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SEC Issues Proposed Rules on Say-on-Pay

The Dodd-Frank Wall Street Reform and Consumer Protection Act requires public companies to provide non-binding shareholder advisory votes on executive compensation and golden parachute arrangements. On October 28, the Securities and Exchange Commission (SEC) issued proposed rules to implement this requirement. The new votes on executive compensation will be required in proxy statements for shareholder meetings that take place on or after January 21, 2011, regardless of whether the SEC issues final rules by that time, but the vote on golden parachutes will not be required until after the SEC issues final rules.

Background

Along with sweeping financial reforms, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) contained provisions that will impact executive compensation and corporate governance practices at publicly-held companies. (See our July 16, 2010 [For Your Information](#).) Among them, Section 951 of the Dodd-Frank Act imposed a requirement for public companies subject to the federal proxy rules to provide non-binding shareholder advisory votes on executive compensation and golden parachute arrangements.

On October 28, the SEC issued [proposed rules](#) to implement the say-on-pay voting requirements. The proposed rules cover three separate shareholder advisory votes on whether to –

- approve the compensation of certain named executive officers
- hold the say-on-pay vote every one, two or three years
- approve golden parachute compensation arrangements in connection with change in control transactions.

The SEC separately proposed [reporting rules](#) for institutional investment managers' reporting of their executive pay votes.

Shareholder Advisory Votes on Executive Compensation

Section 951 of the Dodd-Frank Act added a new section 14A(a)(1) to the Securities Exchange Act of 1934 (Exchange Act) requiring public companies to include within their proxy solicitation filings a separate resolution subject to a non-binding shareholder vote to approve the compensation of the named executive officers (NEOs) (the so-called “say-on-pay” vote). As the SEC confirms, discretionary voting by brokers of uninstructed shares would not be counted for purposes of the say-on-pay vote. Because only NEO executive compensation is covered by the rules, shareholder approval would not extend to compensation paid to directors, or to the disclosure of compensation policies and practices relating to risk management and risk-taking incentive

compensation for employees generally. However, as noted by the SEC, if risk considerations are a material aspect of compensation policies or decisions for NEOs, they must be discussed in the Compensation Discussion & Analysis (CD&A) and thus would be considered by shareholders in the context of their say-on-pay vote.

The say-on-pay vote must be held at least every three years, beginning with the first annual or other shareholder meeting occurring on or after January 21, 2011. Numerical voting results must be reported on Form 8-K within four business days of the meeting.

The proposed rules specify neither the language nor the form of the say-on-pay resolution that must be voted on by shareholders. Thus, companies will still have to determine how best to meet their say-on-pay requirements.

BUCK COMMENT. *There are many precedents for companies to look at, including financial institutions that were required under the Troubled Asset Relief Program (TARP) to have a say-on-pay vote as well as early adopters of say-on-pay.*

However, the annual proxy statement must disclose that the company is conducting a say-on-pay vote, including whether the vote is non-binding. Importantly, under the proposed regulations, inclusion of a say-on-pay or say-on-frequency vote (see below) would not trigger the requirement to file a preliminary proxy statement with the SEC. Beginning the year after the initial say-on-pay vote, the proposed rules would require new and more robust disclosures by amending Item 402 of Regulation S-K to include a CD&A requirement to discuss the influence of prior shareholder votes on the company's compensation decisions.

The proposed rules provide no exemption from say-on-pay, say-on-frequency, or say-on-golden parachute (see below) vote requirements for smaller reporting companies (generally those with a public float of less than \$75 million), nor a delayed effective date. However, the proposed rules clarify that the limited reporting and disclosure requirements that currently apply to smaller reporting companies will not be expanded.

The proposed rules do, however, exempt companies subject to TARP from the say-on-pay and say-on-frequency votes until the first annual shareholder meeting after they are no longer covered under TARP (i.e., after they have repaid all of their TARP indebtedness). The exemption recognizes that TARP companies are already required to include shareholder say-on-pay votes on NEO compensation within their proxy filings on an annual basis.

Say-on-Frequency Votes

New section 14A(a)(2) of the Exchange Act requires public companies to hold a non-binding shareholder advisory vote along with their proxies on whether the advisory vote on executive compensation should occur every one, two or three years. In addition to those three choices, shareholders must be given a fourth choice – to abstain from voting on the frequency. Because there are more than two choices, the outcome of the vote will be based on a plurality rather than a majority vote.

As with say-on-pay, the proxy must disclose that the company is conducting a say-on-frequency vote and whether the vote is non-binding. Again, there is no exemption for small reporting companies. The vote must be held beginning with the first annual or other shareholder meeting on or after January 21, 2011, and at least every six years thereafter.

The proposed rules also add new disclosure requirements to the Form 10-Q and Form 10-K rules. The company will have to disclose its decision on how often it will conduct say-on-pay votes in light of the shareholder vote in its next Form 10-Q (or Form 10-K if the vote occurs in the fourth quarter of the company's fiscal year). Reporting the outcome of the say-on-frequency vote in the Form 8-K will not be sufficient.

BUCK COMMENT. *At this juncture, there does not appear to be a consensus in the activist community on the optimal frequency. Some organizations have suggested three years would be appropriate to correspond with 3-year vesting or performance cycles that often apply to long/mid-term incentive awards. Others suggest that an annual vote would allow investors to routinely use the say-on-pay vote to signal their dissatisfaction with the company's compensation practices rather than voting against compensation committee members.*

Proposed 2011 voting guidelines just released by Institutional Shareholder Services (ISS) indicate that ISS expects to recommend an annual say-on-pay vote in situations where the company offers a menu of options.

