

# Clients & Friends Memo

## SEC Proposes New Rules Regarding Shareholder Approval of Executive Compensation and Golden Parachute Arrangements

November 29, 2010

The Securities and Exchange Commission (the “SEC”) recently issued proposed rules (the “Proposed Rules”) to implement the provisions of Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Act”).<sup>1</sup> Section 951 of the Act requires publicly traded companies to provide for non-binding shareholder votes on executive compensation (“say on pay” and “say when on pay” votes) and golden parachute packages (“say on golden parachutes”) of named executive officers.

Because “say on pay” votes are generally required for the upcoming proxy season, companies should (1) begin to review their executive compensation arrangements and Compensation Discussion and Analysis (“CD&A”) disclosure to identify any issues that might be seen as controversial; (2) in light of the review of their executive compensation arrangements and CD&A disclosure, determine in consultation with their counsel and compensation advisors how best to comply with the mandated “say on pay” votes in their proxies; and (3) determine whether an annual, biennial or triennial “say on pay” vote best fits with their executive compensation program, and whether such determined frequency will be recommended to shareholders in their proxies.

### Highlights:

Under the Act and the Proposed Rules:

- the shareholder votes for “say on pay”, “say when on pay” and “say on golden parachutes” mandated by the Act may not be construed as (1) overruling a decision by an issuer or an issuer’s board of directors; (2) creating or implying any change to the fiduciary duties of such issuer or board of directors; (3) creating or

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<sup>1</sup> Cadwalader has prepared a short summary of the Act and a series of memoranda focused on the Act’s application to specific industries, entities and transactions. To see these other memoranda, please see Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Appendix A links to the various topic-focused memoranda) or visit our website at [http://www.cadwalader.com/list\\_client\\_friend.php](http://www.cadwalader.com/list_client_friend.php). A copy of the Proposed Rules can be found at <http://www.sec.gov/rules/proposed/2010/33-9153.pdf>.

implying any additional fiduciary duties for such issuer or board of directors; or (4) restricting or limiting the ability of shareholders to make proposals for inclusion in proxy materials related to executive compensation;

- while a proxy, consent or authorization for the first annual (or other) shareholder meeting occurring on or after January 21, 2011 (*i.e.*, at least 6 months after enactment of the Act) must include a non-binding “say on pay” vote to approve executive compensation packages and a separate non-binding shareholder vote to determine the frequency of such “say on pay” voting, a non-binding shareholder vote on golden parachute packages will not be required until the SEC finalizes its proposed “say on golden parachutes” rules;
- at least once every six years, shareholders must be given four choices with respect to when (the “say when on pay” vote) the non-binding “say on pay” vote will occur: whether the “say on pay” vote will occur every 1, 2 or 3 years, or to abstain from voting on the matter, with the “say when on pay” vote itself being non-binding, if so determined by the issuer;
- the “say on pay” and “say when on pay” votes do not apply to an issuer’s director compensation or compensation policies and practices as they relate to risk management and risk-taking incentives as they relate to employee compensation generally;
- the “say on pay” and “say when on pay” votes required by the Act would be added to the list of items that do not trigger a preliminary filing and, until the Proposed Rules are finalized, the SEC will not object if issuers do not file proxy materials in preliminary form and the only matters that would require a filing in preliminary form are such “say on pay” and “say when on pay” votes;
- if the Proposed Rules are adopted as final, once effective, in accordance with a new proposed Item 402(t) of Regulation S-K, issuers would be required to disclose specified information with respect to golden parachute compensation arrangements in proxy or consent solicitations in connection with an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all assets, as required by the Act, as well as in information statements filed pursuant to Regulation 14C, proxy or consent solicitations that do not contain merger proposals but require disclosure of information under Item 14 of Schedule 14A pursuant to Note A of Schedule 14A, registration statements on Form S-4 and F-4 containing disclosure relating to mergers and similar transactions, going private transactions on Schedule 13E-3, and third-party tender offers on Schedule TO and Schedule 14D-9;

