PROFESSOR ROBERT J. JACKSON, JR.
COMMENTARY ON "SAY ON PAY" VOTES ON "GOLDEN PARACHUTES"

October 11, 2010

United States Securities and Exchange Commission
100 F Street, Northeast
Washington, D.C. 20549-1090
Attention: Ms. Elizabeth M. Murphy, Secretary
Via Electronic Mail

Dear Ms. Murphy:

I am submitting this letter in response to the Commission's invitation for preliminary comments on the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act") addressing executive compensation. I understand that the Commission intends shortly to adopt preliminary rules under Section 951 of the Act, concerning "say on pay" votes on "golden parachutes." I write to comment on this issue.

I am a law professor who has researched and written on, among other matters, executive compensation and corporate governance. I write solely in my individual capacity; my institutional affiliation is given here for identification purposes only.[1]

In light of the short timeframe in which the Commission is adopting these proposed rules, I have limited my comments to two issues raised by the "golden parachute" vote required by Section 951. (I expect to provide additional reactions to the proposed rules.) In these preliminary comments, I suggest that the Commission's proposed rules:

- ***Limit the definition of "grandfathered" golden parachutes*** to the economic reasoning for the Act's grandfathering provision; and

- Require ***new, separate disclosure of both "grandfathered" golden parachutes and newly granted amounts***.

Defining "Grandfathered" Golden Parachutes

Section 951 adds Section 14A(b)(1) to the Securities Exchange Act of 1934, requiring that a proxy statement requesting approval of a merger give shareholders additional disclosure on payments to executives related to the transaction (these are sometimes called "golden parachutes"). The Act also adds Section 14A(b)(2), which requires that any such proxy include a resolution for shareholders to vote to approve golden parachutes.

[1] Although I served as an advisor to senior officials at the Department of the Treasury on matters related to executive compensation in 2009 and 2010, the views reflected in this letter are solely my own.

Section 14A(b)(2), however, makes clear that the shareholder-vote requirement applies only if the agreements have not been "subject to a shareholder vote" under the annual, biennial, or triennial vote under Section 14A(a) (the ***"Grandfather Clause"***). Under this provision, any agreement that has been the subject of a vote under Section 14A(a) need not be the subject of a vote under Section 14A(b)(2).

The Grandfather Clause distinguishes payments under agreements that existed before the firm agreed to a proposed transaction from payments under new agreements. This distinction is critical because well-established economic analysis of golden parachutes suggests that they serve shareholder interests best when the payments are made pursuant to previously established arrangements rather than new deals struck after the firm agrees to a merger.

Because takeover defenses make hostile acquisitions prohibitively expensive, executives can influence whether a merger occurs. Executives benefit privately from control of the firm, and thus may not pursue a merger that is in shareholders' interests. Under these circumstances, it may be efficient for shareholders to agree to golden parachutes, so that the executive is induced to pursue these mergers.[2]

"Golden parachutes" pursuant to existing agreements can plausibly serve this purpose because the executive is aware that she has a contractual right to payments if she pursues a sale of the firm. Thus, the Grandfather Clause excludes payments under these existing agreements from a separate vote under Section 14A(b)(2) so long as they have been the subject of a prior vote. But payments awarded *after* a sale has been bargained for and agreed are far less likely to have induced the executive to pursue the sale in the first place.[3]

Nevertheless, some commentators have suggested that the Grandfather Clause should be expanded to include not only payments under existing agreements but also to new payments, so long as the new payments are provided under existing compensation plans.[4] For three reasons, the Commission's proposed rules should not adopt this approach.

First, as noted above, new golden parachute payments cannot be justified by the argument that they induced executives to pursue a merger that is in shareholders' interests. The literature has identified these payments as especially problematic from shareholders' point of view. The fact that a new payment is granted to an executive under an existing company plan makes no difference from shareholders' perspective.

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[2] *See generally* Jay C. Hartzell et al., *What's In It For Me? CEOs Whose Firms Are Acquired*, 17 REV. FIN. STUD. 37, 37-40 (2004) (describing this literature).

[3] Because they are not required by any pre-existing agreement, the literature has referred to such payments as "gratuitous" payments. *See* Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 834 (2002). Rigorous analysis of these payments has suggested that they are associated with lower returns for target shareholders. *See generally* Hartzell et al., *supra* note 2, at 39.

[4] *See, e.g.*, Letter from Compensia to Elizabeth M. Murphy, Sec'y, SEC (Oct. 4, 2010), at 5 ("[A]s long as an employee stock plan (or form of award) and any features of such plan (or form of award) that provides for accelerated or greater payment in a merger [has been] subject to the advisory vote required in Section 14A(a)(1), the fact that . . . additional awards are made to named executive officers [should] not require such awards to be approved by shareholders"); *see also* Letter from the Business Law Section of the American Bar Association to Elizabeth M. Murphy, Sec'y, SEC (Sept. 29, 2010), at 9 ("*The Commission's rules should provide that if the material terms of an agreement . . . as they relate to or are proposed by [a merger] were . . . subject to a previous Say on Pay Vote, then the [Grandfather Clause] will be available.*") (italics in original) (describing four specific cases in which the Commission should approve this approach).

