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SEC ISSUES PROPOSALS TO IMPLEMENT DODD-FRANK ACT SAY-ON-PAY REQUIREMENTS

October 27, 2010

Last week, the SEC issued rule proposals to implement the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") relating to shareholder approval of executive compensation, also known as "say-on-pay" (or "SOP"), the frequency of SOP votes and golden parachute compensation arrangements,[1] as well as institutional investment manager vote reporting.[2] Public companies will be required to comply with the SOP and SOP frequency disclosures starting with their first annual shareholders meeting that occurs on or after January 21, 2011, even if the SEC has not finalized the proposals by then.[3] As a result, companies that have not already done so should begin now not only to consider the scope and content of the upcoming SOP proposals and related proxy statement disclosures, but also to analyze whether their compensation plans, practices and disclosures should be modified in order to present their compensation programs in the most favorable light prior to the first – and possibly critical – SOP votes.

Background

The Dodd-Frank Act added Section 14A to the Securities Exchange Act of 1934, as amended (the "Exchange Act"), which requires companies to conduct separate non-binding shareholder votes to (1) approve the compensation of executives, as disclosed pursuant to Item 402 of Regulation S-K; and (2) determine how often the company will conduct such shareholder advisory votes on executive compensation. In addition, new Section 14A requires companies soliciting votes to approve merger or acquisition transactions to provide disclosure of certain "golden parachute" compensation arrangements and, in certain circumstances, to conduct a separate non-binding shareholder vote to approve those arrangements. Finally, Section 14A requires institutional investment managers to report at least annually how they voted on the executive compensation-related shareholder votes described above. Comments on the SEC's recent proposals are due November 18, 2010.

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[1] Shareholder Approval of Executive Compensation and Golden Parachute Compensation, Release No. 33-9153 (October 18, 2010), available at http://www.sec.gov/rules/proposed/2010/33-9153.pdf. See our previous client alerts discussing the compensation and governance aspects of the Dodd-Frank Act at: http://www.wcsr.com/resources/pdfs/cs092010.pdf and http://www.wcsr.com/resources/pdfs/cs072210.pdf. The Dodd-Frank Act clarifies that the SOP shareholder votes are not intended to alter directors' fiduciary duties, which are generally governed by state law.

[2] Reporting of Proxy Votes on Executive Compensation and Other Matters, Release No. 34-63123 (October 18, 2010), available at http://www.sec.gov/rules/proposed/2010/34-63123.pdf.

[3] The "say on golden parachute" disclosures and shareholder votes will not be required for merger proxy statements until the effective date of the final SEC rules. For TARP issuers, the first SOP vote would not be required until the first annual shareholder meeting after the issuer has repaid all outstanding TARP indebtedness.

Shareholder Advisory Votes on Executive Compensation

Say-on-Pay Vote

The SEC is proposing a new Rule 14a-21, which would require issuers,[4] not less frequently than once every three years, to provide a shareholder advisory vote to approve the compensation of executives in proxy statements for annual meetings or other shareholder meetings for which executive compensation disclosure under applicable SEC rules is required (collectively, "annual meetings"). Shareholders would be given the opportunity to approve the compensation of the issuer's named executive officers,[5] as such compensation is disclosed in Item 402 of Regulation S-K, including the Compensation Discussion and Analysis ("CD&A"), the compensation tables and other narrative compensation disclosures.[6] The proposals do not require any specific language to be used in the proxy statement proposal, but the shareholder vote must relate to all executive compensation disclosure required under Item 402 of Regulation S-K, and not just the company's "compensation policies and procedures" generally. The SEC has also proposed to require issuers to disclose in the proxy statement that they are providing a separate shareholder vote on executive compensation and to briefly explain the general effect of the vote, such as whether the vote is non-binding.