- issuers would only be required to provide shareholders a “say on golden parachutes” vote in proxy statements for meetings at which shareholders are asked to approve an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all assets,<sup>2</sup> and not the broader set of circumstances in which proposed Item 402(t) disclosure will be required, such as proxy or consent solicitations that do not contain merger proposals, going private transactions and third party tender offers;
- broker discretionary voting of uninstructed shares would not be permitted for “say on pay” or “say when on pay” votes;
- issuers that have received financial assistance under the Troubled Asset Relief Program (“TARP”) will not be required to include a separate “say on pay” and “say when on pay” vote under the Act until the first annual meeting of shareholders after the issuer has repaid all outstanding indebtedness under the TARP;<sup>3</sup> and
- if proxy service providers are not able to reprogram their systems to enable shareholders to vote among four choices in time for the “say when on pay” votes required by the Act, the SEC will not object if the form of proxy for a “say when on pay” vote provides means whereby the person solicited is afforded an opportunity to specify by boxes a choice among 1, 2 or 3 years, and proxies are not voted on the “say when on pay” votes matter in the event the person solicited does not select a choice among 1, 2 or 3 years.

#### Discussion:

#### 1. “Say on Pay” and “Say When on Pay” Voting

**A. “Say on Pay”.** The Act requires publicly traded companies to provide for a non-binding shareholder vote to approve executive compensation packages at least once every three years. The voting must be provided for in any proxy or consent or authorization for an annual (or other) shareholder meeting for which SEC proxy solicitation rules require compensation disclosure.

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<sup>2</sup> Such a vote would not be required on golden parachute compensation if disclosure of such compensation has been included in the executive compensation disclosure that was subject to a prior advisory vote of shareholders under the Act’s “say on pay” requirements.

<sup>3</sup> Non-binding “say on pay” votes are already mandatory for companies that received government assistance through TARP. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111(e) (2008) (as amended by the American Recovery and Reinvestment Act of 2009); 31 C.F.R. § 30.13 (2009). See also 17 C.F.R. Part 240 (2010) (SEC amendments to the proxy rules under the Securities Exchange Act of 1934 requiring TARP recipients to include a “say on pay” vote in their proxies).

Under the Proposed Rules, shareholders would separately vote to approve the compensation of the issuer's named executive officers, as such compensation is disclosed in Item 402 of Regulation S-K.<sup>4</sup> Issuers would be required to disclose that they are providing such a vote on executive compensation and to briefly explain the general effect of the vote (such as whether the vote is non-binding).

The Proposed Rule for "say on pay" votes would not require issuers to use any specific language or form of resolution to be voted on by shareholders, though the SEC notes that the vote must relate to all executive compensation disclosure set forth pursuant to Item 402 (and not merely be a vote to approve "only compensation policies and procedures" generally).

Under the Proposed Rules, issuers would generally be required to address in their CD&A whether and, if so, how their compensation policies and decisions have taken into account the results of shareholder advisory votes on executive compensation.<sup>5</sup> While this proposed disclosure is not required by the Act, the SEC believes that this mandate to provide disclosure on these issues will "facilitate better investor understanding of issuers' compensation decisions."

**B. "Say When on Pay".** The Act requires a non-binding shareholder vote at least once every 6 years to determine whether the non-binding votes to approve executive compensation packages described above will occur every 1, 2 or 3 years. Under the Proposed Rules, this "say when on pay" frequency vote would be required only in a proxy statement solicited for an annual or other meeting of shareholders for which compensation disclosure is required.

The Proposed Rules for "say when on pay" votes do not provide the specific language to be used with respect to such votes and do not require issuers to frame the vote in the form of a resolution. Issuers would be required to disclose that they are providing a separate shareholder advisory vote on the frequency of the "say on pay" vote on executive compensation and to briefly explain the general effect of the vote (such as whether the vote is non-binding).

The Proposed Rules permit the exclusion of shareholder proposals that would provide a say-on-pay vote or seek future say-on-pay votes or that relates to the frequency of say-on-pay votes, provided the issuer has adopted a policy on the frequency of say-on-pay votes that is consistent with the

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<sup>4</sup> Because smaller reporting companies are subject to scaled executive compensation disclosure requirements and are not required to include a CD&A, the shareholders of a smaller reporting company would vote to approve the compensation of the named executive officers, as disclosed under Item 402(m) through 402(q) of Regulation S-K. The Proposed Rules clarify that this requirement for smaller reporting companies does not change the scaled disclosure requirements applicable to such entities and that smaller reporting companies would not be required to provide a CD&A in order to comply.

