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Dodd-Frank Act Say-on-Pay: The SEC's Final Rules

BY MARY J. MULLANY

Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[1] adds new Section 14A to the Securities Exchange Act of 1934 (the Exchange Act). Section 14A of the Exchange Act sets forth the various ''say-on-pay'' requirements that are applicable to all companies that file periodic reports under the Exchange Act with the Securities and Exchange Commission (the SEC) beginning on Jan. 21, 2011. This article is a companion to the Dec. 2010 article on the proposed rules (229 PBD, 12/2/10; 37 BPR 2653, 12/7/10), and discusses the final SEC rules to implement the Dodd-Frank say-on-pay requirements.

[1] Pub. L. No. 111-203 (July 21, 2010).

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Say-On-Pay Requirements

Dodd-Frank, which brings sweeping regulatory changes that will impact many aspects of business and commerce in America, includes significant corporate governance and executive compensation requirements for all public reporting companies. New Section 14A of the Exchange Act adds three ''say-on-pay'' requirements, which are:

(1) *Say-on-Pay*—At least once every three years, starting at its annual meeting (or special meeting in lieu thereof) held on or after Jan. 21, 2011, at which directors are to be elected, every public reporting company, except smaller reporting companies, must include in its proxy statement a separate resolution subject to shareholder vote to approve the compensation of the named executive officers (NEOs) as disclosed pursuant to Item 402 of Regulation S-K.[2] Smaller reporting companies[3] have a deferral from this requirement until annual meetings held on or after Jan. 21, 2013. In addition, companies that are recipients of funds under the Troubled Asset Relief Program (TARP) can defer compliance with these say-on-pay requirements until the annual meeting held in the calendar year after all TARP indebtedness is repaid.

(2) *Say-on Frequency*—At least once every six years, starting at its annual meeting held on or after Jan. 21, 2011, every public reporting company must include in its proxy statement a separate resolution subject to

[2] Exchange Act Section 14A(a)(1).

[3] A smaller reporting company is generally a company with a public float of less than $75 million. Smaller reporting companies are subject to scaled down disclosure requirements and do not have to provide CD&A.

shareholder vote to determine how frequently the say-on-pay vote will occur—every one, two, or three years.[4] Smaller reporting companies have a deferral from this requirement until annual meetings held on or after Jan. 21, 2013. In addition, companies that are recipients of funds under TARP can defer compliance with these say-on-frequency requirements until the annual meeting held in the calendar year after all TARP indebtedness is repaid.

(3) *Say-on-Parachutes*—Effective for all initial filings made on or after Apr. 25, 2011, in any proxy or consent solicitation material for a meeting of shareholders at which shareholders are asked to approve an ''extraordinary transaction'' (an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all the assets of an issuer), the person making the solicitation must make disclosure about any compensation agreements or understandings the company has with its NEOs (or that the acquiring issuer has with NEOs of the target or acquiring company) that are based on or otherwise relate to the extraordinary transaction, including an aggregate total of all such compensation and the conditions under which it may be paid or become payable.[5] These compensation arrangements and understandings will be referred to in this article as golden parachute compensation. Under Section 14A, if the golden parachute compensation has not been subject to a say-on-pay vote, then the proxy or consent solicitation material must include a separate shareholder vote on such golden parachute compensation. Smaller reporting companies will need to comply with these say-on-parachutes requirements at the same time as other public companies.

Each of these three say-on-pay votes is advisory—none are binding on a company or its board of directors, nor may they be construed to overrule a decision made by a company or its board of directors, or create or change any fiduciary duties applicable to the company or its board of directors. [6]

SEC's Final Rules

On Oct. 18, 2010, the SEC issued proposed rules under the Exchange Act to implement the Dodd-Frank Section 951 say-on-pay shareholder vote requirements. The comment period ended on Nov. 18, 2010. Final rules were issued by the SEC on Jan. 25, 2011 (the ''Say-on-Pay Rules'').[7] The guidance that can be gleaned from the Say-on-Pay Rules and the principal changes from the proposed rules are:

Say-On-Pay Votes. *When say-on-pay votes must be held*. Rule 14a-21(a) specifies how companies must provide a separate shareholder advisory vote to approve the compensation paid to NEOs, as such compensation is disclosed in accordance with the requirements of Item 402 of Regulation S-K, including the Compensation Discussion & Analysis (CD&A), the compensation tables, and other narrative executive compensation disclosures. The SEC clarified that such votes are only required to be held in conjunction with an annual or special meeting at which directors are to be elected. The SEC further clarified that the vote must occur once every three calendar years; there is no requirement to hold any subsequent vote by the anniversary of the most recent annual meeting date at which a say-on-pay vote was sought.

