

Client Alert

SEC Adopts Final Rules on Shareholder Approval of Executive Compensation and Golden Parachute Compensation

EXEQUITY

Independent Board and
Management Advisors

On January 25, 2011, in a 3-2 vote, the Securities and Exchange Commission (the “SEC”) adopted final rules to implement the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) with respect to:

- “Say on Pay (SOP)”—Nonbinding shareholder advisory vote on the executive compensation disclosures in the proxy;
- “Say When on Pay (SWOP)”—Nonbinding shareholder advisory vote on the frequency with which shareholders will vote on the executive compensation disclosures; and
- “Say on Golden Parachutes (SOGP)”—Disclosure and nonbinding shareholder advisory vote on golden parachute arrangements when shareholders are asked to approve a merger or other corporate transaction.

Briefly, the following table summarizes companies’ recommendations with respect to the SWOP vote as of February 2, 2011:

Frequency Recommendation	All Companies (#)	All Companies (%)	Fortune 500 Companies (#)	Fortune 500 Companies (%)
Annual	61	29%	11	37%
Biennial	13	6%	2	7%
Triennial	123	59%	16	53%
No Recommendation	12	6%	1	3%

The purpose of this *Client Alert* is to provide an overview of the changes made in the final rules (from the proposed rules), review the current environment with respect to company responses, briefly discuss implementation issues, and provide an update on SEC regulatory action on other executive compensation provisions in Dodd-Frank.

Overview of Changes Made in Final Rules

The SEC's final rules are substantially as proposed (see our *Client Alert* dated November 5, 2010). The following three tables summarize the more significant changes with respect to the final rules on SOP, SWOP, and SOGP.

SOP

Subject Matter	Proposed Rules	Final Rules
Prescribed Language or Form of Resolution	No prescribed language or form of resolution.	<ul style="list-style-type: none"> No prescribed language or form of resolution. Adds an instruction regarding language that should be included. Provides a nonexclusive example of a resolution.
Discussion in Compensation Discussion and Analysis of Consideration of the Results of Previous SOP Vote(s)	Discuss how companies have considered the results of previous SOP votes.	<ul style="list-style-type: none"> Limits the discussion to the most recent SOP vote (unless discussion of previous SOP votes is material). Must address whether the most recent SOP vote result was considered and, if so, how the consideration affected the compensation decisions and policies.
Exclusion of Future Shareholder Proposals	Proposals that relate to SOP or SWOP can be excluded if the company adopts the frequency choice consistent with a plurality of the votes cast.	Plurality changed to majority . Accordingly, SWOP votes garnering only a plurality will not allow companies to exclude future SOP proposals.
Compliance Deadline for Smaller Reporting Companies	Not addressed.	2-year temporary exemption, i.e., applicable for meetings on or after January 21, 2013.

SWOP

Subject Matter	Proposed Rules	Final Rules
Prescribed Language or Form of Resolution	No prescribed language or form of resolution.	No change.
Disclosure Explaining the General Effect of the Vote	Disclose the general effect of the vote, such as whether the vote is nonbinding.	Also, must disclose the current frequency of the SWOP vote and when the next SOP vote will occur. This will be applicable after the first SWOP vote.
Voting of Returned Uninstructed Shares	Not addressed.	Companies can vote returned uninstructed shares in accordance with management's recommendation.
Exclusion of Future Shareholder Proposals	Proposals that relate to SOP or SWOP can be excluded if the company adopts the frequency choice consistent with a plurality of the votes cast.	Plurality standard changed to majority . Accordingly, SWOP votes garnering only a plurality will not allow companies to exclude future SWOP proposals for alternative frequencies. No-action requests to exclude shareholder proposals that seek shareholder advisory votes on different aspects of executive

Subject Matter	Proposed Rules	Final Rules
		compensation will be evaluated on a case-by-case basis.
Company Decision on Frequency Adopted	Must disclose in its 10-Q (or 10-K, if applicable) its decision with respect to the SWOP vote.	Must disclose decision on Form 8-K (amended Form 8-K if decision is not made at the same time voting results are reported) within 150 calendar days after the shareholder meeting, but no later than 60 calendar days prior to the deadline for the submission of shareholder proposals for the next shareholder meeting.
Compliance Deadline for Smaller Reporting Companies	Not addressed.	2-year temporary exemption, i.e., applicable for meetings on or after January 21, 2013.