<sup>5</sup> Because smaller reporting companies are not required to include a CD&A as part of their Item 402 disclosure, this proposed new disclosure requirement would not apply to smaller reporting companies.

plurality of votes cast in the most recent “say when on pay” vote in accordance with the Proposed Rules. For example, if in the first “say when on pay” vote the largest number of votes were cast for a two-year frequency for future shareholder votes on executive compensation, and the issuer discloses that it has approved a policy to hold the vote every two years, a shareholder proposal seeking a different frequency could be excluded so long as the issuer seeks votes on executive compensation every two years and provides a “say when on pay” vote at least every six years as required by the Act.

Under the Proposed Rules, an issuer would be required to disclose, in the quarterly report on Form 10-Q covering the period during which the “say when on pay” vote occurs, or in the annual report on Form 10-K if the “say when on pay” vote occurs during the issuer’s fourth quarter, its decision regarding how frequently it will conduct “say on pay” advisory votes in light of the results of the “say when on pay” vote on frequency and whether it determines that the “say when on pay” vote by the shareholders is binding on it.

## 2. Disclosure and Approval of Golden Parachutes

**A. Disclosure of Golden Parachutes.** The Act requires all persons making a proxy or consent solicitation seeking shareholder approval of an acquisition, merger, consolidation or proposed sale or disposition of all or substantially all of an issuer’s assets to provide disclosure of any agreements or understandings that the soliciting person has with its named executive officers (or that it has with the named executive officers of the acquiring issuer) concerning compensation that is based on or otherwise relates to the merger transaction. In addition, the Act requires disclosure of any agreements or understandings that an acquiring issuer has with its named executive officers and that it has with the named executive officers of the target company in transactions in which the acquiring issuer is making a proxy or consent solicitation in seeking shareholder approval of an acquisition, merger, consolidation or proposed sale or disposition of all or substantially all of an issuer’s assets. The Act requires that this disclosure be in a “clear and simple form in accordance with regulations” to be promulgated by the SEC and to include “the aggregate total of all such compensation that may (and the conditions upon which it may) be paid or become payable to or on behalf of such executive officer.” The Act does not consider whether such compensation would trigger penalty taxes and loss of tax deductibility under Sections 280G and 4999 of the Internal Revenue Code.

In order to implement these “say on golden parachutes” provisions of the Act, the SEC is proposing to require disclosure with respect to golden parachute compensation arrangements in proxy or consent solicitations in connection with an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all assets, in accordance with a new proposed Item 402(t) of Regulation S-K.

As proposed, Item 402(t) would require disclosure of named executive officers' golden parachute arrangements in both tabular and narrative formats. The table proposed under Item 402(t) would present quantitative disclosure of the individual elements of compensation that an executive would receive that are based on or otherwise relate to the merger, acquisition, or similar transaction, and the total for each named executive officer. Elements that would be separately quantified and included in the total would be any cash severance payment (e.g., base salary, bonus and pro-rata non-equity incentive plan compensation payments; the dollar value of accelerated stock awards, in-the-money option awards for which vesting would be accelerated, and payments in cancellation of stock and option awards; pension and nonqualified deferred compensation benefit enhancements; perquisites and other personal benefits and health and welfare benefits; and tax reimbursements (such as Internal Revenue Code Section 280G tax gross-ups)). Issuers would also be required to quantify any additional elements of compensation not specifically includable in the other columns of the table. The table would require separate footnote identification of amounts attributable to "single-trigger" arrangements (for example, amounts payable upon consummation of the transaction) and amounts attributable to "double-trigger" arrangements (for example, amounts payable upon a qualifying termination of employment within a specified period of time following consummation of the transaction).

In a proxy statement soliciting shareholder approval of a merger or similar transaction, the tabular quantification of dollar amounts based on issuer stock price would be required to be based on the closing price per share as of the latest practicable date.<sup>6</sup> The SEC has asked for comments as to whether this measurement date is appropriate – while in the context of a corporate transaction it would seem more relevant to use the transaction's deal price per share for quantifications based on issuer stock price, as drafted, Item 402(t) specifically requires the use of the closing price per share of issuer stock as of the latest practicable date.