Shareholder Vote on Frequency of Say-on-Pay Vote

In addition, under the proposals, issuers would be required, not less frequently than once every six years, to provide a shareholder advisory vote in annual meeting proxy statements to determine whether the shareholder vote on the compensation of executives discussed above will occur every one, two or three years. The proposals would also amend the SEC rules regarding the form of proxy (i.e., the proxy card) to require proxy cards to reflect the choice of one, two or three years, or abstention, for these votes. Management recommendations regarding SOP frequency would be permitted. As with the SOP votes, the proposals would require disclosure regarding the nature of the shareholder advisory vote on the frequency of SOP votes, such as whether the vote is non-binding.

Preliminary Proxy Statement Not Required

Under the proposals, the SOP vote and vote on frequency of SOP votes would not trigger a preliminary proxy statement filing.

Disclosure Regarding Say-on-Pay Votes in CD&A

The proposals would amend the SEC proxy rules to require issuers to address in their CD&A whether, and if so, how, they have considered the results of previous shareholder votes on executive compensation in determining compensation policies and decisions and how that consideration has affected their compensation policies and decisions.[7]

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[4] The new rules would apply to all issuers with a class of securities registered under Section 12 of the Exchange Act and subject to the proxy rules.

[5] The compensation of directors would not be subject to the shareholder advisory vote. Likewise, the SEC's recently adopted risk management and risk-taking disclosures as they relate to employee compensation policies and practices would not be subject to the SOP vote, except to the extent such risk considerations are material to named executive officer compensation and discussed in the CD&A.

[6] Smaller reporting companies are not required to include a CD&A in their proxy statements, so the shareholders would vote to approve the compensation of named executive officers as disclosed under applicable SEC proxy rules.

[7] Smaller reporting companies are not subject to CD&A requirements; however, if consideration of prior executive compensation advisory votes is a factor necessary to an understanding of the information disclosed in the Summary Compensation Table, disclosure would be required.

Shareholder Proposals Regarding Say-on-Pay

Rule 14a-8 provides eligible shareholders with an opportunity to include a proposal in an issuer's proxy materials for a vote at a shareholders meetings. The issuer may exclude the proposal if it falls within one of the rule's specific bases for exclusion, including an exclusion if the issuer has already "substantially implemented" the proposal. The SEC has proposed to clarify that the "substantially implemented" exclusion would allow an issuer to exclude a shareholder proposal that would provide a SOP vote or seeks future SOP votes or that relates to the frequency of SOP votes, if the issuer has adopted a policy on the frequency of SOP votes that is consistent with the plurality of votes cast in the most recent SOP vote.

Disclosure in Forms 10-K and 10-Q

Under the proposals, issuers would also be required to disclose in their Form 10-Q (or Form 10-K for shareholder meetings taking place during the fourth quarter) their decisions regarding how frequently they will conduct SOP votes in light of the results of the SOP frequency vote. Companies would still be required to disclose the results of shareholder votes on a Form 8-K report within four business days after the end of the shareholders meeting.

Broker Discretionary Vote

As required by the Dodd-Frank Act, the national securities exchanges have begun to amend their rules to prohibit broker discretionary voting of uninstructed shares in SOP votes, votes on the frequency of SOP votes and other executive compensation matters.

Disclosure and Shareholder Approval of Golden Parachute Arrangements

Disclosure of Golden Parachute Arrangements

The Dodd-Frank Act amended the Exchange Act to require all persons making a proxy or consent solicitation seeking shareholder approval of an acquisition, merger, consolidation or proposed sale or disposition of substantially all of an issuer's assets ("mergers") to disclose 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. Disclosure is also required 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 seeking shareholder approval of such a transaction. Such disclosures must include the aggregate total of all compensation that may be paid to such executive officers. In order to implement this disclosure requirement, the SEC proposes to amend its proxy rules (by adding new Item 402(t) of Regulation S-K) to require disclosure of all golden parachute compensation relating to the merger between the target and acquiring companies and the named executive officer of each company. These disclosures would be required under a new a new "Golden Parachute Compensation" table and related narrative disclosures. Disclosure of named executive officer change in control and termination benefits under current SEC proxy rules would not be sufficient.

