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Client**Alert**

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SEC Adopts Final Rules on Say-on-Pay and Related Matters

On January 25, 2011, the Securities and Exchange Commission (the "SEC"), in a 3 to 2 vote, adopted rules implementing Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") that grants shareholders of all public companies subject to the federal proxy rules the right to cast a non-binding advisory vote on executive compensation ("say-on-pay"). The rules also address shareholder voting on the desired frequency of the say-on-pay votes ("say-on-frequency") and non-binding advisory votes on golden parachute arrangements ("say-on-golden parachutes").[1]

Although the required votes are non-binding, the new regime is expected to have a significant impact on the relationship between management and shareholders—in part because of the embarrassment a company would experience from a negative vote. The measure is therefore expected to give shareholders—particularly large shareholders—more influence in behind-the-scenes discussions with management over executive compensation after many shareholders expressed concern during the financial crisis at corporate pay practices. This client alert generally summarizes the final rules, highlights some differences between the adopted rules and the proposed rules, and outlines some current trends and practical considerations for companies to consider in preparing for the upcoming proxy season.[2]

Effectiveness

Say-on-Pay and Say-on-Frequency

The final say-on-pay and say-on-frequency rules become effective on April 4, 2011; however, the Dodd-Frank Act's requirements to hold an advisory say-on-pay and say-on-frequency vote at the first annual shareholder meeting occurring on or after January 21, 2011 are already in effect. As a result, while companies have flexibility with respect to certain aspects of the say-on-pay and say-on-frequency votes prior to the rules' effectiveness (e.g., the format for say-on-pay resolutions is specifically prescribed in the final rules but not in the Dodd-Frank Act), issuers are likely to begin complying with the mechanics of the rules even prior to effectiveness in order to set precedent for future years.

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1. http://sec.gov/rules/final/2011/33-9178.pdf
2. For a more detailed discussion of the proposed rules, please see our November 2010 alert, SEC Proposes Rules on Say-on-Pay and Related Matters.

The SEC adopted a temporary exemption for smaller reporting companies (i.e., with a public float of less than $75 million). Under the final rules, smaller companies, including newly public companies that qualify as smaller reporting companies after January 21, 2011, are not required to conduct say-on-pay and say-on-frequency votes until annual meetings occurring on or after January 21, 2013. In her remarks, Chairman Mary L. Schapiro stated that "this two-year deferral is a balanced and responsible way for the SEC to ensure that its rules do not disproportionately burden small issuers," and would allow the SEC to assess whether any adjustment to the rules is appropriate before it applies to smaller issuers. Absent further guidance from the SEC, it is unclear what smaller issuers who have already filed their proxy statements including say-on-pay and say-on-frequency proposals are supposed to do in light of the newly-adopted two-year exemption. It should be noted that as of January 21, 2011, about 38 smaller reporting companies filed their proxy statements including say-on-pay and say-on-frequency proposals. The adopting release clarified that companies that qualify as smaller issuers as of January 21, 2011, including newly public companies that qualify as smaller reporting companies as of January 21, 2011, are eligible to take advantage of the exemption even though the final rules do not become effective until April 4, 2011. So far, smaller reporting companies were quick to take advantage of the two-year exemption, with 11 smaller reporting companies filing proxy statements not including a say-on-pay or a say-on-frequency proposal in the first week after adoption of the final rules.

Say-on-Golden Parachutes

Unlike the say-on-pay and say-on-frequency vote requirements, which automatically went into effect on January 21, 2011, the say-on-golden parachutes votes and corresponding disclosure requirements are not effective until the completion of SEC rulemaking. The adopting release indicates that all public companies, including smaller reporting companies, must comply with the say-on-golden parachutes rules with respect to any merger proxy statement or other covered transactional document filed on or after April 25, 2011.

General Overview of the Adopted Rules

Summary of Say-on-Pay Rules

New Rule 14a-21(a) requires issuers, at least once every three calendar years, to seek a non-binding shareholder vote to approve the compensation of named executive officers ("NEOs") for the first annual or other meeting of shareholders occurring on or after January 21, 2011. The shareholder vote on executive compensation required by Section 14A(a)(1) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and Rule 14a-21(a) thereunder is required with respect to an annual meeting of shareholders at which proxies will be solicited for the election of directors, or a special meeting in lieu of such annual meeting. In accordance with Section 14A(a)(1), shareholders would vote to approve the compensation of the issuer's NEOs, as such compensation is disclosed pursuant to Item 402 of Regulation S-K. The compensation of directors is not subject to the shareholder vote.

