

## SEC Adopts Final Rules on “Say-on-Pay”, Frequency Vote and Say-on-Parachutes Vote Under Dodd-Frank Act

*Most Public Companies Must Include New Shareholder Advisory Votes on Compensation in 2011 Proxy Statements*

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”), enacted on July 21, 2010, imposed several new requirements on public companies relating to executive compensation and corporate governance. Among other things, the Act requires that public companies hold several types of shareholder advisory votes on executive compensation, starting in 2011. On January 25, 2011, the SEC issued final rules to implement these requirements. The following is a brief summary of the new requirements, followed by Frequently Asked Questions about these shareholder advisory votes.

### **EXECUTIVE SUMMARY**

Key provisions in the Act’s advisory vote requirements, as interpreted by the new SEC rules:

- *Say-on-Pay Vote*: Public companies must hold a non-binding shareholder vote on executive compensation (the “Say-on-Pay vote”) at their first annual shareholders meeting on or after January 21, 2011 (deferred for two years for smaller reporting companies). Pursuant to this vote, shareholders will be asked to approve the executive pay described in the proxy statement (including CD&A and the compensation tables). This vote must be held no less frequently than once every three years.
- *Frequency Vote*: Also, at their first annual meeting on or after January 21, 2011, public companies must hold a separate non-binding vote (the “frequency vote”) in which shareholders will express their opinion on whether the Say-on-Pay vote should be held annually, biennially, or triennially. (Again, this requirement is deferred for two years for smaller reporting companies.) The frequency vote must be held at least once every six years. After their annual meetings, companies must disclose on Form 10-Q whether they will abide by the shareholders’ preference on frequency.
- *Parachutes Disclosure and Say-on-Parachutes Vote*: The proxy materials to approve any merger, sale of assets or similar transaction must include enhanced disclosure of the golden parachutes compensation to executives related to the transaction, including a table and narrative disclosure. The proxy materials must also include a separate shareholder advisory vote on the parachute compensation (the “Say-on-Parachutes vote”), unless the enhanced disclosure was part of a prior Say-on-Pay vote and there are no new arrangements. The parachutes disclosure and Say-on-Parachutes vote requirements are effective for merger proxy statements and other transaction-related filings on or after April 25, 2011, including for smaller reporting companies.

## **FREQUENTLY ASKED QUESTIONS ABOUT THE SHAREHOLDER ADVISORY VOTES**

### **General**

*When will the SEC rules implementing the requirements for the advisory votes go into effect, and when will public companies be required to begin holding these shareholder votes?*

Under the Act, the Say-on-Pay vote and frequency vote must be held at the first annual shareholders meeting on or after January 21, 2011. On the other hand, the Say-on-Parachutes disclosure and vote requirements will be effective for merger proxy statements and other transaction-related documents filed on or after April 25, 2011.

*Must a company file a preliminary proxy statement when including Say-on-Pay and frequency vote resolutions in its annual meeting proxy materials?*

No. The SEC has amended Rule 14a-6(a) to clarify that the inclusion of Say-on-Pay and frequency vote resolutions in a proxy statement do not trigger the requirement for a preliminary proxy statement.

*Are any companies excluded from the new advisory vote requirements?*

The SEC was authorized by the Act to exclude smaller companies or other categories of issuers. In the final rules, the SEC deferred the requirements for the Say-on-Pay vote and the frequency vote (but not the Say-on-Parachutes vote) for smaller reporting companies for two years, to be effective for the first annual meeting on or after January 21, 2013. Before that time, the SEC will consider further whether to modify the requirements for smaller companies.

*Where can I obtain a copy of the SEC's adopting release for the final rules?*

The adopting release, which includes the full text of the final rules, can be found at <http://www.sec.gov/rules/final/2011/33-9178fr.pdf>.

### **Say-On-Pay Advisory Vote**

*What must the Say-on-Pay vote cover, and how must the resolution be phrased in the proxy statement?*

Under new Section 14A(a) of the Securities Exchange Act of 1934, the shareholder advisory vote must be a proposal to approve all executive compensation disclosed under Item 402 of Regulation S-K. This includes the compensation and policies described in the compensation discussion and analysis section of the proxy statement (CD&A), if applicable, the compensation tables and the narrative disclosures on compensation in the proxy statement. The vote does not cover director compensation, and it does not cover a separate disclosure on the risk elements of compensation unless that disclosure is included in CD&A.

The company is not required to use a specific form of resolution under the Act or the new SEC rules, and the vote need not be in the form of a resolution. Some companies have elected to include a short section describing the vote; other companies are choosing to include a brief statement about why the board has recommended that the shareholders vote to approve the company's executive compensation. In final Rule 14a-21(a), the SEC included an example of the language that could be used if a resolution is included:

“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 recently issued interpretations, the SEC confirmed that the specific reference to Item 402 need not be included. We recommend that companies not include any language that would narrow the scope of the vote, such as stating that the vote is to approve the company's “compensation policies.”

