote because of a new arrangement or revised terms will be required to include two separate tables in the merger proxy statement. The first table will disclose total golden parachute compensation provided by the company, including both the arrangements and amounts previously disclosed and subject to a Say-on-Pay vote, and the new arrangements or modified terms. The second table will disclose only the new arrangements or revised terms subject to the Say-on-Golden-Parachutes vote. According to the SEC, this approach will highlight for shareholders which arrangements, or specific provisions of the arrangements, have been modified since the last Say-on-Pay vote and are subject to the current shareholder Say-on-Golden-Parachutes vote.

In situations in which Item 402(t) disclosure includes arrangements between the acquiring company and the target company's named executive officers, Instruction 7 to Item 402(t) requires that the target company provide a separate table reflecting all agreements and understandings subject to the Say-on-Golden-Parachutes vote, if different from the full scope of golden parachute compensation subject to Item 402(t) disclosure, since arrangements with the acquiring company do not require shareholder approval.

Conclusion

Companies should start to prepare now for the new votes by doing the following:

- Try to identify their shareholders' views on their compensation arrangements.
- Consider whether to change controversial compensation arrangements or those that cannot be sufficiently justified.
- Consider whether to recommend a particular frequency for the Say-on-Pay vote and, if so, what that frequency should be.
- Consider whether to include in their annual meeting proxy statement the new Golden Parachute Disclosures once they are adopted, or to wait to make those disclosures until a Say-on-Golden-Parachutes vote must be sought.

If you have any questions concerning the information in this LawFlash, please contact any of the following Morgan Lewis attorneys:

New York

Stephen P. Farrell	212.309.6050	sfarrell@morganlewis.com
Howard A. Kenny	212.309.6843	hkenny@morganlewis.com
Gary S. Rothstein	212.309.6360	grothstein@morganlewis.com

Palo Alto

S. James DiBernardo	650.843.7560	jdibernardo@morganlewis.com
Zaitun Poonja	650.843.7540	zpoonja@morganlewis.com

Philadelphia

Robert L. Abramowitz	215.963.4811	rabramowitz@morganlewis.com
Justin W. Chairman	215.963.5061	jchariman@morganlewis.com
Amy Pocino Kelly	215.963.5042	akelly@morganlewis.com
Robert J. Lichtenstein	215.963.5726	rlichtenstein@morganlewis.com
James W. McKenzie, Jr.	215.963.5134	jmckenzie@morganlewis.com
Joseph E. Ronan	215.963.5793	jronan@morganlewis.com
Alan Singer	215.963.5224	asinger@morganlewis.com
Joanne R. Soslow	215.963.5262	jsoslow@morganlewis.com
Mims Maynard Zabriskie	215.963.5036	mzabriskie@morganlewis.com
David B. Zelikoff	215.963.5360	dzelikoff@morganlewis.com

Pittsburgh

John G. Ferreira	412.560.3350	jferreira@morganlewis.com

Princeton

Emilio Ragosa	609.919.6633	eragosa@morganlewis.com

Washington, D.C.

Benjamin I. Delancy	202.739.5608	bdelancy@morganlewis.com
Linda L. Griggs	202.739.5245	lgriggs@morganlewis.com
Daniel L. Hogans	202.739.5510	dhogans@morganlewis.com
David A. Sirignano	202.739.5420	dsirignano@morganlewis.com
George G. Yearsich	202.739.5255	gyearsich@morganlewis.com

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