In addition, if a company includes disclosure about its compensation policies and practices as they relate to risk management and risk-taking incentives, these policies and practices would not be subject to the shareholder advisory vote as they relate to the company's compensation for employees generally. However, when risk considerations represent a material aspect of the company's compensation policies or decisions for NEOs and are therefore discussed in a Compensation Discussion & Analysis ("CD&A"), such disclosure would be considered by shareholders when voting on executive compensation. Additionally, the SEC noted that issuers are not limited to the required shareholder advisory vote under Rule 14a-21(a) and, if desirable, may solicit additional separate shareholder votes on a range of compensation matters to obtain more specific feedback on the issuer's compensation policies and programs.

Summary of Say-on-Frequency Rules

Rule 14a-21(b) requires issuers, not less frequently than once every six calendar years, to seek a shareholder vote in proxy statements for annual meetings to determine whether the say-on-pay vote will occur every one, two, or three years. Companies are required to offer four choices to shareholders on a say-on-frequency proxy card: (1) one year, (2) two years, (3) three years or (4) abstain, subject to certain transition rules if the transfer agent is unable to tabulate four choices. In the adopting release, the SEC adopted amendments to Rule 14a-4 to permit proxy cards to reflect the choice of one, two, three years or abstain, for the frequency vote. Additionally, the SEC noted that issuers may vote uninstructed proxy cards in accordance with management's recommendation for the say-on-frequency vote only if the issuer follows the existing requirements of Rule 14a-4 to (1) include a recommendation for the say-on-frequency votes in the proxy statement, (2) permit abstention on the proxy card, and (3) include language regarding how uninstructed shares will be voted in bold on the proxy card. As discussed below, amended Form 8-K will require disclosure of the issuer's decision on the frequency of say-on-pay votes. Due to concerns raised by some commentators, the SEC clarified final Rule 14a-21(b) to state that the frequency vote is required at least once during the six calendar years following the prior frequency vote.

Summary of Say-on-Golden Parachutes Rules

All issuers filing proxy statements related to an acquisition, consolidation, or proposed sale or disposition of all or substantially all assets of the issuer will be required to seek a non-binding shareholder vote on payments to NEOs in connection with a change in control transaction (unless previously approved by a say-on-pay vote). Issuers would not be required to include in the merger proxy statement a separate say-on-golden parachutes vote disclosed under new Item 402(t) if such disclosure had been included in the executive compensation disclosure that was subject to a prior vote of shareholders (i.e., Section 14A(b)(2) requires only that the golden parachute arrangements have been subject to a prior shareholder vote, not that such arrangements have been actually approved by shareholders), provided that the previously included disclosure related to the same golden parachute arrangements. Therefore, a company seeking to take advantage of the exception to the shareholder advisory vote on golden parachutes requirement would have to provide disclosure in its annual meeting proxy statement about its change in control arrangements in compliance with the more detailed disclosure requirements of new Item 402(t) rather than relying on the more general requirements of Item 402(j) (which would continue to apply to other severance arrangements).

While companies may consider the advantages and disadvantages of holding a golden parachute vote at the time of their annual meeting and including the more extensive Item 402(t) disclosures in their annual meeting proxy statements, we believe that companies are unlikely to take advantage of such votes at annual meetings because any subsequent changes to golden parachute arrangements would make an earlier vote ineffective for purposes of avoiding another vote in the acquisition context. As discussed below, even though a shareholder vote may not be implicated in all change in control transactions, the SEC has expanded the list of transactions that would trigger Item 402(t) disclosure obligations, including, among others, mergers, going-private transactions and third-party tender offers. In the case of a third-party tender offer, the information is only required to be included to the extent the bidder has made a reasonable inquiry and has knowledge of such arrangements.

How are the Final Rules on Say-on-Pay, Say-on-Frequency and Say-on-Golden Parachutes Different from the Proposed Rules?

