SHEARMAN & STERLING LLP

CLIENT PUBLICATION

EXECUTIVE COMPENSATION AND EMPLOYEE BENEFITS

October 26, 2010

SEC Issues Proposed Rules on Say-on-Pay Voting and Disclosures

On October 18, 2010, the Securities and Exchange Commission issued proposed rules implementing the say-on-pay provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[1] Section 951 of the Reform Act requires (1) a non-binding shareholder vote on executive compensation, (2) a non-binding vote on the frequency of the say-on-pay vote, (3) disclosure of "golden parachute" arrangements in connection with specified change in control transactions, and (4) a non-binding shareholder vote on golden parachute arrangements in connection with these change in control transactions.

The proposed rules clear up many issues on say-on-pay left unanswered by the Reform Act and expand issuer disclosure obligations in ways not required by the Act. The proposed rules:

- Resolve any remaining uncertainty by affirmatively restating that all of the three required votes are non-binding on issuers and their boards of directors.
- Specify that issuers must be given four choices with regard to the say-on-pay frequency vote (i.e, annual, biennial, triennial, or abstain) and establish a limited transition rule in situations where proxy service providers are unable to accommodate the four choice rule.

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203 (July 21, 2010). If you wish to review a general discussion of the compensation-related provisions of the Reform Act, you may refer to our client publication entitled, "*Financial Reform Act Brings Significant Executive Compensation Changes*" (July 15, 2010), available at http://www.shearman.com/financial-reform-act-brings-significant-executive-compensation-change-07-15-2010/.

- State that the golden parachute voting requirements do not apply until the proposed rules become effective (in contrast to the other two voting requirements, which apply to shareholder meetings occurring on or after January 21, 2011).
- Mandate a specified form of tabular and narrative disclosure for golden parachute disclosure and suggest that arrangements not presented in that form will not be deemed to have been subject to a prior say-on-pay vote.
- State that issuers would not be required to file a preliminary proxy solely as a result of including a required say-on-pay vote or a frequency vote in their proxy.
- Note that director compensation and risk disclosures made in response to Item 402(s) of Regulation S-K are not covered by say-on-pay votes.
- Generally expand the golden parachute disclosure to the SEC forms for tender offers, going private transaction and registration statements prepared in connection with mergers.
- Give issuers subject to the Troubled Asset Relief Program, or TARP, general relief from certain of the say-on-pay voting requirements until all TARP indebtedness is repaid and also give small issuers relief from certain of the say-on-pay requirements.

The key details are described below.

Say-on-Pay Vote

The Reform Act requires domestic issuers to provide shareholders with the right to cast a non-binding vote approving the issuer's executive compensation as it is disclosed in the issuer's proxy statement. Shareholders must have the right to cast a say-on-pay vote at least once every three years. The proposed rules would add new Rule 14a-21(a) under the Securities Exchange Act of 1934 implementing this requirement.

Information Subject to the Vote. The say-on-pay vote covers the compensation of the issuer's named executive officers set forth in the compensation discussion and analysis, the compensation tables and the related narratives required by Item 402 of Regulation S-K. Non-employee director compensation is not subject to the vote. The proposed rules clarify that the disclosure required pursuant to Item 402(s) regarding risk management and risk-taking incentives is not within the scope of the vote. The SEC notes, however, that any disclosure in the CD&A regarding risks associated with the named executive officers' compensation would be considered by shareholders when voting. Finally, if an issuer includes disclosure regarding golden parachute compensation arrangements in the format mandated by the proposed rules, it will be considered to have been subject to a prior the say-on-pay vote.

Disclosure Format. The SEC did not prescribe the wording to include in an issuer's proxy statement for the say-on-pay vote. The proposed rules would, however, add a new Item 24 to Schedule 14A pursuant to which issuers must disclose they are providing a separate shareholder vote on executive compensation and briefly explain the general effect of the vote, including the non-binding nature of the vote. This provision is similar to the requirements for the say-on-pay vote applicable to participants under TARP.

Enhanced CD&A Disclosure. The proposed rules would require issuers to address in the CD&A whether and, if so, how their compensation policies and decisions have taken into account the results of the prior say-on-pay votes. While this disclosure was not required by the Reform Act, the SEC indicates in the preamble to the proposed regulations that this information would "facilitate better understanding of issuers' compensation decisions." The SEC has requested comments on whether this disclosure should be mandatory, as proposed, or a non-exclusive example of topics that may be appropriate for CD&As.

