

Client Alert

Latham & Watkins Tax Department

SEC Announces Preliminary Say on Pay Rules

On October 18, 2010, the Securities and Exchange Commission (SEC) published proposed rules (Proposed Rules) implementing Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), commonly referred to as "say on pay." Section 951 generally enables shareholders of public companies to cast advisory votes to approve certain payments made in connection with mergers and similar corporate transactions and the compensation of named executive officers, as well as the frequency with which such compensation should be approved. A complete copy of the Proposed Rules, which are subject to public comment through November 18, 2010, may be found on the SEC's website at <http://www.sec.gov/rules/proposed/2010/33-9153.pdf>. This *Client Alert* briefly describes the general application of the Proposed Rules in simple Question and Answer format and discusses some preparatory steps that companies may wish to consider before the adoption of final rules by the SEC.

Shareholder Vote to Approve Executive Compensation

The Dodd-Frank Act's requirement that companies hold a shareholder advisory vote to approve the compensation of named executive officers (Say on

Pay Vote) would be embodied in new proposed Exchange Act Rule 14a-21(a), the key features of which are:

Q: When is a Say on Pay Vote required?

A: An initial Say on Pay Vote is required at a company's first regular meeting of shareholders occurring on or after January 21, 2011 (even if proxy statements are filed prior to that date and even if final rules implementing Section 951 have not yet been adopted). The Proposed Rules then require a Say on Pay vote no less frequently than once every three years with respect to a shareholder meeting at which proxies are solicited for director elections.

Q: What subject matter does the required Say on Pay Vote cover?

A: The Say on Pay Vote is an overall approval or disapproval of all executive compensation disclosed in the proxy statement, including the Compensation Discussion and Analysis (CD&A), the executive compensation tables and the other narrative compensation disclosure regarding a company's named executive officers required by Item 402 of Regulation S-K. The Say on Pay Vote does not cover other matters such as director compensation or a company's

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disclosure of policies and practices as they relate to risk management and risk taking incentives (except to the extent such discussion is included in the CD&A).

Q: What should my company's Say on Pay Vote proposal look like?

A: When a Say on Pay Vote is being provided, the proxy statement must explain that the Say on Pay Vote is a separate shareholder vote on executive compensation and must describe the general effect of the vote, including whether the outcome is non-binding. No specific language or form of resolution is required, though the vote proposal should make clear that the vote covers all of the executive compensation disclosed in the proxy statement. For example, a vote proposal that refers only to "compensation policies and procedures" would not satisfy the Proposed Rules.

Q: What should and must a company do after a Say on Pay Vote?

A: Following a Say on Pay Vote, a company's proxy statement must include in the CD&A disclosure of whether and, if so, how its compensation policies and decisions have taken into account the results of previous Say on Pay Votes. No other affirmative action is required. If the vote is negative, it could have reputational consequences and could impact other shareholder voting decisions, including director elections. In addition, the relatively high passage rates of say on pay votes in prior years may not accurately predict the outcomes of future mandatory say on pay votes because Section 957 of the Dodd-Frank Act effectively prohibits broker discretionary voting of uninstructed shares in these matters. All of these factors combined may allow shareholders to use the Say on Pay Vote to exert considerable pressure on company boards. Determining how to respond

to a negative Say on Pay Vote could be a substantial challenge given the non-specific nature of the required vote. Ultimately, a variety of strategies may develop based on the collaborative input of boards, compensation committees, management, compensation consultants and legal advisors.

Shareholder Vote Regarding Say on Pay Vote Frequency

In addition to the Say on Pay Vote, the Dodd-Frank Act requires companies to hold a separate shareholder advisory vote on whether Say on Pay Votes will be conducted annually, biannually or triennially (Say on Frequency Vote). The requirements for the Say on Frequency Vote would be embodied in new proposed Exchange Act Rule 14a-21(b), the key features of which are:

Q: When is a Say on Frequency Vote Required?

A: An initial Say on Frequency Vote must accompany the Say on Pay Vote at a company's first regular meeting of shareholders occurring on or after January 21, 2011. The Proposed Rules then require a Say on Frequency Vote at least once every six years with respect to a shareholder meeting at which proxies are solicited for director elections.

Q: How is the Say on Frequency Vote constructed and how does a company determine which Say on Pay Vote frequency shareholders have adopted?

A: The Say on Frequency Vote proxy card must provide shareholders with four voting alternatives: annual, biannual or triennial Say on Pay Votes and abstention. It is, therefore, possible that no single frequency will garner a majority vote. The Proposed Rules do not provide a standard for determining which frequency has been approved, as the Say on Frequency Vote is advisory

and non-binding on the Company. However, the Proposed Rules provide that a company may exclude a shareholder proposal that seeks a Say on Pay Vote or relates to its frequency from its proxy statement as "substantially implemented" only if the company has adopted a Say on Pay Vote frequency that is consistent with a plurality of votes cast in the company's most recent Say on Frequency Vote.

Q: What disclosure is required in connection with a Say on Frequency Vote?

A: When a Say on Frequency Vote is provided to shareholders, the proxy statement must disclose the Say on Frequency Vote and briefly discuss its general effect, including whether the vote is non-binding, as it is permitted to be. Following a Say on Frequency Vote, the periodic report covering the period in which the vote occurred must include disclosure of a company's decision regarding Say on Pay Vote frequency in light of the outcome of the Say on Frequency Vote.