Say-on-Pay and Say-on-Frequency Resolutions

The final rules do not require issuers to use any specific language or form of resolution to be voted on by shareholders. However, the SEC specified that the say-on-pay proposal should be framed as a resolution and the rules seem to require a specific reference to Item 402 of Regulation S-K. In an added instruction to Rule 14a-21(a), the SEC gave a non-exclusive example of a resolution that would satisfy the applicable requirements: "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." Further, the rules do not expressly require any accompanying supporting statement. As of writing, almost half of the companies that filed their proxy statements included supporting statements, ranging from extensive discussions to brief paragraphs, intended to persuade their shareholders to cast a favorable vote. On the other hand, some companies chose to instead add an executive summary section to the CD&A. Others have chosen to include both. Because the rules will be in effect for the first time this year, we believe that it is reasonable to include a supporting statement in addition to referencing the disclosure in the CD&A and the executive compensation tables.

Because say-on-frequency is a form of a referendum on what shareholders prefer, not an up or down vote, it may be difficult to frame a say-on-frequency proposal as a resolution. The SEC did not provide an example of, or any guidance with respect to, a complying say-on-frequency proposal. As with say-on-pay, a supporting statement is not required. As a result, issuers have flexibility as to the format of their say-on-frequency proposals. In preparing for the upcoming proxy season, issuers have to consider whether to make a recommendation and, if so, whether a supporting statement is desirable. A supporting statement, if included, should make it clear that the say-on-frequency vote is not on the board's recommendation (i.e., not a vote for or against the proposal as recommended by the board), but rather on one of four options (i.e., one year, two years, three years or abstain). To date, companies recommending a triennial vote seem to be more likely to include a supporting statement explaining rationales for their frequency recommendation than those recommending an annual vote signaling a perception that an annual vote is more favored by shareholders. Such perception may be reinforced by the fact that Institutional Shareholder Services, Inc. ("ISS") is recommending an annual say-on-frequency vote. As the actual say-on-pay and say-on-frequency vote results begin to appear, companies may rethink their approach to both how they present their say-on-pay and say-on-frequency proposals as well as what the actual frequency recommendations are. We discuss some of the current trends under "Emerging Trends" below.

One practical issue for companies to consider in drafting their say-on-pay and say-on-frequency resolutions is where such proposals should be included in the proxy statements. For example, companies who decide to omit a supporting statement would be well advised to ensure that their say-on-pay and say-on-frequency

proposals immediately precede their CD&A. So far, however, most companies seem to continue to follow the existing structural format of their proxy statements including their say-on-pay and say-on-frequency resolutions with the rest of the proposals.

CD&A Disclosure of Impact of Most Recent Say-on-Pay Vote

Originally, the SEC had proposed that companies be required to disclose in their CD&As whether and, if so, how their compensation policies and decisions had taken into account the results of previous say-on-pay votes. The final rules clarify that this disclosure need only address whether, and if so, how companies have considered the results of the most recent say-on-pay vote. If consideration was given to the vote, disclosure is required addressing how it has affected the issuer's executive compensation policies and decisions. The SEC believes that this disclosure will facilitate better investor understanding of issuers' compensation decisions. It should be noted that some early filers included a statement in their say-on-pay and say-on-frequency proposals indicating that, despite the fact that the votes are advisory, to the extent there is any significant vote against NEO compensation, the board will consider whether any further action is appropriate.

Disclosure of Say-on-Frequency Vote Results and Final Say-on-Frequency Decisions

The SEC originally proposed that, following a say-on-frequency vote, companies would disclose how often they intended to hold future say-on-pay votes in a quarterly report on Form 10-Q or an annual report on Form 10-K for the quarter in which the vote was conducted. Under the final rules, Item 5.07 of Form 8-K requires an issuer to disclose the results of the say-on-frequency vote and to discuss whether and how the issuer will implement the results of the say-on-frequency vote (i.e., how frequently it will hold the say-on-pay votes). To comply, an issuer must file, within the four-day deadline, an Item 5.07 Form 8-K to disclose the results of the votes, and at a later time, an amendment to that Form 8-K filing under Item 5.07 to disclose its final decision on the frequency of say-on-pay votes. The amended Form 8-K will be due no later than 150 calendar days after the date of the end of the annual or other meeting in which the vote took place, but in no event later than 60 calendar days prior to the deadline for the submission of shareholder proposals under Rule 14a-8 for the subsequent annual meeting, as disclosed in the issuer's proxy materials for the meeting at which the frequency vote occurred.