Amended Shareholder Proposal Rules

Importantly, the proposed rules would amend Rule 14a-8 on shareholder proposals. As proposed, a company could exclude from the proxy subsequent shareholder proposals related to say-on-pay or on say-on-frequency if the company has adopted a policy on say-on-pay frequency most recently approved by a plurality of shareholders.

BUCK COMMENT. *Although the votes are non-binding, we would expect the overwhelming majority of companies to follow shareholder say-on-pay and say-on-frequency vote recommendations in order to avoid negative shareholder reaction and bad press. Further, a company's decision to ignore shareholder advisory votes could potentially influence subsequent votes in which shareholder approvals are required – such as additional share requests for a company-sponsored equity incentive plan. The ability to exclude later shareholder proposals requiring more frequent say-on-pay votes provides an added incentive for companies to follow the plurality vote on frequency.*

Golden Parachute Arrangements

New Section 14A(b)(1) of the Exchange Act adds a specific disclosure requirement in change of control proxies and consent solicitations relating to golden parachute arrangements with NEOs. The golden parachute disclosure would also be required in going-private transactions and third-party tender offers. The requirement would apply to proxies for shareholder meetings on or after January 21, 2011.

In the context of a shareholder meeting to approve a change in control transaction (i.e., merger, acquisition, consolidation, sale or other disposition of all or substantially all of the company's assets), the soliciting company will be required to –

- disclose all NEO compensation contingent on the change in control unless already the subject of a say-on-pay resolution, and
- have a separate non-binding golden parachute vote.

Pursuant to new Item 402(t) of Regulation S-K, disclosure will be required of all golden parachute compensation relating to the merger among the target and acquiring companies and the NEOs of each in order to cover the full scope of golden parachute compensation applicable to the transaction. Thus, even when an acquiring company is not soliciting a shareholder vote on the transaction itself, disclosure will still be required with respect to parachute arrangements between the acquirer and target company NEOs even though such arrangements will be exempt from the shareholder vote requirement. Previously vested awards or compensation related to *bona fide* post-transaction employment agreements that are entered into in connection with the transaction generally would not be included.

New Item 402(t) will require a tabular disclosure format for golden parachute arrangements along with narrative disclosure in merger proxies to disclose present, deferred and contingent compensation. This “Golden Parachute Compensation Table,” which significantly differs from current termination or change of control disclosures in Item 402(j), would disclose cash payments (e.g., base salary, bonus, severance), accelerated or cashed out equity awards, pension and nonqualified deferred compensation enhancements, perquisites, tax reimbursements (e.g., Section 280G tax gross-ups), and other compensation. *De minimis* perquisites and other personal benefits would have to be included. Further narrative disclosures on material factors are required, such as whether the parachute payments are “single-trigger” versus “double-trigger” and whether payments are contingent on non-compete provisions.

Issuers would not be required to include in the merger proxy a separate shareholder vote on the golden parachute compensation if that compensation had been included in the executive compensation disclosure that was subject to a prior say-on-pay vote (as discussed above). However, for issuers to take advantage of this exception, the executive compensation disclosure subject to the prior shareholder vote would need to have included new item 402(t) disclosure of the same golden parachute arrangements, including the same required tabular format and narrative discussion. New golden parachute arrangements and any revisions to arrangements that were subject to a prior shareholder vote would be subject to the separate merger proxy shareholder vote requirement. For this purpose, changes in the value of parachute payments attributable to price movements in the issuer’s securities (e.g., the value of parachute payments attributable to stock awards) would not be considered revisions to existing arrangements. However, it is unclear whether this exemption would apply in cases where a change in stock price would materially affect payments (e.g., if an excise tax gross-up is triggered as a result of a change in the stock price).

BUCK COMMENT. *It would be prudent for companies to include within their annual proxy filings the tabular format and narrative disclosures required by the say-on-parachute vote. However, as a practical matter, it likely will be difficult to avoid altogether a separate vote at the time of the actual transaction.*

Unless approved as part of a prior say-on-pay vote, a separate shareholder advisory vote on golden parachutes would be required at the time of the change in control transaction. However, a vote on parachutes will not be required until after the SEC issues final rules.

BUCK COMMENT. *The proposed 2011 voting guidelines just released by ISS indicate that ISS will adopt a new policy under which they will vote on a case-by-case basis on proposals to approve golden parachute compensation, consistent with their policies on problematic pay practices related to severance packages. ISS has cited a number of features that may lead to a recommendation against such proposals, including (but not limited to) recently adopted or amended agreements that include excise tax gross-ups, single trigger payments, and potentially excessive severance agreements.*

Effective Date

The requirements for say-on-pay and frequency votes are effective for all annual meetings (and special meetings for the election of one or more directors) held on or after January 21, 2011, regardless of when the proxy statement for the meeting is filed or whether the SEC has final rules for proxy statements in effect. However, the effective date for TARP fund recipients will be delayed until the first shareholder meeting following repayment of all TARP funds.

The golden parachute advisory vote will not be required until after the SEC issues final rules. The SEC has previously indicated that they expect to adopt final rules during the January through March 2011 timeframe.

The SEC has invited comments on the proposed rules to be submitted by November 18, 2010.

Conclusion

With the new say-on-pay requirements, companies and their compensation committees and boards of directors should expect increased scrutiny of their executive compensation policies and practices. In anticipation of this, they should consider reassessing their current pay practices now. Even though golden parachute votes will not be required until after the SEC issues final regulations, companies should also begin preparing now by reviewing and updating their proxy disclosures associated with potential change in control payments.

Buck's consultants can assist companies in preparing for the 2011 proxy season.

This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.