*Does a Say-on-Pay shareholder vote have any binding effect?*

No. The Act provides that the Say-on-Pay vote is not binding and may not be construed as overruling any decision by the company or board of directors or to affect the fiduciary duties of the company or the board. However, the Say-on-Pay vote could have other effects on the board and its decision-making process for compensation matters. For example, if a company receives a negative Say-on-Pay vote and does not make subsequent changes in its compensation practices that may be desired by shareholders, at future annual meetings the shareholders may be more inclined to vote against directors (particularly compensation committee members). Further, a negative Say-on-Pay vote may make it more difficult to obtain future shareholder approval of a new equity compensation plan or an expansion of an existing equity plan, unless the company has shown that it has addressed the practices that may have created the negative Say-on-Pay vote. These factors may increase pressure on boards of directors and compensation committees to communicate with large shareholders and proxy advisory firms (such as ISS) to determine what compensation practices might be necessary to achieve a positive vote.

*Do the SEC rules change the requirements for compensation disclosures in proxy statements?*

The final SEC rules, effective on April 25, 2011, change the proxy statement disclosure requirements to add one additional disclosure to CD&A. The company will be required to address in CD&A whether, and if so, how the board's compensation policies and decisions have taken into account the results of the most recent Say-on-Pay vote.

*How often does a public company need to hold the Say-on-Pay vote?*

The Act requires that the Say-on-Pay vote be held no less often than once every three years, starting with the required vote at the 2011 annual meeting. The Act also requires that the company hold the frequency vote, described below, to provide shareholder input on the frequency of the Say-on-Pay vote.

## **Frequency Vote Requirement**

*What must be covered by the frequency vote?*

The frequency vote, which some have called the “Say When On Pay” vote, must allow shareholders to express their opinion on whether the Say-on-Pay vote should be held every one year (annual), two years (biennial) or three years (triennial). The SEC rules require that shareholders be offered four choices on the company’s proxy card – annual, biennial, triennial, or a vote to abstain. The SEC has adopted an amendment to Rule 14a-4 to permit the form of proxy cards to conform to these four choices.

*How often does the frequency vote need to be taken?*

Under the Act, the frequency vote must be held no less often than once every six years.

*Does the frequency vote have any binding effect?*

The frequency vote is a non-binding advisory vote, similar to the Say-on-Pay vote. However, in the new rules, the SEC has created mechanisms that will encourage companies to abide by the preference expressed by the shareholders. First, the rules amend Form 8-K to require that the company disclose its decision on how frequently it will conduct the Say-on-Pay votes in light of the voting results. This Form 8-K is due 150 days after the annual meeting (but at least 60 days before the deadline for shareholder proposals for the next annual meeting).

Second, the SEC amended Rule 14a-8 to allow shareholders to introduce a shareholder proposal on the frequency of Say-on-Pay votes **unless** the company adopts a frequency vote policy consistent with the results in the shareholder advisory vote that received a majority vote. For example, if a company’s shareholders in 2011 express a preference for a biennial Say-on-Pay vote and the company subsequently announces in its Form 8-K that the board will only hold triennial votes, then at the 2012 annual meeting, a shareholder will be entitled to introduce a resolution to hold a specific frequency (either annual or biennial) of Say-on-Pay votes, which would be required to be included in management’s proxy statement. The company would not be permitted to exclude the shareholder proposal.

*What is the optimal frequency for Say-on-Pay votes?*

Many companies have taken the position that a triennial vote is preferable, because they will want to avoid the effort, expense and disruption of holding a Say-on-Pay vote every year or every two years. Further, some commentators have favored a triennial vote because it can encourage shareholders to take a long-term view of compensation matters, and many companies have long-term incentive compensation plans that include 3-to-5 year measurement periods.

However, annual or biennial Say-on-Pay votes can have advantages in some cases, and companies should consider their current relationships with shareholders and other factors. For example, annual Say-on-Pay votes would give shareholders a regular means of expressing disenchantment with the

company's pay practices without having to vote against individual directors, or against a resolution to authorize a new or expanded equity compensation plan.

ISS and other shareholder advisory groups have generally favored annual Say-on-Pay votes, and to date shareholders of most companies have indicated their preference for an annual vote, regardless of the company's recommendation. Companies may want to consider advisory group recommendations and trends in shareholder preferences when recommending a frequency to shareholders. However, the ultimate recommendation should reflect the board's conclusions on the best alternative for the particular company.

