October 20, 2010

SEC Proposes Say-on-Pay Rules for Companies and Proxy Vote Reporting Rules for Investment Managers

On October 18, 2010, the SEC proposed rules to implement the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act that require U.S. public companies to conduct separate shareholder advisory votes on:

- executive pay ("**say-on-pay**");
- frequency of the say-on-pay vote (the "**frequency vote**"); and
- executive payments in connection with M&A transactions that are presented for shareholder approval ("**say-on-golden parachutes**").

Under the Dodd-Frank Act, the say-on-pay vote must be held at least once every three years and, at least once every six years, shareholders must be afforded a frequency vote on whether the say-on-pay vote should occur every one, two or three years. The proposed rules do not apply to companies that are not subject to the SEC's proxy rules, and thus generally do not apply to foreign private issuers.

In a companion release issued the same day, the SEC also proposed rules implementing the Dodd-Frank Act provision requiring institutional investment managers to disclose how they voted on say-on-pay, the frequency vote and say-on-golden parachutes.

Shareholder Advisory Votes

No Specific Resolution Required. The SEC declined to mandate any specific language or form of resolution for the say-on-pay, the frequency and say-on-golden parachute votes. However, companies must disclose in their proxy statements the general effects of these shareholder votes, including their non-binding nature.

Say-on-Pay and Frequency Vote

Say-on-Pay Votes Effective for Meetings on or after January 21, 2011. Both the say-on-pay and frequency votes must be included in any proxy statement for an annual meeting taking place on or after January 21, 2011, regardless of the filing date of the proxy statement and regardless of whether the SEC's final rules have become effective.

Say-on-Pay Limited to Executive Compensation. Say-on-pay applies only to executive compensation disclosed pursuant to Item 402 of Regulation S-K and does not cover Item 402 disclosures for the compensation of directors and risk considerations to the extent they relate to broader compensation policies and practices.

Preliminary Proxy Not Required. Inclusion of any say-on-pay or frequency vote in a proxy statement will not trigger a requirement to file a preliminary proxy statement. The SEC indicated that it would not object if a company does not file, before the final rules become effective, a preliminary proxy statement for an annual meeting occurring on or after January 21, 2011 where the only matters that would otherwise require such a preliminary filing are the say-on-pay and frequency votes.

Disclosure on Impact of Previous Say-on-Pay Votes in the CD&A. Companies will be required to disclose in their CD&As whether and, if so, to what extent they have taken into account the results of previously required say-on-pay votes in making compensation decisions.

Four Vote Choices for the Frequency Vote. Proxy cards must provide shareholders with four vote choices with regard to the frequency vote: whether a say-on-pay vote should be provided every one, two

or three years, or to abstain from voting on the matter. A company may make a recommendation in its proposal as to how often a say-on-pay vote should occur, but it must present all four choices to shareholders.

No Voting Standard Required for the Frequency Vote. Because the frequency vote is non-binding, the SEC views it to be unnecessary to propose a standard by which any one of the choices would be viewed as being "adopted" by shareholders. It is possible that none of the choices will receive a majority of shareholder support.

***Disclosure of Frequency Determination in Form 10-Qs*.** Because companies can select a frequency that did not receive the most votes from shareholders, companies are required to disclose in their Form 10-Qs covering the period during which any frequency vote took place (or in a Form 10-K where a vote occurred during a company's fourth quarter) their decisions as to how often they will hold say-on-pay votes going forward. Under the proposed rules, including this disclosure in the Form 8-K announcing the annual meeting voting results would not be sufficient.

***Some Shareholder Proposals May Be Excluded Under Substantial Implementation*.** The rules create an incentive for companies to follow the plurality view as to the frequency vote. If a company adopts a frequency policy that is in accordance with the plurality of votes cast in the most recent frequency vote, the company may exclude any shareholder proposals that seek say-on-pay votes or a different frequency for say-on-pay votes than what the company selected.

***TARP Companies Exempt from the Frequency Vote*.** TARP companies are required to conduct annual say-on-pay votes under the Emergency Economic Stabilization Act of 2008 ("**EESA**") and are therefore exempt from holding a frequency vote until their outstanding indebtedness under TARP is repaid and they are no longer subject to this vote under EESA.

No Broker Discretionary Voting. Under current exchange rules and pursuant to the Dodd-Frank Act, brokers may not vote on the say-on-pay and frequency votes without instruction.

