SEC Issues Proposed 'Say on Pay' Rules

eALERT

On October 18, the SEC issued proposed rules implementing the three "say on pay" voting provisions mandated by the Dodd-Frank Act — the vote on approval of executive compensation ("say on pay"), the vote on the frequency of future say on pay votes ("say on frequency"), and the vote on approval of compensation payable in connection with a merger or other corporate transaction ("say on parachutes"). The SEC interprets all three votes as being advisory in nature.

As proposed, these provisions would apply to all companies that are subject to the SEC's proxy rules, including smaller reporting companies. For the most part, the statutory requirements would be implemented by a new Rule 14a-21, which would mandate the required shareholder votes, and a new Item 24 of Schedule 14A, which would prescribe the required disclosure with respect to such votes.

The SEC interprets the Dodd-Frank Act as requiring companies to include the say on pay and say on frequency votes in their proxy statements for the first annual meeting occurring on or after January 21, 2011, whether or not the final SEC rules implementing those provisions have been adopted. However, the disclosure and voting with respect to golden parachute arrangements will not be required until final rules have been adopted.

The SEC has proposed amending the proxy rules so that say on pay and say on frequency proposals do not trigger a requirement to file a preliminary proxy statement. In anticipation that some issuers will be filing proxy statements containing these proposals before the final rules are effective, the proposing release states that pending adoption of the final rules, preliminary proxy statements need not be filed solely on account of say on pay or say on frequency proposals.

Say on Pay

The say on pay vote must be held at least once every three years. The company must provide a separate shareholder advisory vote to approve the compensation of the company's named executive officers (*i.e.,* the officers whose compensation is required to be disclosed under the current rules) as such compensation is disclosed under Item 402 of Regulation S-K. Thus the vote would encompass the Compensation Discussion and Analysis ("CD&A") as well as the compensation tables and related narrative. (For smaller reporting companies, the vote would be based on the simplified compensation disclosures applicable to them, which do not include a CD&A.) While the proposed rules do not require any specific language to be used for the say on pay proposal, the language must be broad enough to encompass the entire compensation disclosure. Thus, the SEC release expressly provides that the proposal cannot be limited to a vote only on compensation policies and procedures. However, the rules do not prohibit a shareholder vote on a narrower aspect of compensation policy as long as it is in addition to the mandated vote.

The new golden parachute disclosures would not be required to be included in an annual meeting proxy statement in the absence of a corporate transaction, but if included would be within the scope of the say on pay vote. Director compensation is not subject to the say on pay vote. Disclosures with respect to the company's compensation policies as they relate to risk-taking by non-executive employees would not be within the scope of the say on pay vote; however the SEC release indicates that such discussion with respect to the compensation policies affecting named executive officers should be included in the CD&A, and thus would be covered by the say on pay proposal.

The proposed rules would require proxy statements to expressly state that the say on pay proposal is required by the proxy rules, as well as "the general effect of the vote, such as whether the vote is non-binding." (These disclosure requirements also apply with respect to the say on frequency and say on parachutes proposals.) In addition, the SEC is proposing to require companies to state in their CD&A whether, and if so how, the company's compensation policies and decisions have been affected by the results of prior shareholder votes on executive compensation. (Smaller reporting companies, while not required to provide a CD&A, would be expected to include similar information if the say on pay vote was a material factor affecting their compensation decisions.)

Say on Frequency

The say on frequency vote must be held at least once every six years. Shareholders must be given a choice as to whether advisory say on pay votes will occur every 1, 2, or 3 years. The proposed rules specify that the proxy card must present four choices with respect to this proposal — every 1, 2, or 3 years, or abstain. While the issuer is permitted to make a recommendation, the vote cannot be limited to approval or rejection of the issuer's recommendation.

As a transition matter until the final rules are effective, if proxy service providers are unable to re-program their systems to provide the three choices plus a box for abstentions, the SEC will not object if proxy cards provide a choice of 1 year, 2 years, or 3 years — without a box to indicate abstention — provided that the proxy will not be voted on the say on frequency proposal unless one of the three choices is indicated.

The SEC is also proposing to amend Rule 14a-8 (the rule governing when a company may exclude a shareholder proposal from the company's proxy statement) to provide that a company may exclude a shareholder proposal dealing with say on pay or say on frequency if the company has adopted a policy with respect to the frequency of say on pay votes that is consistent with the plurality of votes cast in the most recent say on frequency vote. As proposed, Rule 14a-8 would allow companies to exclude say on pay proposals having the same broad scope as the proposal required by Rule 14a-21, but would not allow exclusion of narrower shareholder proposals dealing with a specific element of compensation.

In addition to the existing Form 8-K requirement to disclose the results of all shareholder votes within four business days after the date of the meeting, the SEC has proposed amending Forms 10-K and 10-Q to require companies to disclose, in the next Form filed after the shareholder meeting, the company's decision regarding how frequently it will hold say on pay votes.

While for most companies the first say on frequency vote will be required for the first annual meeting occurring on or after January 21, 2011, companies with outstanding TARP indebtedness — which are required under the TARP rules to have an annual say on pay vote — would not be required to have a say on frequency vote until the first annual meeting after their TARP indebtedness has been repaid.