## **Parachutes Disclosures and Say-On-Parachutes Advisory Vote**

*What enhanced disclosures are required under the new rules?*

Under new Item 402(t) of Regulation S-K, starting on April 25, 2011, golden parachutes disclosures will be required in a proxy statement for shareholder approval of a merger, sale of the company's assets or similar transaction. For consistency, the SEC has also amended other SEC forms to require similar disclosures in the relevant documents for tender offers and other similar transactions. Under the new rules, the elements of golden parachute compensation for each named executive officer must be set forth in a new table. A table need only cover incremental amounts relating to the transaction, and need not include amounts that were already vested. The rule also requires a narrative description of the terms of the payment obligations and other material terms. The disclosures must cover payments to be made by the acquiring company as well as by the target company, although it is only the latter that must be voted on in the Say-on-Parachutes vote.

*What does the Say-on-Parachutes vote cover?*

The Say-on-Parachutes vote is an advisory vote on the compensation of the company's named executive officers related to the merger or other change in control transaction, as disclosed under the new Item 402(t). Similar to the Say-on-Pay resolution, no particular language is required.

*Are there any exceptions to the Say-on-Parachutes vote requirement?*

Yes. The vote need not be held if the disclosures under Item 402(t) have been previously included in the annual meeting proxy statement in which the company previously held a Say-on-Pay vote. Therefore, a company that wishes to take advantage of this exclusion in a future merger must voluntarily include the Item 402(t) disclosures in its proxy statements for annual meetings at which a Say-on-Pay vote will be held. However, if the company includes the Item 402(t) disclosures in the annual meeting proxy statement and there are changes to the arrangements after the date of the annual meeting, or if new arrangements are adopted that were not subject to a prior Say-on-Pay vote, then a Say-on-Parachutes vote will still be required. For example, if following the date of the most recent Say-on-Pay vote the company implements executive salary increases or issues additional equity grants that affect the amounts of golden parachutes compensation disclosed in the previous proxy statement, then the company would be required to hold a Say-on-Parachutes vote covering the new or amended parachute payment arrangements.

*Does a Say-on-Parachutes shareholder vote have any binding effect?*

Like the Say-on-Pay vote, the Act provides that the Say-on-Parachutes vote is not binding and may not be construed as overruling any decision by the company or board of directors or to affect the fiduciary duties of the company or the board. Whether a Say-on-Parachutes vote will have any practical impact on the board and its decision-making process remains to be seen. Unlike the Say-on-Pay vote, the Say-on-Parachutes vote will generally be held at a time when the board will not be facing a future re-election vote or a future vote to authorize a new or expanded equity plan. However, the enhanced disclosure required by Item 402(t), which will be the subject of a shareholder advisory vote, may make compensation committees more reluctant to adopt new parachute arrangements shortly before a merger transaction.

## **How To Prepare**

*What should a public company do to prepare for these advisory votes?*

We recommend that public company boards of directors, compensation committees and management immediately consider the following steps to prepare for these new shareholder advisory vote requirements:

- Evaluate the company's prior and upcoming compensation disclosures, particularly CD&A. The company should determine what steps should be taken to enhance the clarity and transparency of the compensation disclosure and should consider including an executive summary in the CD&A section that sets forth the company's philosophy and the reasons that shareholders should support the compensation committee's decisions. The company should keep in mind that it will now be facing a referendum on its compensation policies, and communication will be critical.
- In evaluating its compensation disclosures, including matters to be highlighted in a summary, the company should especially consider the following topics, which have been mentioned by shareholder advisory groups and institutional investors as areas of particular focus: (1) Establish the link between executive pay and the company's financial performance. Because shareholders often focus on total shareholder return (TSR), the proxy statement should clearly explain how incentives based on measures other than TSR are consistent with enhancing long-term shareholder value. (2) Address, and be prepared to defend, compensation practices that may be considered problematic by major shareholders or ISS or other advisory groups. These would include "single trigger" payouts upon change in control; "gross-up" arrangements to reimburse executives for excise taxes upon change in control payments; and excessive "perks." (3) Clearly explain how the company's compensation practices mitigate risk-taking behavior.
- Consider on an ongoing basis whether to adjust any of the company's pay practices, especially if they are considered problematic by ISS, or if large shareholders have commented on the practices or have introduced shareholder proposals on compensation matters at past annual meetings.

- Consider active engagement with large shareholders on “red flag” compensation issues on an ongoing basis. Investor relations officers should be part of the planning process, as they will be especially important in engaging with shareholders and crafting ongoing communications.
- Consider hiring a proxy solicitation firm to communicate with shareholders and to facilitate the voting of shares in broker accounts by “street name” holders. Under the Act, brokers can no longer vote shares on any compensation-related matters without voting instructions from the beneficial owners of the shares – similar to a change to the broker voting rules effective last year, relating to election of directors. This lack of broker discretionary voting is likely to make it more difficult for some companies to achieve an affirmative vote on Say-on-Pay.
- Consider what frequency for Say-on-Pay votes should be recommended by the board in connection with the frequency vote.

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