Shareholder Advisory Vote on Golden Parachute Arrangements

The proposals also would require issuers to provide a separate non-binding shareholder vote on certain golden parachute arrangements in merger proxy statements. This advisory vote would be required only with respect to the golden parachute agreements or understandings between the soliciting person and any named executive officer of the issuer or any named executive officers of the acquiring issuer, if the soliciting person is not the acquiring issuer. Notably, the SEC's proposed requirement to disclose golden parachutes arrangements under Regulation S-K Item 402(t), described above, is broader than the Dodd-Frank Act requirement to provide a shareholder advisory vote, so there may be certain arrangements for which disclosure

is required, but a shareholder advisory vote is not.[8] In addition, a separate shareholder advisory vote on golden parachute arrangements would ordinarily not be required if proxy statement disclosure of those arrangements had been included in the executive compensation disclosure that was subject to a prior SOP vote. Thus, some issuers may voluntarily include golden parachute disclosure with their other executive compensation disclosure in annual meeting proxy statements seeking a SOP vote so that this exception would be available to the issuer for a potential subsequent merger or acquisition transaction.

Reporting of Proxy Votes on Executive Compensation and Other Matters

The Dodd-Frank Act added new Section 14A(d) of the Exchange Act, which requires that every institutional investment manager subject to Section 13(f) of the Exchange Act report at least annually how it voted on the executive compensation-related shareholder votes required under applicable SEC proxy rules. To implement this requirement, the SEC is proposing a new Rule 14Ad-1 under the Exchange Act, which would require institutional investment mangers to file their record of such votes with the SEC annually on Form N-PX. If adopted, the first Forms N-PX, including voting records for shareholder meetings between January 21, 2011 and June 30, 2011, would be due August 31, 2011.

Conclusion

As noted above, companies should begin now to assess steps that need to be taken in order to comply with the proposed SOP and disclosure rules since such disclosures will be required with respect to annual shareholders meetings starting in January 2011. Such actions include but are not limited to the following:

- Companies should reassess their compensation programs and policies – and related disclosures – to identify potentially problematic pay practices that could impact SOP votes. Companies may need to consider whether certain controversial pay practices (such as perquisites, gross ups, overly generous severance packages and the like) should be modified or eliminated.

- Likewise, companies with "best practices" pay provisions in place (such as performance-based vesting, clawback policies, hold til retirement or stock ownership guidelines, double trigger change in control provisions, etc.) should be sure that such practices are prominently disclosed in their proxy statements. Companies should also consider the use of an "executive summary" to the CD&A to highlight the key provisions of their executive compensation programs.

- Companies should also review the proxy guidelines of proxy advisory firms and their largest institutional shareholders to see if additional changes to their compensation programs may be appropriate or if communications with these groups may be helpful to explain why the company thinks so-called "questionable" practices are justified. Companies may also need to communicate with proxy service providers to assess whether such entities have the capability to program their systems so that shareholders can vote among four choices in the SOP frequency vote (one, two or three years, or abstain).

- In addition, companies will need to review and revise their disclosure controls and procedures so that they are positioned to comply with the SOP rules once they are finalized.

[8] For example, when a target issuer conducts a proxy solicitation to conduct a merger, golden parachute arrangements between the acquiring issuer and the named executive officers of the target issuer are not within the scope of the Dodd-Frank Act requirement and thus would not require a shareholder advisory vote. However, such arrangements would be required to be disclosed under Regulation S-K Item 402(t).

If you have any questions regarding the SOP proposals, please contact Meredith Burbank, the principal drafter of this client alert, or you may contact the Womble Carlyle attorney with whom you usually work or one of our Corporate and Securities attorneys at the following link: http://www.wcsr.com/default.asp?id=1099&objId=10.