Additional Proxy Statement Disclosure Requirements

The final rules add new Item 24 to Schedule 14A to require companies to include disclosure in the proxy statement about the requirement to provide separate shareholder votes on say-on-pay, say-on-frequency and say-on-golden parachutes in connection with merger transactions; and the general effect of the shareholder advisory votes, such as whether such votes are non-binding. In addition, the final rules require companies to disclose their current frequency for conducting say-on-pay votes, as well as when the next say-on-pay vote will occur. The SEC noted that, in its view, these disclosure requirements will lead to disclosure of useful information about the nature and effect of the vote for shareholders to consider.

Expanded Scope of Transactions Triggering Say-on-Golden Parachutes Disclosure Requirements

The final rules confirm that in connection with a merger or similar transaction, disclosure of golden parachute arrangements between the target or acquirer, and the NEOs of each company is required in both tabular (Item 402(t) table) and narrative format. In the adopting release, the SEC expressed concern that issuers could structure transactions in a manner that avoids implicating Section 14(a) of the Exchange Act (e.g., tender offers and certain Rule 13e-3 going-private transactions), while still effectively seeking the consent of shareholders with respect to their investment decision (e.g., whether or not to tender their shares or approve a going-private transaction, in instances where such going-private transactions are not subject to Regulation 14A). Therefore, it expanded the list of transactions requiring the Item 402(t) golden parachute disclosure to include any merger, acquisition, a Rule 13e-3 going-private transaction or a tender offer. While the SEC expanded the list of transactions that would trigger say-on-golden parachutes disclosure requirements, the actual say-on-golden parachutes advisory votes will still only be required in any transaction involving an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all assets.

Rule 14a-8 Proposals—Change From Plurality to Majority Standard

Rule 14a-8 provides eligible shareholders with an opportunity to include a proposal in an issuer's proxy materials for a vote at an annual or special meeting of shareholders. An issuer generally is required to include the proposal unless the shareholder has not complied with the rule's procedural requirements or the proposal falls within one of the rule's 13 substantive bases for exclusion. Rule 14a-8(i)(10) provides that an issuer may exclude a shareholder proposal that has already been substantially implemented. The SEC initially proposed adding a note to Rule 14a-8(i)(10) to permit the exclusion of a shareholder proposal that would provide for a say-on-pay vote or seeks 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 plurality of votes cast in the most recent vote in accordance with Rule 14a-21(b). In response to comments, the

SEC changed the threshold from plurality to majority. As adopted, the note to Rule 14a-8(i)(10) will permit exclusion of such a shareholder proposal if, in the most recent shareholder vote on frequency of say-on-pay votes, a single frequency (i.e., one, two or three years) received the support of a majority of the votes cast and the issuer has adopted a policy on the frequency of say-on-pay votes that is consistent with that choice.

No Preliminary Proxy Statement Required

The final rules confirm that say-on-pay and say-on-frequency votes will not trigger a requirement to file a preliminary proxy statement. As adopted, a proxy statement that includes a solicitation with respect to any advisory vote on executive compensation, including a say-on-pay vote or say-on-frequency vote, would not trigger a requirement that the issuer file the proxy statement in preliminary form, so long as any other matters to which the solicitation relates include only the other matters specified by Rule 14a-6(a).

No Discretionary Voting

The adopting release confirmed that for issuers with a class of securities listed on a national securities exchange, broker discretionary voting of uninstructed shares is not permitted for say-on-pay or a say-on-frequency vote. Whether this would make a difference for any particular issuer will depend on the composition of the shareholder base of that particularly issuer.

Emerging Trends

Say-on-Frequency Recommendations: Current Roundup

While still early in the 2011 proxy season, trends have begun to emerge as companies begin to submit say-on-pay and say-on-frequency proposals for advisory votes. While ISS recommends annual votes, companies tend to lean toward either triennial vote recommendations or annual vote recommendations. Of the companies that have opted for an annual vote recommendation, most are larger, more prominent issuers. Very few companies recommended biennial votes or chose not to make a recommendation at all. According to Mark Borges, a principal for Compensia, and one of the leading authorities on SEC executive compensation disclosure matters, as of February 4, 2011, the breakdown of company recommendations for the say-on-frequency vote in definitive and preliminary proxy statements that had been filed for annual meetings of shareholders to be held on or after January 21, 2011 was as follows:

- 127 companies (including 35 smaller reporting companies) had recommended a triennial vote;
- 67 companies (including 11 smaller reporting companies) had recommended an annual vote;
- 13 companies (including two smaller reporting companies) had recommended a biennial vote; and
- 12 companies (including four smaller reporting companies) had made no recommendation.