Say on Parachutes

In order to implement the new say on parachutes requirement, the SEC is proposing to add a new Item 402(t) to Regulation S-K prescribing the required disclosure of executive compensation arrangements "based on or otherwise related to" a merger or other corporate transaction. Under the SEC proposal, the disclosure of such "golden parachute" arrangements would be required not only for the transactions specified in the Dodd-Frank Act (merger, acquisition, consolidation, or sale of all or substantially all assets), but also for SEC filings with respect to registration statements relating to a merger or similar transaction, proxy statements by acquiring companies that do not contain merger proposals but do contain proposals whose adoption is necessary to effect a merger (such as a proposal to increase the number of authorized shares), third party tender offers (and issuer responses), and going private transactions. The disclosure would be required in any proxy or consent solicitation to approve any of these transactions, as well as in any information statement filed with respect to any such transaction — and would be required whether or not a say on parachutes vote was required.

In another expansion of the Dodd-Frank Act requirement, proposed Item 402(t) would require disclosure of all golden parachute compensation payable to named executive officers of either the target or the acquiring company — whether payable by the target or the acquiring company. However, such disclosure would not be required with respect to named executive officers (other than a former CEO or CFO) who left the company before year-end.

The disclosure is required to be provided in tabular form with accompanying narrative. The table would be required to contain columns quantifying each of the following categories of golden parachute compensation and a column showing the total of such compensation for each executive officer covered by the table:

- Cash severance payments (including salary, bonus, and pro-rated non-equity incentive plan payments)
- Equity (including the dollar value of accelerated stock awards, the aggregate spread of accelerated in-the-money option awards, and payments in cancellation of any stock or option awards), in each

case based on company stock price as of the latest practicable date

- Pension or deferred compensation benefit enhancements
- Perquisites and health and welfare benefits (unlike the current rules for annual proxy statements, disclosure would be required even if the aggregate value of perquisites was below $10,000 and even if health and welfare benefits were provided on a non-discriminatory basis)
- Tax reimbursements (including parachute gross-up payments)
- Other (with each component separately identified)

In each of these columns, disclosure would be required only for amounts payable based on or otherwise relating to the transaction. However the SEC apparently views a cash-out of previously-vested options as covered by this criterion. Footnotes to the table would be required to separately quantify amounts payable on a single trigger (*i.e.,* payable upon the transaction without regard to any other condition) and those payable on a double trigger (*e.g.,* requiring both a termination of employment and occurrence of the transaction). If any column includes more than one form of compensation, each separate form would be required to be quantified by footnote.

Under the proposed rules, the table would not include compensation pursuant to employment agreements dealing with post-transaction employment, but disclosure of such arrangements may be required under the existing disclosure item calling for disclosure with respect to "substantial interests" in the transaction.

If there are uncertainties as to whether an element of golden parachute compensation will be paid or the amount of the payment, the table must include a reasonable estimate, and the narrative must identify the material assumptions underlying such estimate, as well as the specific conditions under which the payment would be made. Health benefits are required to be quantified using the assumptions used for financial reporting purposes. The narrative must state by whom each payment would be made, whether each type of payment would be lump sum or over a period of time, and in the latter case, the duration of such payments, as well as any other material factors regarding each compensation agreement. The narrative must also disclose any non-compete or similar conditions to receipt of the compensation and any provisions regarding waiver of such provisions.

The Dodd-Frank Act provides that a separate advisory vote on golden parachute arrangements is required in the proxy statement to approve the transaction unless such arrangements have been subject to a previous say on pay vote. In implementing this provision, the proposed rules treat such golden parachute arrangements as having been subject to a prior say on pay vote only if the information required by new S-K Item 402(t) was included in a prior proxy statement and thus subject to the general say on pay vote. For purposes of this disclosure in an annual proxy statement, equity compensation would be valued based on the company's stock price on the last day of the fiscal year. If the Item 402(t) information is provided in an annual proxy statement, the Item 402(j) disclosures (termination of employment and change of control payments) could omit the information related to change of control payments, but would continue to be required to cover other types of terminations.

The compensation required to be made subject to the say on parachutes vote is narrower than the compensation required to be disclosed under Item 402(t). The vote is required only with respect to the types of transactions specified in the Dodd-Frank Act. In addition, consistent with a narrow, technical reading of the Act, the SEC proposal provides that in the case of solicitations by the target company, the advisory vote is not required to encompass arrangements between the acquiring company and the officers of the target. (Arrangements between the acquiring company and the officers of the target would be required to be subject to an advisory vote in proxy solicitations by the acquiring company.) Finally, the say on parachutes vote is not required as long as the Item 402(t) information was provided in a prior proxy statement and made subject to a general say on pay vote — whether or not the compensation arrangements were approved by shareholders. However, under the proposed rule any new golden parachute arrangements and any modifications to arrangements previously subject to a say on pay vote would be required to be subject to a say on parachutes vote.

In order to clarify the scope of the compensation subject to the say on parachutes vote, the proposed rule contemplates that proxy statements would contain two Item 402(t) tables — one containing the compensation that is subject to the say on parachutes vote and the other containing all golden parachute compensation required to be discussed under Item 402(t). Alternatively, the issuer could choose to have the say on parachutes vote encompass all of the golden parachute compensation, in which case only a single Item 402(t) table would be required.

For more information about the say on pay rule proposals, or other executive compensation and corporate governance provisions of the Dodd-Frank Act, or Hughes Hubbard's executive compensation and corporate governance practices, please contact any of the following attorneys:

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