Shareholder Vote to Approve "Golden Parachute" Arrangements

The Dodd-Frank Act requires companies seeking shareholder approval of a merger or similar corporate transaction to provide "clear and simple" disclosure of payments that may be made to named executive officers based upon or in relation to the transaction, sometimes called "golden parachutes." The SEC has proposed new Item 402(t) of Regulation S-K to implement this disclosure requirement. Relatedly, the SEC has also proposed Exchange Act Rule 14a-21(c) to require a separate shareholder advisory vote on golden parachute compensation (Say on Parachutes Vote). The following briefly describes these new requirements:

Q: When is a Say on Parachutes Vote required?

A: Unlike Say on Pay and Say on Frequency Votes, Say on Parachutes Votes are not required until the SEC has adopted final rules defining the parameters of the vote, which is expected to occur no later than January 2011. If the Proposed Rules are adopted as final, once effective, a Say on Parachutes Vote will be required when shareholders are asked through proxy solicitation to approve an acquisition, merger, consolidation or sale or other disposition of all or substantially all of a company's assets (M&A transaction). As discussed below, a Say on Parachutes Vote may be avoided if the golden parachute compensation has been subjected to a prior Say on Pay Vote after complete disclosure as if it were subject to the Say on Frequency Vote.

Q: What is golden parachute compensation?

A: Golden parachute compensation is defined broadly to include any agreements or understandings with any named executive officer concerning any type of compensation that is based on or otherwise relates to the applicable M&A transaction, without regard to amount or whether such compensation would trigger penalty taxes and loss of tax deductibility under Sections 280G and 4999 of the Internal Revenue Code.

Q: What is the subject matter of a Say on Parachutes Vote?

A: The Say on Parachutes Vote is an overall approval or disapproval of the golden parachute compensation arrangements between the person soliciting the proxies and named executive officers of the target and acquiring companies involved in the M&A transaction, as such

compensation is required to be disclosed in the proxy statement. The Say on Parachutes Vote does not extend to golden parachute compensation in relation to other merger-like transactions, such as certain Rule 13e-3 going private transactions and tender offers where shareholder votes are not solicited, even though disclosure of such compensation may be required pursuant to proposed Item 402(t).

Q: When is proposed Item 402(t) disclosure required?

A: Proposed Item 402(t) disclosure is required in certain registration and information statements related to, and proxy or consent solicitations seeking the approval of, a merger or similar transaction, in whatever form the transaction may take, including an M&A transaction, a going private transaction or a tender offer. This disclosure must be included regardless of whether a Say on Parachutes Vote is required in connection with the applicable transaction.

Q: What disclosure does proposed Item 402(t) require?

A: Proposed Item 402(t) requires tabular and narrative disclosure of golden parachute compensation based upon or related to a merger or similar transaction for named executive officers of both the target and acquiring companies, excluding disclosure for those individuals who were not serving as executive officers at the end of the applicable fiscal year. The disclosure requirements do not apply to arrangements with senior management of foreign private issuers. Disclosure under proposed Item 402(t) is separate from, and in addition to, disclosure under Item 402(j) of Regulation S-K, which currently requires that each annual proxy statement contain narrative and quantitative (though not tabular) disclosure of potential termination

and change in control payments.

Q: How can a Say on Parachutes Vote be avoided?

A: The Proposed Rules do not require a Say on Parachutes Vote with regard to golden parachute arrangements for which Item 402(t) disclosure was previously included in an annual proxy statement and subjected to a Say on Pay Vote, regardless of the Say on Pay Vote's outcome, provided that the arrangement has not since been modified. If the arrangement has been modified or new arrangements exist, a Say on Parachutes Vote must be provided with respect to the new arrangements and/or modified terms. For example, stock options subject to accelerated vesting upon a change in control that are granted after the prior vote would need to be disclosed and subjected to a Say on Parachutes Vote, with the proxy disclosing all of the golden parachute compensation, including that previously subjected to a vote.

Preparing for the Dodd-Frank Act's Shareholder Votes

While the Proposed Rules are not final and may be changed prior to final adoption, the contours of the Dodd-Frank Act's compensation-related shareholder voting reforms are quickly coming into focus. There are several steps that companies may wish to consider even before the final rules are adopted. Some key considerations are:

Q: What steps can companies take to prepare for a Say on Pay Vote?

A: In preparation for a Say on Pay Vote, companies may wish to review the following items:

- Results of past shareholder votes on equity plans and director elections to assess the level of shareholder satisfaction on executive compensation matters.
- Voting guidelines of proxy advisors and significant

shareholders to determine whether revisions of pay practices that have been identified as problematic should be considered.

- Past pay disclosures to make certain they are accurate and complete so that overburdened proxy advisors do not misunderstand the practices.

Q: What steps can companies take to prepare for a Say on Frequency Vote?

A: In preparation for a Say on Frequency Vote, companies may wish to discuss with significant shareholders the company's desired frequency of Say on Pay Votes. There is no universal rule regarding which frequency is best. Generally, annual voting, which Institutional Shareholder Services is expected to support, arguably provides the highest level of direct communication, while biannual or triennial voting may be considered to align Say on Pay Votes with evaluating pay practices in relation to long-term performance and allowing sufficient time between

votes for meaningful shareholder discussions and thoughtful company responses.

Q: What steps can companies take in relation to potential Say on Parachutes Votes?

A: In consideration of future Say on Parachutes Votes, companies may wish to review and potentially update existing golden parachute arrangements to ensure these arrangements work for the company and are consistent with mainstream practices.

Companies should begin thoughtfully preparing now for their upcoming Say on Pay and related votes (if they have not already). The individual actions that should be taken depend on company-specific voting policies, pay practices and other circumstances. While the foregoing provides a framework for companies to begin developing an approach to address the now-mandatory Say on Pay and related votes, companies should be working closely with their compensation consultants, legal advisors and proxy solicitors to determine what specific actions they should take to work toward a successful 2011 proxy season.

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