Item 402(t) would require quantification with respect to any agreements or understandings, whether written or unwritten, between each named executive officer and the acquiring company or the target company, concerning any type of compensation, whether present, deferred or contingent, that is based on or otherwise relates to an acquisition, merger, consolidation, sale or other disposition of all or substantially all assets. As described above, the table would quantify cash severance, equity awards that are accelerated or cashed out, pension and nonqualified deferred compensation enhancements, perquisites, tax reimbursements and the value of any other compensation related to the transaction.

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<sup>6</sup> Where Item 402(t) disclosure is included in an annual meeting proxy statement, such amounts would be calculated based on the closing market price per share of the issuer's securities on the last business day of the issuer's last completed fiscal year, consistent with quantification standards used in Item 402(j).

Item 402(t) would not require separate disclosure or quantification with respect to compensation otherwise required to be disclosed in the Pension Benefits Table and the Nonqualified Deferred Compensation Table, and Item 402(t) would also not require disclosure or quantification of previously vested equity awards. Item 402(t) would also not require disclosure and quantification of compensation from bona fide post-transaction employment agreements to be entered into in connection with the merger or acquisition transaction – the SEC notes that it does not view future employment arrangements as compensation “that is based on or otherwise relates to” the transaction.

Item 402(t) would require issuers to describe any material conditions or obligations applicable to the receipt of payment, including but not limited to non-compete, non-solicitation, non-disparagement or confidentiality agreements, their duration, and provisions regarding waiver or breach. Issuers would also be required to provide a description of the specific circumstances that would trigger payment, whether the payments would or could be lump sum, or annual, and their duration, and by who the payments would be provided, and any material factors regarding each agreement.

In order to minimize the regulatory disparity that might otherwise result if Item 402(t) disclosure were only required in proxy or consent solicitations in connection with an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all assets, the Proposed Rules would require that Item 402(t) disclosure also be included in information statements filed pursuant to Regulation 14C, proxy or consent solicitations that do not contain merger proposals but require disclosure of information under Item 14 of Schedule 14A pursuant to Note A of Schedule 14A, registration statements on Form S-4 and F-4 containing disclosure relating to mergers and similar transactions, going private transactions on Schedule 13E-3, and third-party tender offers on Schedule TO and Schedule 14D-9. While a bidder in a third-party tender offer would be required to provide information in its Schedule TO about a target’s golden parachute arrangements, such information will only be required to the extent the bidder has made a reasonable inquiry about the golden parachute arrangements and has knowledge of such arrangements.

**B. “Say on Golden Parachutes”.** The Act generally requires a separate shareholder advisory vote on golden parachute compensation arrangements required to be disclosed in connection with mergers and similar transactions. A separate shareholder advisory vote would not be required on golden parachute compensation if disclosure of that compensation has been included in the disclosure that was subject to a prior advisory vote of shareholders under the Act’s “say on pay” requirements. Under the Proposed Rules, issuers would be required to provide a separate shareholder advisory vote on golden parachute compensation arrangements only in proxy statements for meetings at which shareholders are asked to approve an acquisition, merger,

consolidation, or proposed sale or other disposition of all or substantially all assets (and not in all circumstances in which Item 402(t) disclosure is otherwise required).

The Proposed Rules would not require issuers to use any specific language or form of resolution to be voted on by shareholders, and the shareholder vote would not be binding on the issuer or its board of directors.

In the event an issuer has disclosed its golden parachute compensation arrangements as part of the disclosure that was subject to a prior advisory vote of shareholders under the Act's "say on pay" requirements but new arrangements have been adopted and/or the terms of existing golden parachute arrangements have been revised prior to the "say on golden parachutes" vote required by the Act, these new and revised arrangements would be subject to a non-binding shareholder vote. Issuers providing for such a shareholder vote would provide two separate tables in merger proxy statements: one table would disclose all golden parachute compensation, including both arrangements and amounts previously disclosed and subject to a "say on pay" vote and the new arrangements or revised terms; the second table would disclose only the new arrangements or revised terms subject to the "say on golden parachutes" vote so that shareholders can clearly identify what is subject to the "say on golden parachutes" vote.

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If you have any questions regarding this memorandum, please contact the individuals listed below or any other member of the Cadwalader Tax Department.

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