Second, the Grandfather Clause acknowledges that previous disclosure of a golden parachute arrangement provides shareholders with meaningful notice of amounts to be paid to executives. But shareholders will not have had notice of new payments, even where the new payment is made under an existing plan. To be sure, shareholders will have had notice that a plan existed, and that executives may receive new payments under that plan. But the Grandfather Clause does not contemplate, and the Commission should not provide, that the existence of a general plan provides sufficient notice to shareholders of large new golden parachute payments under that plan.

Third, as a practical matter the proposed approach would permit issuers to grant executives large new payments that will vest and be paid immediately upon a merger—yet not be disclosed to shareholders or voted on under Section 14A(b)(2). For example, substantial new stock and option awards granted to executives during the time between signing and closing of a merger agreement would fall under the Grandfather Clause under this approach.

Standard public-company equity plans provide for vesting of equity awards upon a merger (or, in some cases, upon a termination of employment following the sale of the firm). These plans are required to be disclosed to, and approved by, public company shareholders under exchange-listing rules, and are described to shareholders in disclosures under Item 402.[5] Thus, on the proposed view, new awards under these plans—for example, substantial of new stock and options that will vest upon the change in control—fall under the Grandfather Clause.

Rather than this approach, I suggest that the Commission's rules follow the clear distinction drawn in the literature and in the statute between agreements likely to have induced the executive to pursue a merger and those unlikely to have done so. Thus, the Commission's proposed rules under Section 951 should ***limit the Grandfather Clause to agreements between the firm and executive that existed, and were disclosed to and voted on by shareholders, before the firm agreed to a merger or sale.***

New Golden Parachute Disclosure

As noted above, new Section 14A(b)(1) requires that shareholders be provided with disclosure, "in a clear and simple form in accordance with regulations to be promulgated by the Commission," on "any agreements" regarding compensation contingent on a sale or merger. Some commentators have suggested[6] that existing rules under Item 402(j) of Regulation S-K are appropriate for this purpose.[7]

In my view, the policy goals of Section 14A(b)(1) may be reached in a variety of ways. The exact design of the disclosure is beyond the scope of these preliminary comments.

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[5] *See, e.g.*, Order Approving NYSE and Nasdaq Proposed Rule Changes Relating to Equity Compensation Plans, Exchange Act Release No. 48,108, 68 Fed. Reg. 39,995 (July 3, 2003).

[6] *See, e.g.*, Letter from Compensia, *supra* note 4, at 6 (favoring Item 402(j) disclosure); Letter from the Business Law Section of the American Bar Association, *supra* note 4, at 9, 11 & n.9 (favoring 402(j) and arguing that, *inter alia*, compensation arrangements between an acquirer and target executives that require services after the closing of a transaction should not be subject to disclosure).

[7] *See* 17 C.F.R. § 229.402(j).

What is clear even at this early stage, however, is that the statute requires more than reproduction of the existing rules under Item 402(j). Congress drafted Section 951 aware of Item 402(j), yet required new disclosures under regulations "*to be promulgated*" by the Commission, demanding a "clear and simple form" rather than the complex table at Item 402(j). To be sure, the regulations at Item 402(j) may inform the Commission's judgment as to the appropriate disclosure under Section 14A(b)(1), for example with respect to agreements between target executives and acquirers. But in a statute that expressly refers to the Commission's regulations where Congress deemed them adequate to its purposes, it is implausible that Congress intended the Commission to satisfy this requirement solely by way of existing disclosure rules.[8]

Moreover, without modification, Item 402(j) is inadequate for the purposes of Section 14A(b)(1). For example, as noted above, the statute distinguishes between payments under previously established arrangements and new payments. While Section 14A(b)(2), which includes the Act's golden-parachute voting requirement, contains the Grandfather Clause, Section 14A(b)(1), which includes the disclosure requirement, does not include a similar grandfathering provision. Thus, the new disclosure should include both types of payments, and clearly distinguish one from the other, so that shareholders understand which payments are subject to a vote and which are not. Item 402(j) does not provide such disclosure.

In sum, in light of the purpose, structure, and text of Section 14A(b)(1), I suggest that the Commission's rules ***require separate disclosure of both "grandfathered" golden parachutes and newly granted amounts*** so that shareholders can distinguish payments on that basis.

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I appreciate the opportunity to provide comments in advance of the Commission's proposal of rules on "say on pay" votes on "golden parachutes" under Section 951 of the Act. If further discussion of these comments would be helpful to the Commission or the Staff, I would be pleased to be of assistance. Please do not hesitate to contact me at your convenience at (212) 854-0409 or via electronic mail at robert.jackson@law.columbia.edu.

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cc: Mary L. Schapiro, Chairman
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[8] For example, Section 953 of the Act expressly refers to 17 C.F.R. § 229.402 as the basis for measuring employee compensation for purposes of that provision.