SOGP

Subject Matter	Proposed Rules	Final Rules
Effective Date	Not effective until SEC issues final rules.	Applicable for filings made on or after April 25, 2011.
Tabular Quantification of Amounts Based on Stock Price	If separate SOGP vote, stock price based on the closing price per share as of the latest practicable date.	If separate SOGP vote, stock price based on the "deal" price if it is a fixed dollar amount, or otherwise on the average closing price per share over the first 5 business days following the first public announcement of the transaction.
Exemption From SOGP Vote	No disclosure required if disclosure had already been included in the executive compensation disclosure that was already the subject of an SOP vote. New arrangements and revisions to golden parachute arrangements since the SOP vote would be subject to the separate SOGP vote.	<ul style="list-style-type: none"> Clarifies that even routine, nonsubstantive changes since the last SOP vote (e.g., application of existing arrangements to new named executive officers, subsequent grants in the ordinary course of business with the same terms as previous awards, and routine changes in salary) would be subject to an SOGP vote. Also, any change that results in a 280G gross-up becoming payable, even if it becomes payable only because of an increase in the company's stock price, is a change that would trigger the SOGP vote. Exemption applies if the only changes are to the stock price or if the value of the total compensation payable is less than the value disclosed in the most recent SOP vote.

SOP

The SEC's final rule (Rule 14a-21(a)) requires a separate shareholder vote on executive compensation with respect to an annual meeting for which proxies are solicited for the election of directors (or a special meeting in lieu of an annual meeting) at least once every three **calendar** years. The initial vote is required for annual meetings that occur on or after January 21, 2011 (January 21, 2013 for smaller reporting companies).

Companies have the flexibility to craft the resolution language; however, the SEC has added an instruction to its rules that the language from Section 14A(a)(1) of Dodd-Frank should be included in the resolution. Section 14A(a)(1) requires that the advisory vote must be "to approve the compensation of executives, as disclosed pursuant to [Item 402 of Regulation S-K] or any successor thereto." In addition, the final rules provide a nonexclusive example of a resolution that would satisfy the applicable requirements, i.e., "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."

SWOP

The SEC's final rule (Rule 14a-21(b)) requires a separate shareholder vote with respect to an annual meeting at which directors will be elected at least once every six **calendar** years. The initial vote is required for annual meetings that occur on or after January 21, 2011 (January 21, 2013 for smaller reporting companies).

As indicated in the Overview above, companies must disclose in the proxy the general effect of the vote, such as whether the vote is nonbinding. In addition, companies must disclose the current frequency of SOP votes and when the next scheduled SOP vote will occur. The SEC does not expect disclosure on the current frequency or when the next SOP vote is to occur in the proxy statements where companies initially conduct SOP and SWOP votes. Thus, this additional disclosure requirement will not occur until the next proxy for which an SOP vote is included.

The final rules also provide that companies may vote returned uninstructed proxy cards in accordance with management's recommendation on the SWOP vote if the company includes a recommendation for the SWOP vote, permits abstentions on the proxy card, and includes language (in bold) on how returned uninstructed shares will be voted.

The SEC continues to believe that companies should be permitted to exclude subsequent shareholder proposals that seek a vote on the same matters as the SOP or SWOP vote. Accordingly, companies will be permitted to exclude a shareholder proposal that would provide an SOP vote, seeks future SOP votes, or relates to the frequency of SOP votes if a single frequency (i.e., one, two, or three years) received the support of the majority of the votes cast and the company adopted a policy on the SWOP vote consistent with the majority choice. No-action requests to exclude shareholder proposals that seek shareholder advisory votes on different aspects of executive compensation will be evaluated on a case-by-case basis by the staff.

The proposed rules had required that the company's decision with respect to the frequency it will actually adopt would have needed to be disclosed in the next filed Form 10-Q or 10-K. However, in order to provide companies with sufficient time to make a decision, the final rules require the decision on Form 8-K within 150 calendar days after the date of the shareholder meeting, but no later than 60 calendar days prior to the deadline established for the submission of shareholder proposals for the next shareholder meeting. Since the voting results are required to be filed on Form 8-K within 4 business

days of the shareholder meeting, the disclosure of the frequency decision would be an amendment to that Form 8-K (unless the decision is included in the initial 8-K disclosing the voting results).