Format of the say-on-pay resolution. The Say-on-Pay Rules do not specify the language or form of resolution required to be used for such shareholder vote, but an instruction to Rule 14a-21(a) gives a nonexclusive example of a say-on-pay resolution.[8] Only executive compensation for NEOs is covered—no shareholder approval is required for director compensation, or for any disclosure regarding compensation policies and practices as they relate to risk management and risk-taking incentive compensation for employees generally.

The Say-on-Pay Rules do add New Item 24 of Schedule 14A, which requires disclosure of the general effect of the vote, such as whether the vote is nonbinding. The SEC retained this disclosure requirement as consistent with similar disclosure requirements for TARP companies, despite some comments critical of the need for this required disclosure.

Treatment of smaller reporting companies. One significant change from the proposed rules is the deferral of the applicability of the say-on-pay and say-on-frequency requirements to smaller reporting companies until the first annual meeting held on or after Jan. 21, 2013. The SEC indicated that such deferral allows smaller reporting companies, and the SEC, a period of time to evaluate the disclosure requirements and the impact of these say-on-pay votes as presented by larger companies.

Subsequent CD&A disclosure. Under the Say-on-Pay Rules, the SEC retained the requirement for mandatory CD&A disclosure, in subsequent proxy statements, of whether, and if so, how, each company has considered the results of the most recent say-on-pay vote in determining compensation polices and decisions, and, if so, how that consideration has affected the company's compensation policies and decisions.[9] The final rules have a slight modification from the proposed rules—this mandatory disclosure is required for only the most recent say-on-pay vote. Additional prior votes can be discussed if material to a particular company. This mandatory disclosure requirement received a number of critical comments when proposed, since overwhelmingly positive approval of a say-on-pay vote may not be factored into subsequent considerations of executive compensation, but disclosure will still be required.

Say-on-Frequency Votes. Under Section 14A(a)(2) of the Exchange Act and Rule 14a-21(b), at each annual meeting held on or after Jan. 21, 2011, and at least once every six years thereafter, each public reporting company (other than smaller reporting companies and

[4] Exchange Act Section 14A(a)(2).
[5] Exchange Act Section 14A(b).
[6] Exchange Act Section 14A(c).
[7] SEC Release Nos. 33-9178; and 34-63768; File No. S7-31-10, titled ''Shareholder Approval of Executive Compensation and Golden Parachute Compensation'' published in the Federal Register on Feb. 2, 2011.

[8] The example given is: ''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 & Analysis, compensation tables and narrative discussion is hereby APPROVED.''
[9] This requirement was added to Item 402(b)(1) of Regulation S-K as mandatory disclosure, rather than as disclosure that is required only if material to understanding the compensation paid.

TARP recipients as described above) need to provide a nonbinding shareholder vote on the frequency of how often to seek the say-on-pay vote. Under the Say-on-Pay Rules, the SEC clarified that the vote is required only at a meeting at which directors are to be elected, and are held once every six calendar years. Further, companies that are newly subject to the public company disclosure requirements following an initial public offering will need to comply with these votes (say-on-pay and say-on-frequency) in the proxy statement for the first annual meeting held after such IPO. The SEC expressed the view that this early adoption requirement will give shareholders the opportunity to express a view on executive compensation while the company is formulating its compensation policies as a public company.

The Say-on-Pay Rules confirm that the say-on-frequency vote will be approved on a plurality basis. It is important to check the applicable state law and a company's bylaws to confirm that a vote other than a majority vote can be held on a matter other than election of directors.

Changes are made to Rule 14a-4 (form of proxy) to provide the four choices to be made available to shareholders (say-on-pay vote every one, two or three years, or abstain). Management cannot vote an uninstructed proxy unless: (1) the company has included a board of directors recommendation on say-on-frequency in the proxy statement; (2) the proxy card provides an abstention choice; and (3) a notice of how the uninstructed proxy will be voted is set forth in bold typeface on the proxy itself. The requirement for a proxy with four choices may cause issues for certain shareholder voting system providers, so, until Dec. 31, 2011, if only three voting alternatives are available, the abstention alternative can be dropped; however any such company will not be able to use its proxy authority to vote unauthorized shares.[10]

Item 24 of Schedule 14A requires the disclosure of the general effect of the say-on-frequency vote, i.e., whether the vote is nonbinding. In addition, under the final rules, the SEC added a disclosure obligation—in future proxy statements each company will need to identify the then-current frequency of say-on-pay votes, and when the next vote will occur.