The recommendations, according to the supporting statements included as part of many of the early filers' say-on-frequency proposals tend to be based on each company's specific compensation structures and shareholder relationships (i.e., with companies recommending annual advisory votes emphasizing immediate feedback and increased accountability and companies recommending a vote every three or two years emphasizing the importance of being able to evaluate any executive compensation program over a longer period of time and better account for completion of multi-year performance and service periods).

Companies Begin to Announce Actual Vote Results

So far, 33 companies have reported the voting results from their annual meeting of shareholders. As companies begin to report the outcomes of the votes in their Form 8-Ks, trends and patterns begin to emerge. As reported by Mark Borges, as of February 4, 2011, only one—Jacobs Engineering Group—has had its say-on-pay vote rejected (with only 45.5 percent voting in favor of its executive compensation program). Further, say-on-frequency vote outcomes continue to favor annual votes:

- Annual vote recommendation—ten companies recommended an annual vote and received their shareholder support.
- Biennial vote recommendation—three companies recommended a biennial vote, two (Fair Isaac Corporation and Rochester Medical Corporation) have seen their shareholders express a preference for annual votes (i.e., Fair Isaac Corporation by a clear majority and Rochester Medical Corporation by a plurality of the votes cast).
- Triennial vote recommendation—20 companies recommended a triennial vote, 11 have seen their shareholders express a preference for annual votes. For example:
  - Shareholders at Monsanto Company (62 percent to 36 percent), Air Products and Chemicals (60 percent to 39 percent), Jacobs Engineering Group (68 percent to 29 percent), and Woodward Governor (57 percent to 39 percent), ignored their boards' triennial frequency vote recommendation and expressed a preference for an annual vote instead.

These results should be a warning to companies still contemplating the appropriate frequency recommendation and, as trends emerge, upcoming votes will undoubtedly be closely monitored.

CD&A Disclosures and Interplay with Say-on-Pay and Say-on-Frequency Proposals

Recently filed proxies also reveal certain trends with respect to CD&A disclosures as companies tend to rethink their CD&As as investor communication tools based on which advisory say-on-pay and say-on-frequency votes will be cast and not merely disclosure statements. The number of companies choosing to include an executive summary section in their CD&As is steadily increasing as companies recognize that highlighting important aspects of their executive compensation policies and practices may help them at the margins in obtaining a favorable vote. We believe that an executive summary section is an effective platform to communicate the company's specific executive compensation message, highlighting pay for performance correlation, describing good governance and compensation practice, such as compensation recovery policy or stock ownership guidelines, and summarizing key accomplishments of NEOs, particularly the CEO. Some companies also highlight their risk assessment processes by indicating that the company has conducted a risk assessment and cross-referencing the section of the proxy statement where this is described in greater detail. More companies seem to be including graphs or charts in their executive summaries attempting to simplify and clarify the format in which their most significant executive compensation message is conveyed to investors. In preparing for the upcoming proxy season, companies need to consider whether including both a supporting statement as part of the say-on-pay and the say-on-frequency proposals and an executive summary as part of the CD&A is appropriate. One consideration is that these two disclosures may target two different audiences, with institutional investors being more likely to focus on full disclosures, and retail shareholders focusing on shorter and more focused supporting statement.

Golden Parachutes

As expected, companies to date do not appear to be taking advantage of the rule allowing them to seek approval of their golden parachute arrangements so as to avoid subjecting them to a golden parachute advisory vote at the time of a corporate transaction. The upside of getting a pre-approval is unclear as a new vote would be required to the extent the golden parachute arrangements change at the time of the change in control transaction. To date, only two companies chose to include golden parachute tables as required and a few more chose to expand their existing disclosures (perhaps in an attempt to set the stage for any future say-on-golden parachutes votes) but did not technically comply with the specific disclosure requirements of new Item 402(t).

Conclusion

As companies begin to comply with the new rules and questions begin to arise, we expect that there will be further interpretive guidance and instructions from the SEC throughout the upcoming 2011 proxy season.

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