

## **SEC Issues Proposed Rules Regarding Say-On-Pay and Golden Parachute Requirements Under the Dodd-Frank Financial Reform Bill**

**November 15, 2010**

On October 18, the Securities and Exchange Commission (SEC) issued the first set of proposed rules (the Proposed Rules) to implement the executive compensation and related corporate governance requirements imposed on most public companies by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act). The Proposed 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) and a vote on compensation (Say-on-Golden-Parachutes) together with new disclosure requirements (Golden Parachute Disclosure) associated with votes relating to and acquisitions effected by means of mergers, acquisitions, consolidations, sales, or other similar transactions and dispositions.

Highlights of the Proposed Rules include the following:

- The Say-on-Pay and Say-on-Frequency requirements will apply with respect to annual shareholder meetings on or after January 21, 2011 whether or not the Proposed Rules are finalized by then; the Say-on-Golden-Parachutes rules will become effective only when finalized (and only for shareholder votes on or after January 21, 2011).
- The Say-on-Frequency vote must provide shareholders with four choices: every year, every two years, every three years, or abstain. (For the 2011 proxy season, a company can offer a choice among only every one, two, or three years if the company's proxy service provider's system cannot handle abstentions, but no proxy vote will be counted if no vote is marked.)
- Companies will not need to file a preliminary proxy solely because of the Say-on-Pay or Say-on-Frequency proposals.
- The Golden Parachute Disclosure would require at least one detailed table, and probably more, and additional text disclosing *all* compensation and benefits resulting from the proposed transaction (this disclosure will be substantially beyond the current proxy requirements) even if the Say-on-Golden-Parachutes proposal is not required in the proxy statement or other transactional disclosure document.
- Additional tabular disclosures relating to golden parachute arrangements may be necessary notwithstanding prior approval by shareholders of golden parachute payments in connection

with the Say-on-Pay vote to the extent that named executive officers receive new or modified golden parachute arrangements.

- The Golden Parachute Disclosure will be required in proxy and information statements that include Item 14 disclosures, registration statements relating to mergers and similar transactions, third-party tender offers, and going-private transactions, even if golden parachute payments and benefits have previously been addressed by a Say-on-Pay vote.

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

## **Say-on-Pay**

***Scope of the Proposed Rules.*** The Proposed Rules will require a shareholder Say-on-Pay vote at the first meeting of shareholders, annual or otherwise, occurring on or after January 21, 2011. This requirement will be applicable without regard to whether the SEC issues final Say-on-Pay rules before that date. As specified in the Act, the Proposed Rules will require issuers 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 Proposed Rules do not require any specific language or form for the Say-on-Pay resolution; however, the Proposed Rules indicate that a Say-on-Pay vote to approve a company's compensation policies and procedures will not satisfy the statutory Say-on-Pay requirement. Instead, the Say-on-Pay vote must approve the compensation of the named executive officers as such compensation is disclosed pursuant to Item 402 of Regulation S-K (including the Compensation Discussion and Analysis (CD&A), the compensation tables, and other narrative executive compensation disclosures, if applicable, required by Item 402). Many issuers are likely to use resolutions that merely follow the statutory language.<sup>1</sup>

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

***Scope of the Disclosure Requirements.*** The Proposed Rules will require issuers to explain the general effect of the shareholder Say-on-Pay vote, including, for example, that the vote is nonbinding. Although the SEC's proposal release does not give any other examples of disclosures to explain "the general effect" of the vote, footnote 69 states the SEC's view that the vote "could play a role in an issuer's executive compensation decisions." Accordingly, issuers should consider whether to indicate in the proxy statement

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<sup>1</sup> Section 14A(a)(1), as adopted in the Act, provides that proxy statements that include compensation disclosure "shall include a separate resolution subject to shareholder vote to approve the compensation of executives, as disclosed pursuant to Item 402 of Regulation S-K or any successor thereto."

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 an issuer need not take any specific action in response to a Say-on-Pay vote, the Proposed Rules will require an issuer to address in its next CD&A (i) whether the compensation committee has taken into account the results of any Say-on-Pay vote and, if so, how; and (ii) how the results of previous Say-on-Pay votes have affected the compensation committee's policies and decision-making processes. This proposed requirement will be cumulative; thus, multiple negative votes over several years may pose challenges in terms of responding to this requirement. The SEC specifically requested comments on whether the disclosure requirement should apply only to the most recent vote.

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 company's 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 Proposed Rules.*** The Proposed Rules will require companies to provide at the first shareholder meeting, annual or otherwise, occurring on or after January 21, 2011, a separate shareholder advisory vote regarding how often the issuer 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. If the Proposed Rules are adopted in their current form, issuers will not be allowed to structure a Say-on-Frequency vote to provide shareholders with fewer than the four choices mentioned above.

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 plurality of votes cast in the most recent Say-on-Frequency vote. This Say-on-Frequency vote must occur at least once every six years and will be required only in a proxy statement relating to an annual or other shareholder meeting for which the SEC rules require compensation disclosure.

