Milbank

Corporate Governance Group
Client Alert

February 10, 2011

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# SEC ADOPTS NEW RULES FOR SHAREHOLDER "SAY ON PAY" VOTES ON EXECUTIVE COMPENSATION AND GOLDEN PARACHUTES

## *Background*

Shareholder "say on pay" has been a hot button issue for institutional investors and corporate governance activists for many years now. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank")[1] addressed this concern by adding Section 14A to the Securities Exchange Act of 1934 (the "Exchange Act") and requiring the Securities and Exchange Commission (the "SEC") to adopt rules implementing "say on pay." On January 25, 2011, the SEC adopted final rules implementing "say on pay" voting for executive compensation (including with respect to the frequency of "say on pay" votes) and golden parachutes payable in connection with corporate change-in-control transactions, as mandated by Dodd-Frank. These rules follow closely, with a few modifications, the rules proposed by the SEC in October 2010.[2]

In its release announcing the final rules (the "Release"),[3] the SEC echoes the principles of Dodd-Frank that these shareholder votes are advisory only and are not to be construed "as overruling a decision" by an issuer or its board of directors. Moreover, according to the Release, the newly-mandated shareholder votes do not "create or imply any change to the fiduciary duties of" or "create or imply any additional fiduciary duties for" an issuer or its board of directors. Nevertheless, despite the advisory nature of these votes, corporate boards who ignore their results will certainly attract the attention, if not incur the wrath, of institutional investors and proxy advisory firms, which in turn could impact future director elections.

[1] For a further discussion of Dodd-Frank, please *see* our Client Alert entitled "Corporate Governance Highlights of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010," dated July 21, 2010.

[2] For a discussion of the "Say on Pay" rules in the form originally proposed, please *see* our Client Alert entitled "SEC Proposes New Rules to Implement Executive Compensation and Golden Parachute 'Say on Pay,'" dated November 3, 2010.

[3] *See* Release No. 33-9178 entitled "Shareholder Approval of Executive Compensation and Golden Parachute Compensation," which is available on the SEC website at http://sec.gov/rules/final/2011/33-9178.pdf.

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## *"Say on Pay"*

New Exchange Act Rule 14a-21(a) requires SEC-registered issuers, *at least once every three years*, to provide shareholders with a separate advisory vote on the compensation of its "named executive officers." For this purpose, the executive compensation to be voted is the compensation reflected in the Compensation Discussion and Analysis ("CD&A"), the compensation tables and other required narrative compensation disclosures in the issuer's annual meeting proxy statement.[4] The advisory vote is required only in connection with annual meetings (or special meetings in lieu thereof) for which SEC rules require proxy statement disclosure of executive compensation.

It should be noted that if an issuer includes disclosure (pursuant to Item 402(s) of Regulation S-K) regarding its "compensation policies and practices as they relate to risk management and risk-taking incentives," such policies and practices will not be subject to the shareholder advisory vote. In the SEC's view, these policies and practices "relate to the issuer's compensation for employees generally" and therefore are not disclosures to which the principles of Dodd-Frank relate. The Release does note, however, that if risk considerations "are a material aspect" of compensation policies or decisions for a particular issuer's named executive officers, then such policies or decisions must be disclosed as part of the CD&A and will thereby become a piece of the executive compensation package subject to the shareholder "say on pay" vote.

Although the new rules do not specify the form of the "say on pay" resolution to be voted on by shareholders, the Release indicates that the "say on pay" vote "must relate to all executive compensation disclosure disclosed [in the applicable proxy statement] pursuant to Item 402 of Regulation S-K." This means, for instance, that a vote on a resolution that by its terms is "to approve only compensation policies and procedures" would not be compliant. In a footnote, the SEC provides a "non-exclusive example" of a resolution that would satisfy the new rule, as follows:

"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."

It will not be surprising if most issuers adopt this formulation.

Finally, Item 402(b) of Regulation S-K has been amended to require CD&A disclosure of "whether and, if so, how" the issuer considered the results of its *most recent* "say on pay" vote in determining compensation policies and decisions, as well as the actual impact of such consideration on compensation policies and decisions. The SEC notes in the Release that, "consistent with the principles-based nature of CD&A," issuers also should address their consideration of previous "say on pay" votes to the extent material to its current compensation policies and decisions.

[4] The "say on pay" vote *does not* apply to corporate director compensation.