Subsequent disclosure requirements. The Say-on-Pay Rules add new disclosure requirements to the Form 8-K, Item 5.07, disclosures. A company will amend the Form 8-K it files to report the results of the various shareholder votes to provide this disclosure. The required disclosure is of the company's decision on how frequently it will conduct say-on-pay votes in light of the results of the most recent shareholder vote on say-on-frequency. Such Form 8-K amendment must be filed no later than 150 calendar days after the date the meeting ends, but in no event later than 60 calendar days prior to the deadline for shareholder proposals under Rule 14a-8 for the next annual meeting. This represents a change from the proposed rules, where disclosure was to have been provided in the Form 10-Q or Form 10-K filed for the period in which the annual meeting took place. The SEC noted that this change in the final rules was designed to address the concerns that a shorter disclosure period did not provide sufficient time for proper company deliberations, while also ensuring that the disclosure would occur in sufficient time prior to the deadline for shareholder proposals for the next annual meeting.

Amendment to Shareholder Proposal Rules. Rule 14a-8 (which covers shareholder proposals) is amended to add a note to Rule 14a-8(i)(10) to permit a company to exclude a shareholder proposal that would provide for a say-on-pay vote at a particular shareholder meeting or at future shareholder meetings, or that relates to the frequency of say-on-pay votes, as long as the company has adopted a policy on the frequency of say-on-pay votes that commits the company to select a say-on-pay vote frequency that is consistent with the majority shareholder vote at the most recent meeting. This represents a change from the proposed rules, where the company determination needed to be consistent with the plurality vote on say-on-frequency. The SEC indicated that a plurality vote likely meant that a majority of shareholders selected a different say-on-frequency alternative, and that future shareholder proposals should only be excludable in the face of a clear majority vote. Companies should factor the potential for receiving future shareholder proposals, including the time and expense associated with dealing with such shareholder proposals, in making say-on-frequency vote recommendations in the 2011 proxy statement.

Other Issues Addressed in the Say-On-Pay Rules. The Say-on-Pay Rules confirm the following:

(1) broker discretionary voting of uninstructed shares will not be permitted for these say-on-pay, say-on-frequency, and say-on-parachutes votes; and

(2) companies will not be required to file a preliminary proxy statement because of the inclusion of the say-on-pay and say-on-frequency shareholder votes.

In addition, the SEC published new Compliance & Disclosure Interpretations: Exchange Act Rules on Feb. 11, 2011, that provide some helpful guidance on say-on-pay and say-on-frequency matters.

Say-on-Parachutes Votes. *Golden parachute compensation*. Section 14A(b)(1) of the Exchange Act requires all persons making a proxy or consent solicitation seeking shareholder approval of an extraordinary transaction to provide disclosure of any compensation arrangements the soliciting person (or the acquiring person, if different) has with the NEOs of the target or acquiring company concerning compensation that is based on or otherwise relates to the extraordinary transaction. Such compensation may be present, deferred or contingent, but must be disclosed if it relates to the extraordinary transaction. The Say-on-Pay Rules implement this new disclosure requirement through new Item 402(t) of Regulation S-K. Item 402(t) disclosure must be presented in a clear and simple form in both tabular and narrative format. The tabular disclosure is as follows:

[10] In a comment letter to the proposed rules, Broadridge Financial Solutions expressed confidence that its systems would be able to provide the four choices; and four alternatives are available from them.

Golden Parachute Compensation							
Name	Cash($)	Equity($)	Pension/NQDC ($)	Perquisites/ benefits($)	Tax reimburse-ment($)	Other($)	Total($)
PEO							
PFO							
A							
B							
C							

Additional information about the tabular disclosure elements follows:

■ Cash – include all cash compensation, such as base salary and severance;

■ Equity – include the dollar value of accelerated stock awards, in-the-money stock options that vest as a result of the extraordinary transaction and cash payments in cancellation of equity awards;

■ Pension/NQDC – include any enhanced pension or nonqualified deferred compensation benefits; do not include such benefits that are vested and/or not payable directly as a result of the extraordinary transaction;

■ Perquisites/benefits – include the value of all perquisites, personal benefits, and health and welfare benefits, with no exception for *de minimis* benefits;

■ Tax reimbursements – include any gross-up payments or other tax-related payments; and

■ Other – include any other compensation paid or payable as a result of, or in connection with, the extraordinary transaction.