***No CD&A Needed for Smaller Reporting Companies to Comply*.** Smaller reporting companies are not exempt from providing shareholders with the say-on-pay and frequency votes; however, among other rule modifications for smaller reporting companies provided in the proposed rules, they do not need to prepare a CD&A in order to comply.

Say-on-Golden Parachutes

Say-on-Golden Parachutes Not Effective Until Final Rules. The proposed rules relating to say-on-golden parachutes have two components: disclosure and voting. Neither requirement is triggered until the SEC's final rules become effective, unlike the say-on-pay and frequency votes. Once final rules are effective, say-on-golden parachute disclosure and votes will be required in proxy statements related to an M&A transaction (merger, acquisition, consolidation or proposed sale or disposition of all or substantially all of a company's assets) for meetings taking place on or after January 21, 2011.

Expanded Disclosure of Golden Parachutes. "Golden parachutes" for the purposes of the new disclosure requirements are broadly defined and include all agreements and understandings between the target or the acquirer and each named executive officer of the target or the acquirer that relate to an M&A transaction. Golden parachutes do not include certain types of compensation that are not related to the transaction, such as previously vested equity awards or compensation from *bona fide* post-transaction employment agreements. The proposed rules do not require disclosure of, or a say-on-golden parachute vote on, agreements and understandings with management of foreign private issuers where the target or acquirer is a foreign private issuer.

New Disclosure Table Required. Golden parachute disclosure is required to be provided in both tabular and narrative formats and is more extensive than the current requirements of Item 402(j) of Regulation S-K and the "Interest of Certain Persons" disclosure required by Item 5 of Schedule 14A. For example, the

new disclosure does not provide for a *de minimis* exception for perquisites and requires disclosure of all arrangements whether or not they discriminate in scope, terms or operation in favor of executive officers. In addition, the SEC has specified the tabular format for the disclosure. The new table will require specific disclosure of, and a total aggregate amount for:

- cash severance payments;
- the dollar value of accelerated stock awards, in-the-money option awards for which vesting would be accelerated, and payments in cancellation of stock and option awards;
- pension and non-qualified deferred compensation benefit enhancements;
- perquisites and other personal benefits and health and welfare benefits;
- tax reimbursements (*i.e.*, tax gross-ups); and
- "other" elements of compensation (this category is meant to be a catch-all).

Companies must also disclose the conditions upon which the golden parachutes may be paid, such as the obligation to comply with non-compete arrangements and other restrictive covenants, whether the payments will be made in lump sum or other form and the obligor of the payments.

Disclosure Required for All M&A Transactions. A company must disclose its golden parachute arrangements in proxy statements for any M&A transaction for which the approval of its shareholders is sought. In addition, the proposed rules expand the statutory language of the Dodd-Frank Act to require golden parachute disclosure in filings pertaining to all types of M&A transactions, including tender offers and going-private transactions. There is an exception where a bidder does not have the required information after making a reasonable inquiry (*e.g.*, hostile takeover).

Scope of Say-on-Golden Parachute Vote. Companies must provide a non-binding shareholder vote on their golden parachute arrangements in proxy statements where a company solicits shareholders to approve an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all assets of the company. As discussed below, there is an exception for arrangements that were previously voted on in an annual meeting say-on-pay vote and have not been modified. In addition, if, as is often the case, the target company is the soliciting person, then agreements or understandings between the acquirer and the named executive officers of the target, while required to be disclosed, are not subject to the say-on-golden parachute vote.

***Annual Meeting Say-on-Pay Vote May Cover Say-on-Golden Parachute Vote*.** If disclosure satisfying the enhanced requirements, including the new table, is provided in an annual meeting proxy statement and that proxy statement includes a say-on-pay vote, a proxy statement used in connection with a subsequent M&A transaction need not include the say-on-golden parachute vote so long as no changes or modifications have been made to the golden parachute arrangements. If changes have been made, the company is required to include a separate table showing the modifications, and the separate say-on-golden parachute vote can be limited to just the changes. Regardless of whether a say-on-golden parachute vote is required in a proxy statement for an M&A transaction, the full golden parachute disclosure must be provided.