### *"Say on Frequency"*

New Exchange Act Rule 14a-21(b) requires SEC-registered issuers to provide shareholders with a separate advisory vote, *at least once every six years*, on whether the issuer's "say on pay" vote "will occur every 1, 2, or 3 years." Like the "say on pay" vote itself, this "say on frequency" vote is required only in connection with annual meetings (or special meetings in lieu thereof) for which SEC rules require proxy statement executive compensation disclosure. Furthermore, Item 24 to Schedule 14A requires that issuers disclose (in proxy statements filed *after* the issuer's initial "say on pay" and "say on frequency" votes) the current frequency employed by the issuer for scheduling "say on pay" votes and when the next "say on pay" vote will occur.

To facilitate "say on frequency" voting, amended Exchange Act Rule 14a-4 requires that the proxy card provided by management to shareholders include four choices for the "say on frequency" vote: every 1 year, every 2 years, every 3 years or abstain. The SEC presumes that the issuer's "board of directors will include a recommendation as to how shareholders should vote on the frequency of shareholder votes on executive compensation," but also notes that "the issuer must make clear in these circumstances that the proxy card provides for four choices . . . and that shareholders are not voting to approve or disapprove the issuer's recommendation."[5]

It is worth noting that according to *sayonpay.com*, of the 220 issuers that have filed annual meeting proxy statements through February 5, 2011, with "say on pay" proposals, approximately 59% have recommended a triennial vote on "say on pay." However, a trend towards an annual vote on "say on pay" is gathering momentum in the face of two key developments: (i) ISS and other proxy advisory firms, as well as many influential institutional investors, are urging annual "say on pay" votes, and (ii) shareholders have dealt well publicized defeats to several issuers who recommended triennial "say on pay" votes, voting instead in favor of annual "say on pay" votes in line with the recommendations of proxy advisory firms and institutional investors.

### *"Say on Golden Parachutes"*

New Exchange Act Rule 14a-21(c) requires SEC-registered issuers, in connection with any solicitation undertaken in connection with a shareholders meeting to approve "an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all the assets" (an "M&A Transaction"), to provide shareholders with a *separate* advisory vote to approve golden parachute compensation arrangements for its named executive officers. Notably, an advisory vote will not be required with respect to any such arrangements to be provided by an acquiring company to the target's executive officers (or to any arrangements with either companies' directors).

The golden parachute arrangements subject to shareholder advisory votes under the new rule are those which are disclosed by the issuer pursuant to newly-adopted Item 402(t) of Regulation S-K described below.[6] However, the new rule allows an issuer to dispense with this separate vote at the time of the vote on the related

[5] If a shareholder submits a proxy card that does not specify one of the four choices, the card may be voted by management in accordance with its recommendation (but only if the proxy card so provides).

[6] It should be noted that Item 402(j) of Regulation S-K already requires certain disclosures of change-in-control compensation arrangements for company executives in annual meeting proxy statements, but such disclosure (which includes certain "*de minimis*" and other exceptions) will *not* be sufficient for purposes of the new shareholder vote requirements.

M&A Transaction if the issuer previously included the requisite golden parachute compensation disclosure, on a voluntary basis, in an annual meeting proxy statement subject to a "say on pay" vote. In order to satisfy this exception, the issuer's annual meeting proxy statement must include the more expansive golden parachute disclosure required by Item 402(t). Nevertheless, any subsequently-adopted golden parachute arrangements, or changes to the previously-described golden parachute terms, must be put to a vote at the shareholders meeting for the M&A Transaction.[7] Due to these groundrules – and perhaps to a reluctance to subject golden parachute arrangements to a shareholder vote in the absence of an actual M&A Transaction benefiting shareholders – so far, we have not seen issuers voluntarily seeking an advisory vote on golden parachutes at 2011 annual meetings. We expect this will continue to be the case.