Say-on-Pay Frequency Vote

The Reform Act provides that the say-on-pay vote must be held at least once every one, two or three years. Shareholders must also be given the opportunity, at least once every six years, to have a separate shareholder vote to redetermine the frequency of the say-on-pay vote. The proposed rules would add new Rule 14a-21(b) under the Exchange Act implementing this requirement.

Disclosure Format. As is the case with the say-on-pay vote, the SEC does not specify the format or wording to be included by issuers in their proxy statements for the frequency vote. However, new Item 24 to Schedule 14A would require issuers to state that they are providing a separate shareholder advisory vote on the frequency of the say-on-pay vote and briefly explain the general effect of the vote. The SEC anticipates that an issuer's board of directors will include a recommendation on the frequency of the vote and, where recommendations are included, the proxy statement must be clear that shareholders are voting to approve the actual frequency and not the board of directors' recommendation.

Form of Proxy. Under current Rule 14a-4 of the Exchange Act (which provides requirements as to the form of proxy), shareholders are generally given three voting choices for matters subject to a vote: "for," "against" or "abstain." The proposed rules would amend this provision to allow shareholders to cast their frequency vote by choosing from among four choices on the proxy card: "one year," "two years," "three years" or "abstention from voting." The SEC acknowledges that proxy service providers may not be able to reprogram their systems to add the additional options in time for the first votes required on and after January 21, 2011. For transition purposes, until the rules become final issuers may offer only three options: "one year," "two years" or "three years."

Additional Say-on-Pay Matters

Meetings Subject to Say-on-Pay and Frequency Votes. The proposed rules clarify that the say-on-pay and frequency votes are required only for annual or other meetings of shareholders for which compensation disclosure is required under Item 402 (typically, where directors are to be elected).

Form 10-K and 10-Q Disclosure. Proxy voting results are currently required to be disclosed on a Form 8 K within four business days following the applicable shareholder meeting. The proposed rules would add an additional requirement that issuers disclose their decision as to how frequently they will conduct their say-on-pay votes (after taking into account the shareholders' recommendation) in the first 10-Q following the frequency vote (or the 10-K if the vote occurred during the fourth quarter). The SEC is seeking comments on this requirement, and practitioners have already expressed concern that, as a result of this disclosure obligation, boards of directors may be required to make an unnecessarily quick decision regarding the frequency of say-on-pay voting.

TARP. Currently TARP participants are separately obligated to hold an annual, non-binding say-on-pay vote. The SEC acknowledges in the proposed rules that requiring TARP entities to hold a say-on-pay vote under TARP and a separate vote to comply with the Reform Act would be redundant. The proposed rules would exempt TARP entities from the say-on-pay and frequency votes until the first annual meeting of shareholders after the entity has repaid all borrowed funds under TARP. TARP entities may rely on this proposed rule pending adoption of the final rules.

Preliminary Proxy. The proposed rules state that issuers would not be required to file a preliminary proxy solely as a result of including a required say-on-pay vote or a frequency vote in their proxy. Issuers may rely on this provision prior to the adoption of the final rules.

Shareholder Proposal Rules. Rule 14a-8 of the Exchange Act provides eligible shareholders with an opportunity to include proposals in an issuer's proxy materials for a vote at an annual or special meeting. Issuers can exclude these shareholder proposals if the proposal has already been substantially implemented by the issuer. The proposed rules would

amend Rule 14a-8 to provide that issuers be permitted to exclude shareholder proposals that would provide a say-on-pay vote, seek future say-on-pay votes or provide a frequency vote if (1) 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 frequency vote and (2) the issuer provides a frequency vote at least once every six years. The SEC notes, however, that nothing in the Reform Act or the proposed rules limits or restricts shareholders from making proxy proposals relating to executive compensation.

Non-binding Advisory Vote. The proposed rules confirm that say-on-pay and frequency votes are non-binding and will not be construed as overruling the compensation decisions of the issuer's board of directors, imposing additional fiduciary duties on the board or limiting shareholders' ability to make compensation-related proposals for inclusion in proxy statements.