The SEC has provided some flexibility for the 2011 proxy season. In response to issuer 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 issuer choosing that approach, the Proposed Rules provide that the proxy must be disregarded for purposes of the vote if no choice is selected on the proxy card. To the extent that an issuer includes its recommendation in the proxy, it must make clear to the shareholders that their vote is not on the issuer'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 Proposed Rules will 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). The Proposed Rules will also require companies to disclose in their quarterly

reports for the period in which the Say-on-Frequency vote occurs (Form 10-Q, or Form 10-K if the vote occurs in the fourth quarter) their decision about how frequently the company will hold its Say-on-Pay vote in light of the Say-on-Frequency voting results. Given the previously discussed footnote in the SEC's proposal release and the proposed Form 10-Q and Form 10-K disclosure requirements about the company's response to the vote, companies should consider whether to disclose in the proxy statement seeking the Say-on-Frequency vote how they will react to the vote, for example, that they will submit Say-on-Pay votes according to the frequency chosen by a plurality of the shareholders that voted on the Say-on-Frequency proposal unless the votes on more than one option are close.

Submitting the Say-on-Pay proposal in the future, in accordance with the choice selected by a plurality of the shareholders, is necessary under the proposal to avoid future shareholder proposals relating to Say-on-Pay and Say-on-Frequency. The Proposed Rules will allow companies to exclude shareholder proposals relating to both Say-on-Pay and Say-on-Frequency if the issuer has adopted a policy that is consistent with the plurality of the votes cast in the most recent Say-on-Frequency vote.

Companies should consider whether to make a recommendation with respect to the Say-on-Frequency vote. Although the SEC's proposal 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 proposed to recommend that Say-on-Pay votes be held annually); 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; and whether the company wants Say-on-Pay approval in advance of a change in control.

### **Say-on-Golden-Parachutes**

***Scope of the Proposed 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 substantial interest, direct or indirect, by security holdings or otherwise, of any person who has been an executive officer or director since the beginning of the last fiscal year in any matter to be acted upon. 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 Proposed Rules will require, in any proxy or consent solicitation in connection with a Business Combination, disclosure in both tabular and narrative formats 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 Proposed Rules will add new section 402(t) to Regulation SK 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 not specifically includable in the other columns of the table
- (vii) The total of all such payments and benefits

The Proposed Rules will also require footnotes disclosing which benefit enhancements are single-trigger enhancements (i.e., triggered by the covered transaction), or double-trigger enhancements (i.e., enhancements that are contingent upon conditions in addition to the covered transaction, such as termination of employment within a given period of time).

The proposed table will quantify all agreements or understandings, whether written or oral, entered into between any named executive officer and the acquiring or target company concerning present, deferred, or contingent compensation that relates to a Business Combination. The Proposed Rules will 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. Because the Say-on-Golden-Parachutes vote is limited to arrangements between the target and its named executive officers, as discussed more fully below, this additional disclosure 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.

The additional disclosure required by the Proposed Rules will be limited to compensation based on or otherwise relating to the specific Business Combination and will not include compensation previously disclosed in the Pension Benefits Table and Nonqualified Deferred Compensation Table or compensation related to previously vested equity awards. Since those amounts are already vested without regard to the Business Combination, the SEC does not view them as compensation “that is based on or otherwise relates to” the Business Combination.

**Narrative Disclosure.** In addition to the new table, the Proposed Rules will also require issuers to describe:

- (i) Any material obligations or conditions to the receipt of payments or benefits (including restrictive covenants such as noncompete, nonsolicitation, nondisparagement or confidentiality agreements, 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 sum or annually
- (iv) The duration of such payments
- (v) By whom the payment 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 Proposed Rules will require a separate Say-on-Golden-Parachutes advisory vote of the target's shareholders to approve golden parachute agreements and understandings or arrangements of the target company with its named executive officers that are required to be disclosed as discussed above. Under the Proposed Rules, the Say-on-Golden-Parachutes vote will be required to be included in proxy statements for shareholder meetings in which shareholders are asked to approve a Business Combination. The Proposed Rules will not require issuers to use any specific language or format for the resolution to be voted on by the shareholders and, like the other advisory votes, this vote will not be binding on the issuer or its board of directors. The SEC requires only that golden parachute arrangements be subject to a shareholder vote and not necessarily shareholder approval.

Under the Proposed Rules, an issuer 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 issuer's executive compensation disclosures that were subject to a prior Say-on-Pay vote.

To satisfy this proposed 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 issuers 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 so that those issuers can take advantage of this in the event of a future Business Combination.

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 issuer's golden parachute arrangements, or any new golden parachute arrangements, that occur after the issuer'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 Proposed Rules indicate that if the only changes to a prior Say-on-Pay disclosure pursuant to Item 402(t) are changes in the amounts shown to reflect price movements in the issuer's securities, no new 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, the SEC appears to view any change that results in a Section 280G tax gross-up becoming payable as a change in terms that will trigger the obligation to have a new Say-on-Golden-Parachutes vote. Similarly, items such as additional grants of stock or stock options will also appear to trigger the new vote requirement, although the SEC specifically asked for comments on this point. It is unclear whether "ordinary course" changes such as increases in base salary or higher bonuses (e.g., if reflected in the applicable severance formula) will require this additional disclosure and Say-on-Golden-Parachutes vote.

Issuers 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, 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 proposed Item 402(t) requires that issuers provide a separate table reflecting all agreements and understandings subject to the Say-on-Golden-Parachutes vote, 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:

- Trying to identify their shareholders' views on their compensation arrangements.
- Considering whether to change controversial compensation arrangements or those that cannot be sufficiently justified.
- Considering whether to disclose in the proxy statement whether and, if so, how, the company will take into account the shareholders' vote, particularly the Say-on-Frequency vote given the proposal to disclose the frequency in the next periodic report covering the period when the vote is taken.
- Considering 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.

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