Issues Relating to Both SOP and SWOP

Both the SOP and the SWOP vote would be required for newly public companies in the proxy statement for the first annual meeting that occurs after the initial public offering.

Consistent with the proposed rules, the final rules would provide that neither the SOP nor SWOP votes would trigger the filing of a preliminary proxy.

With respect to companies that have received assistance under the Troubled Asset Relief Program, or TARP, an annual vote to approve executive compensation is already required pursuant to the Emergency Economic Stabilization Act of 2008. Accordingly, companies will not be required to include a separate SOP or SWOP vote pursuant to Section 14A(a)(1) and (a)(2). This separate SOP and SWOP vote pursuant to Section 14A(a)(1) and (a)(2) would be required for the first annual meeting after the company has repaid its outstanding indebtedness under the TARP.

SOGP

Section 14A(b)(1) adopts a broad disclosure requirement, substantially as proposed. Basically, all persons seeking shareholder approval of an acquisition, merger, consolidation, or proposed sale or disposition of all or substantially all of the company's assets (a "Proposed Transaction") must provide disclosure of any agreements or understandings that it has with its named executive officers (or with the named executive officers of the acquiring issuer). In addition, if the acquiring company is seeking shareholder approval of a Proposed Transaction, disclosure is required of any agreements or understandings the acquiring company has with its named executive officers and with the named executive officers of the target company. The disclosure must be in a clear and simple form and include the aggregate total of all the compensation that may be paid or become payable to the named executive officers.

New Item 402(t) requires disclosure and is adopted substantially as proposed. Item 402(t) requires disclosure of the compensation arrangements in both tabular and narrative formats. Also, as proposed, final Item 402(t) requires disclosure of all golden parachute compensation relating to the Proposed Transaction among the target and acquiring issuers and the named executive officers of each. The final rules make it clear that disclosure is only required of compensation that is based on or otherwise relates to the Proposed Transaction. In other words, disclosure of already vested amounts or post-transaction employment agreements is not required.

Under the final rules, companies will be permitted to add additional named executive officers and additional rows or columns to the tabular disclosure such as to disclose cash severance separately from other cash compensation or to distinguish "single trigger" and "double trigger" arrangements.

Also, for purposes of the Item 402(t) disclosure, the final rules modify how the stock price will be measured for purposes of calculating the dollar amounts disclosed in the table if a separate SOGP vote is conducted. As finalized, the dollar amounts that are based on the company's stock price will be based on the actual consideration per share, if that is a fixed dollar amount, or otherwise on the average closing price per share over the first five business days following the first public announcement of the transaction. If the Item 402(t) disclosure is included in the annual meeting proxy statement, the price per share is calculated based on the closing market price per share on the last business day of the company's last completed fiscal year.

The proposed rules required 402(t) disclosure in filings for certain other transactions, such as information statements, registration statements, going-private transactions, third-party tender offers, and bidders in a third-party tender offer (to the extent a reasonable inquiry was made and there was knowledge of the arrangements). The final rules eliminate bidders in third-party tender offers from the list but clarify that acquiring companies soliciting proxies to approve the issuance of shares or a reverse stock split in order to conduct a merger transaction are subject to the disclosure requirements. There is also an exception from the disclosure requirements in the final rules for targets that are foreign private issuers.

Consistent with the proposed rules, the final rules provide an exception to the separate SOGP vote on golden parachute arrangements if the required 402(t) disclosures are included in the executive compensation disclosures that are subject to the SOP vote. The exception is only available to the extent the same golden parachute arrangements subject to the SOP vote at the annual meeting remain in effect and the terms of the arrangements are not subsequently modified. In the final rules, the SEC took a rather narrow view of what is considered a modification so that even increases in salary, additional grants of equity awards in the normal course and consistent with previously approved terms, or the addition of a new named executive officer are considered modifications. Also, any change that would result in a 280G gross-up becoming payable, even if the gross-up becomes payable only because of an increase in the company's stock price, is considered a change that would trigger a separate SOGP vote. The exception to the separate SOGP vote is available, however, if the total amounts payable are less than what was disclosed in the proxy subject to the SOP vote or if the stock price has changed.