The narrative disclosure that follows the table, including any footnotes to the table, needs to:

(1) identify each separate form of compensation;

(2) describe whether such compensation is paid on a ''single'' or ''double'' trigger basis;

(3) provide information about any material conditions or obligations applicable to the receipt of payment, such as noncompete obligations, the duration of such conditions or obligations and any provisions regarding waiver or breach;

(4) identify the specific circumstances that trigger payment;

(5) state whether the payments are in a lump sum or periodic, including duration; and

(6) identify who makes the payment (i.e., target or acquiring company).

A company can add additional columns to the tabular disclosure and/or add additional NEOs, as long as the disclosure is not misleading. For stock-price-based disclosure, the stock price at fiscal year end is used if the Item 402(t) disclosure is included in an annual meeting proxy statement; for filings related to an extraordinary transaction, if the transaction consideration is fixed, that price should be used, and, if variable, the average price for the five trading days following initial announcement of the extraordinary transaction should be used.

Disclosure under Item 402(t) is not required for *bona fide* post-transaction employment agreements to be entered into in connection with the extraordinary transaction or for persons who were not serving as executive officers of the target or acquiring company at the most recent fiscal year end.

Filings requiring Item 402(t) disclosure. The following filings will need to include Item 402(t) disclosure to the extent they relate to an extraordinary transaction:

■ Registration statements on Forms S-4 and F-4 containing disclosure relating to mergers and similar transactions;

■ Information statements on Schedule 14C;

■ Proxies or consent solicitations that require disclosure under Item 14 of Schedule 14A pursuant to Note A to Schedule 14A;

■ Going-private transactions on Schedule 13E-3; and

■ Third party tender offers on Schedule TO and Schedule 14D-9.

One change in the final Say-on-Pay Rules: the bidder in a third party tender offer will not be required to include Item 402(t) disclosures because the target company will be providing such disclosures in its Schedule 14D-9 filed within 10 business days after the tender offer is launched. However, the disclosure requirements do apply to the soliciting group in a going-private transaction, even if structured as a tender offer.

Say-on-Parachutes Votes. Section 14A(b)(2) of the Exchange Act and Rule 14a-21(c) set forth the requirements for this separate advisory shareholder vote. Like the other say-on-pay votes, these votes are advisory and no specific language is provided in the Say-on-Pay Rules for the resolution.

A separate say-on-parachutes vote is not required in every instance where Item 402(t) disclosure is required. For example, in a proxy statement of the acquiring company to approve a reverse split or an increase in authorized shares, no say-on-parachutes vote is required if the acquiring company's shareholders are not approving the extraordinary transaction. However, if the disclosure under Item 402(t) is broader than the required say-on-parachutes vote information, then the company will need to provide a separate table with Item 402(t) disclosure that relates only to the golden parachute compensation that is subject to the vote required by Section 14A(b)(2) and Rule 14a-21(c).

A separate say-on-parachutes vote is not required if the target is a foreign private issuer.

A company would not be required to include a separate say-on-parachutes vote in an extraordinary transaction filing if full Item 402(t) disclosure of its golden parachute compensation had been included in the proxy statement in which a prior say-on-pay vote was provided. Prior provision of a say-on-pay vote would be sufficient if the only change in compensation amounts is based on fluctuations in the company's stock price, or if the golden parachute compensation had been modified to provide less compensation than the amounts previously disclosed and presented as part of the say-on-pay vote disclosure. Otherwise, any modification to, or new, golden parachute compensation arrangements will require a separate say-on-parachutes vote. The company in that circumstance will need to provide two separate tables—disclosing all golden parachute compensation in one table and only the new or modified arrangements in the second table.

Because of the limited ability to avoid the separate say-on-parachutes vote by providing the Item 402(t) disclosure in a proxy statement that provides a say-on-pay vote, not many companies are expected to include the golden parachute compensation disclosure in annual meeting proxy statements.