Broker Discretionary Voting. Under Section 957 of the Reform Act, national securities exchanges are required to amend their rules so that brokers are prohibited to vote uninstructed shares on executive compensation. The proposed rules confirm that say-on-pay and frequency votes are executive compensation matters and that brokers therefore may not vote uninstructed shares on these matters.

Foreign Private Issuers. The SEC has clarified in the proposed rules that say-on-pay votes do not apply to foreign private issuers.

Disclosure of Golden Parachutes

The Reform Act adds new disclosure requirements for payments made to named executive officers in connection with certain change in control transactions. The proposed rules implement these disclosure requirements by adding Item 402(t) to Regulation S-K.

Covered Employees and Scope of Disclosure. Section 14A(b)(1) of the Exchange Act requires a target issuer that is making a proxy or consent solicitation seeking shareholder approval of an acquisition, merger or significant asset sale to disclose (1) the compensation agreements (whether present, deferred or contingent) between the target issuer and its named executive officers that relate to the transaction and (2) the aggregate compensation that may be paid or become payable in connection with the transaction to the target issuer's named executive officers. If the target company is not the person soliciting proxies, the Reform Act requires such disclosure to be made by the person doing the proxy or consent solicitation. In addition, disclosure must also be made of agreements related to the transaction between the acquiring company and the named executive officers of the target issuer.

Proposed new Item 402(t) disclosure does not apply to individuals who are named executive officers because they would have been among the most highly compensated executives but for the fact that they were not serving as an executive officer at the end of the last completed fiscal year. On the other hand, Item 402(t) disclosure would be required for individuals treated as named executive officers because they served as the principle executive or financial officer during the last completed year, even if such individuals are no longer employed at the time of the solicitation. The SEC is seeking comments on the scope of covered employees.

Tabular Disclosure Format. Proposed new Item 402(t) to Regulation S-K specifies a tabular format for the disclosure, with accompanying narrative and footnote text. The aggregate dollar values of the following elements of compensation separately must be quantified in the seven columns of the table:

- Cash severance payments (including base salary, bonus and *pro rata* payments of non-equity incentive compensation);

- (1) Stock awards for which vesting is accelerated, (2) in-the-money stock options for which vesting is accelerated and (3) cash payments made upon cancellation of stock and option awards;[2]
- Pension and nonqualified deferred compensation benefit enhancements;
- Perquisites and other personal benefits (*e.g.*, health and welfare), even if *de minimis*;
- Tax gross-ups;
- Other compensation; and
- The total amount payable in connection with the transaction.

For disclosure made in connection with a corporate transaction, the amounts in the table are generally quantified assuming that the transaction occurred on the latest practicable date and using the closing price of the common stock on that date. Footnote disclosure is required quantifying each separate form of payment and the portion of the payments triggered (1) solely by the transaction or (2) upon a termination of employment within a specified period following the transaction.

Proposed new Item 402(t) does not require disclosure of vested pension and non-qualified deferred compensation or of previously vested equity awards, although the proposed rules appear to contemplate disclosure of cash-outs of all equity awards, whether or not vested. Unlike other provisions of Item 402, new Item 402(t) disclosure must include benefits pursuant to arrangements that are generally available to all salaried employees (such as group health and life insurance).

Proposed new Item 402(t) does not require disclosure of compensation under a *bona fide* post-transaction employment agreement entered into at the time of the transaction. The proposing release indicates that the SEC does not view these amounts to be based on, or related to, the transaction (however, depending on the type of transaction involved, such agreements may need to be disclosed under other applicable SEC rules). The SEC has, however, requested comments on whether these agreements should be quantified and included in the table.

The Item 402(t) table is to be accompanied by narrative and footnote disclosure describing:

- Any material conditions or obligations applicable to the receipt of payment, including restrictive covenants;
- The specific circumstances that would trigger payment;
- Whether the payments will be made in a lump sum or annual installments and the duration of the payments;
- By whom the payments will be provided; and
- Any material factors regarding each agreement (for example, provisions regarding modifications of outstanding options to extend the vesting period or the post-termination exercise period or modify the exercise price).