Exequity Comment: *Generally, we expect that it will **not** be beneficial or advantageous to include the Item 402(t) disclosures in the annual proxy that is subject to the SOP vote for the following reasons:*

- *The exception is extremely narrow, and it is unlikely that the compensation elements subject to the SOGP vote will remain the same from the last SOP vote. Although the SEC stated that the SOGP vote only covers the new arrangements and revised terms, there is still disclosure of two tables in the merger proxy statement, i.e., one table disclosing **all** the golden parachute compensation, and a second table disclosing only the new arrangements or revised terms. Shareholders are likely to consider all of the golden parachute compensation even though the vote is technically on only the new arrangements or revised terms.*
- *ISS has indicated that if the annual shareholder meeting proxy includes the prescribed golden parachute disclosure under Item 402(t), the golden parachute information will carry more weight in ISS's overall SOP recommendation. Companies that have design features or provisions that ISS has identified as having an impact on its recommendation on a Vote on Golden Parachutes will be under increased scrutiny on its SOP vote. These design features include paying out performance shares at other than pro rata actual, single-trigger arrangements (including single-trigger equity plan arrangements), excise tax gross-ups, and potentially excessive change-in-control accelerated payments.*

Companies seeking to avoid ISS confusion and applying its voting on golden parachute criteria to the normal golden parachute disclosure that is currently required under Item 402(j) should make it very clear in its headings and narrative that the disclosure is pursuant to Item 402(j), and not Item 402(t).

Current SOP and SWOP Environment

As of the date of this *Client Alert*, we are very early in the 2011 proxy season so it is difficult to assess how the proxy season will end with respect to SOP and SWOP. Nevertheless, there are some strong indications in the market that lead us to preliminarily conclude the following:

- Although the percentage of companies recommending a triennial frequency is significantly greater than the percentage of companies recommending an annual or biennial frequency, the actual votes coming in for the companies that have recommended triennial are expressing a clear and majority support for an annual vote. This is the case regardless of the support level for the SOP vote. The following table discloses some recent results on SOP and SWOP.

Company ¹	Support for Executive Compensation Disclosures (SOP Vote) ²	Support for Annual Frequency ³	Support for Triennial Frequency ³
Air Products & Chemicals	83%	60%	39%
Costco Wholesale ⁴	99%	53%	44%
Jacobs Engineering	45%—Failed	68%	29%
Johnson Controls, Inc.	62%	59%	40%
LaClede Group Inc.	91%	47%	50%
Monsanto ⁴	56%	62%	36%
Roebing Financial Corp, Inc. ⁵	77%	28%	67%
Rock-Tenn	96%	79%	19%
Sally Beauty Holdings Inc. ⁶	98%	37%	63%
Woodward Governor	93%	57%	39%

- ISS's policy is to support annual SOP votes and we believe ISS's recommendation is having an impact.
- On January 31, 2011, 39 institutional investors, representing more than \$830 billion in assets, issued a public call for companies to support an annual advisory vote on executive compensation and for investors to vote for annual SOP votes. The investor statement argues that an annual frequency provides maximum accountability, is the standard in all other major markets, and encourages companies to effectively communicate with shareowners.
- Most companies will adopt the frequency supported by the majority and many of these companies will make an immediate announcement to that effect. If a company does not adopt the frequency supported by the majority, it risks receiving a shareholder proposal requesting a different (most likely annual) frequency.
- Although a triennial recommendation has been the overwhelming choice, we expect, given recent developments, that many calendar year-end companies who are in the process of preparing their proxies will end up with an annual frequency recommendation.

¹ All companies recommended a triennial frequency except Rock-Tenn, which made no recommendation.

² Based on company's voting standard as stated in the proxy.

³ Based on votes cast for annual, biennial, and triennial. Abstentions excluded.

⁴ Immediately announced they are adopting annual.

⁵ 40% of shares owned by insiders and more than 5% owners.

⁶ Majority of shares owned by insiders and more than 5% owners.

You can find the latest SOP and SWOP developments, including weekly tracking of SWOP voting recommendations, on www.say-on-pay.com.

Other Dodd-Frank Executive Compensation Rulemaking

The SEC has updated its implementation schedule with respect to rulemaking on other Dodd-Frank executive compensation provisions. Specifically, it has pushed back its timetable for issuing proposed rules on disclosure of “pay for performance,” CEO to median employee compensation, clawback provisions, and hedging policies. A timeline for issuing final rules on these matters has not been identified. Given this timing, it is possible that we may not have rules on these matters before the 2012 proxy season.



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