Proxy Vote Reporting Rules

New Reporting Requirements; Covered Persons. The proposed reporting rule provides that an institutional investment manager subject to reporting obligations under Section 13(f) of the Exchange Act must report annually on Form N-PX how it voted on say-on-pay, frequency and say-on-golden parachute votes. Under Section 13(f), an "institutional investment manager" includes "any person, other than a natural person, investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person." Institutional investment mangers are generally required to file Section 13(f) reports if they manage accounts holding certain equity

securities with an aggregate fair market value of at least $100 million. Such institutional investment managers would now be required to file Form N-PX and disclose how they voted on say-on-pay, frequency and say-on-golden parachute votes.

Form N-PX is currently used by registered management investment companies ("**RICs**") to file their proxy voting records. The use of Form N-PX would be expanded to include institutional investment managers, but only with respect to say-on-pay, frequency and say-on-golden parachute votes. The proposed rule would also expand the information required to be reported on Form N-PX generally and, in the case of RICs, would apply to the reporting of their entire proxy voting record.

Effective Date of Reporting Requirements. Covered institutional investment managers will be required to report votes relating to shareholder meetings that occur on or after January 21, 2011. If the proposed amendments to Form N-PX are adopted, the SEC anticipates the first Form N-PX filing deadline reporting on these votes to be August 31, 2011, covering the period from January 21, 2011 to June 30, 2011.

Covered Securities. An institutional investment manager will be required to report its voting of "any security" over which the manager had or shared "voting power" with respect to say-on-pay, frequency and say-on-golden parachute votes, without regard to whether it had voting power over other matters.

Annual Reporting. Covered institutional investment managers will be required to report votes annually on Form N-PX not later than August 31 of each year, with respect to votes that occurred in the twelve months ending June 30 of such year. The proposed rule provides a transition period, with respect to Form N-PX reporting obligations, for institutional investment managers that were previously not subject to Section 13(f) reporting obligations but became subject to such obligations in a given calendar year (*e.g.*, by crossing the $100 million threshold).

Joint Reporting. In order to prevent duplicative reporting, the Form N-PX amendments will permit a single institutional investment manager to report votes in cases where multiple institutional investment managers share voting power. In the case of a RIC, a fund manager will be allowed to satisfy its reporting obligations with respect to its voting of fund securities by reference to the fund's Form N-PX if it includes such manager's voting record with respect to say-on-pay, frequency and say-on-golden parachute votes.

Changes to Form N-PX. The proposed amendments to Form N-PX accommodate reporting by institutional investment managers with respect to say-on-pay, frequency and say-on-golden parachute votes. Form N-PX will now include a cover page, summary page and voting information. Institutional investment managers filing Form N-PX will be required to have the form signed by an authorized person, as is the case currently for RICs.

Information Required to be Reported. The information required to be disclosed in Form N-PX will include:

- name of the issuer of the security;
- exchange ticker symbol of the security and its CUSIP number;
- shareholder meeting date;
- brief identification of the matter voted on;
- with respect to RICs only, whether the matter was proposed by the issuer or a shareholder;
- number of shares the reporting person was entitled to vote (with respect to RICs) or had or shared voting power over (with respect to institutional investment managers);
- number of shares actually voted;
- how the person voted those shares including, with respect to votes cast in multiple manners, the number of votes cast in each manner;

- whether the vote was for or against management's recommendation; and
- identification of each institutional investment manager on whose behalf the Form N-PX is being filed.

The proposed amendments modify the existing Form N-PX by, among other things, requiring the disclosure of the number of shares entitled to vote (for RICs) or over which the manager had or shared voting power (for institutional investment managers) and the number of shares that were actually voted by the manager. Importantly, because investment managers to RICs are required to file Form N-PX with respect to the fund's entire proxy voting record, the proposed rule will extend the above reporting requirements to all matters voted on by RICs.

Narrow Exception for Confidential Treatment. An institutional investment manager may request confidential treatment with respect to information reported on Form N-PX; however, confidential treatment would only be appropriate, if at all, in narrow circumstances. RICs are generally not able to request confidential treatment with regard to information filed on Form N-PX.

- See the SEC release containing the full text of the proposed say-on-pay, frequency vote and say-on-golden parachute rules
- See the SEC release containing the full text of the proposed proxy vote reporting rules
- See the press release issued by the SEC

The SEC has requested public comment on these proposed rules. Comments are due to the SEC by **November 18, 2010**.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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