Transaction for Which Disclosure is Required. In an apparent effort to minimize the regulatory disparity that would otherwise result from differential treatment of various transactions, the proposed rules expand the disclosure requirements

[2] With respect to payments made in cancellation of equity awards, the proposed rules do not distinguish between vested and nonvested equity awards.

of the Reform Act, so that new Item 402(t) disclosure would be required not only in proxy and consent solicitations but also in: (1) information statements filed pursuant to Regulation 14C;[3] (2) proxy or consent solicitations that do not contain merger proposals but require disclosure of information under Item 14 of Schedule 14A;[4] (3) registration statements on Forms S-4 and F-4 containing disclosure relating to mergers and similar transactions; (4) going private transactions on Schedule 13E-3; and (5) third-party tender offers on Schedule TO and Schedule 14D-9.[5]

Vote on Golden Parachutes

The proposed rules would adopt new Exchange Act Rule 14a-21(c) requiring issuers to provide a separate shareholder advisory vote on the arrangements described pursuant to Item 402(t). The golden parachute vote is only applicable for proxy and consent solicitations and not the additional transactions described above.

While Item 402(t) requires disclosure of compensation paid by both the target and the acquiring companies, the golden parachute vote is only required for compensation paid by the target issuer to its named executive officers. Arrangements between the acquiring company and the named executive officers of the target issuer would not be subject to the golden parachute vote. If disclosure is required for arrangements between the target company's named executive officers and the acquiring company, the proposed rules require that the disclosure should be provided in two separate tables each meeting the requirements of new Item 402(t).

As is the case with the say-on-pay vote, the golden parachute vote will not overrule the board of directors' compensation decisions or impose additional fiduciary duties on the board of directors.

Prior Shareholder Approval in Connection with a Say-on-Pay Vote. The proposed rules provide that compensation and compensation arrangements are not subject to the golden parachute vote if the compensation or arrangement was included in the executive compensation disclosure for a prior annual meeting and was subject to a prior say-on-pay vote. In order to take advantage of this exemption, an issuer must have voluntarily included disclosure regarding the change in control arrangements in its annual meeting proxy statement in accordance with new Item 402(t). This disclosure would replace the current change in control disclosure required by Item 402(j) of Regulation S-K (which requires less information than the new rules and does not have specific format requirements) in connection with annual proxy or consent solicitations (i.e., those not made in connection with a change in control transaction).[6]

[3] Schedule 14C governs the information required in Information Statements which issuers generally must send to every holder of the registered security who is entitled to vote on any matter for which the issuer is not soliciting proxies.

[4] For example, acquiring companies may solicit proxies to approve the issuance of shares or a reverse stock split in order to conduct a merger transaction.

[5] A bidder in a third-party tender offer is required to provide Item 402(t) disclosure to the extent it has made reasonable inquiry about the golden parachute arrangements and has knowledge of the arrangements. The SEC notes in the proposing release that bidders in non-negotiated (hostile) transactions may not have access to information about the target's golden parachute arrangements.

[6] The amounts payable upon a termination of employment not in connection with a change in control would continue to be required to be disclosed in accordance with Item 402(j).

Compensation payable pursuant to an arrangement that has been subsequently amended or modified is not treated as having been subject to a previous say-on-pay vote to the extent of such amendment or modification. In addition, the proposed rules generally do not treat grants or awards made after a say-on-pay vote as having been the subject to that vote, even when the terms of conditions of these awards are similar to the terms of a plan or awards that were the subject of the vote; however, the SEC has requested comments on this point. In these instances, Item 402(t) would require issuers to segregate future disclosure in two tables each meeting the requirements of new Item 402(t): the first covering all arrangements related to the change in control transaction (whether or not subject to a prior say-on-pay vote), and the second covering only the new or amended arrangements. Only the amounts in the second table would then be subject to the vote.

Foreign Private Issuers. If the target company is a foreign private issuer, disclosure under Item 402(t) is generally not required. However, as discussed above, if the target company is a domestic issuer, disclosure is required even if the acquiror is a foreign private issuer.

* * *

The SEC has requested comments on the Proposed Rules by November 18, 2010. It is expected that final rules will be adopted before the end of the year or shortly thereafter.

Linda E. Rappaport
New York
+1.212.848.7004
lrappaport@shearman.com

John J. Cannon III
New York
+1.212.848.8159
jcannon@shearman.com

Jeffrey P. Crandall
New York
+1.212.848.7540
jcrandall@shearman.com

Kenneth J. Laverriere
New York
+1.212.848.8172
klaverriere@shearman.com

Doreen E. Lilienfeld
New York
+1.212.848.7171
dlilienfeld@shearman.com