New Item 402(t) of Regulation S-K requires disclosure of golden parachute arrangements with respect to each named executive officer of the acquiring company *and* the target company – even though the related advisory vote only relates to golden parachute arrangements between the issuer and its named executive officers – in both tabular *and* narrative formats. Disclosure is not required of (i) compensation already disclosed in the proxy statement pension or deferred compensation table, (ii) previously vested equity awards or (iii) compensation under "bona fide post-transaction employment agreements." In the narrative portion, issuers will need to describe any material conditions or obligations for receipt of golden parachute payments, including non-compete, non-solicitation, non-disparagement or confidentiality agreements. In addition, description will be required of (1) the specific circumstances triggering payment, (2) by whom such payments would be made, (3) whether such payments are lump sum or annual, and their duration, and (4) any other material factors regarding each agreement. It should be noted that footnote identification will be required of payments triggered by the M&A Transaction itself ("single-trigger") *versus* those triggered by additional events such as termination of employment ("double-trigger").[8]

Because an M&A Transaction can be structured in ways that do not require a shareholder vote solicited via a Schedule 14A proxy statement, the new rules also require golden parachute disclosure in (1) information statements under Regulation 14C relating to meetings or actions by written consent relating to an M&A Transaction for which proxies or consents are not being solicited, (2) proxy or consent solicitations unrelated to merger proposals but requiring disclosure of an M&A Transaction under Item 14 of Schedule 14A, (3) Form S-4 registration statements containing disclosure relating to an M&A Transaction, (4) Schedule 13E-3 going private transaction statements and (5) Schedule TO's and Schedule 14D-9's relating to third party tender offers. Acquirers who are required to solicit proxies from their shareholders in connection with the issuance of shares in an M&A Transaction also will be required to include golden parachute disclosures for both companies' named executive officers in its proxy materials (even though such disclosures are not subject to a separate shareholder vote).

[7] The SEC notes in the Release that "additional grants of equity compensation in the ordinary course" and "increases in salary" affecting golden parachute pay represent changes that *will* trigger the need for such a separate advisory vote.

[8] If the only golden parachute arrangements that are subject to a vote at a shareholders meeting called to approve an M&A Transaction are those entered into since a previous "say on pay" vote, then the issuer's proxy statement for such meeting must contain two tables: one disclosing all golden parachute compensation and another disclosing only the new arrangements.

### *Related Matters*

The final rules and the Release also address several related matters of note:

- Because the new votes are advisory in nature, the SEC decided not to specify either (i) which shares are entitled to participate in any of these votes or (ii) the percentage vote required to approve each matter. Rather, these choices are left to the discretion of each issuer.

- Exchange Act Rule 14a-8 has been amended to clarify when an issuer may rely on the Rule's "substantially implemented" exclusion to exclude from proxy statements shareholder proposals relating to shareholder votes on executive compensation. Specifically, if an issuer implements the frequency for "say on pay" voting receiving the *majority* of the votes cast at the most recent meeting at which "say on frequency" has been put to a vote, then the issuer may exclude from future proxy statements any shareholder proposal "that would provide a say-on-pay vote or seeks future say-on-pay votes or that relates to the frequency of say-on-pay votes."[9] If none of the alternatives receives a majority vote, then this exclusion will not be available to the issuer.

- Form 8-K, Item 5.07 has been amended to provide that disclosure of an issuer's decision regarding how often it actually will seek a "say on pay" vote, "in light of the results of a shareholder vote on frequency," will be required in an amendment to the issuer's prior Form 8-K announcing the results of the frequency vote. This amendment must be filed within 150 calendar days following the applicable shareholders meeting, but not later than 60 calendar days prior to the deadline for the submission of shareholder proposals for the next annual meeting.

- Exchange Act Rule 14a-6(a) has been amended to provide that inclusion of a "say on pay" or "say on frequency" vote in a proxy statement does not trigger the need for a preliminary filing of the issuer's proxy statement. On the other hand, because a "say on golden parachute" vote would be included in a proxy statement relating to an M&A Transaction, it will necessarily be the subject of a preliminary filing.

- Finally, the Release confirms that, in accordance with Dodd-Frank, the national securities exchanges "have made substantial progress" in revising their rules to prohibit broker discretionary voting on any of the new advisory votes required by Exchange Act Rule 14a-21.

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Please let us know if you have any questions or need further information or assistance with respect to the newly-adopted "say on pay" rules, including in connection with the preparation of upcoming annual meeting proxy statements or in the design of executive compensation programs.

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[9] For this purpose, an abstention would not count as a vote cast. The Release makes it clear that this majority voting requirement relates solely to the availability of the Rule 14a-8 exclusion, and is not intended to impact the determination whether a particular frequency vote has been adopted or approved by shareholders, which is left to the discretion of each issuer.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided below.

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