Cooley

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Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, public companies will need to ask their shareholders at least once every six years whether say-on-pay votes (*i.e.,* shareholder votes to approve the compensation of executives) should occur every one, two or three years. Although this "say-on-frequency" vote is non-binding, under proposed SEC rules, each company will need to disclose how frequently it will conduct say-on-pay votes in light of the results of the shareholder vote. In addition, the SEC has proposed that a company may exclude a shareholder proposal that seeks an advisory say-on-pay vote or that relates to the frequency of say-on-pay votes only if it has implemented a policy regarding the frequency of say-on-pay votes that is consistent with the plurality of votes cast in the company's most recent frequency vote. Because Dodd-Frank requires inclusion of this frequency vote in the proxy statement for each public company's first meeting of shareholders held on or after January 21, 2011, companies will soon need to decide which frequency to recommend to their shareholders. While companies are not required to make a vote recommendation, we believe that most companies will want to recommend the alternative that is most appropriate for their individual circumstances. Following are eleven factors, not in any particular order, companies may want to consider in making that decision:

What do your shareholders prefer?

Understanding the policies and preferences of your most significant shareholders is critical, and, if necessary, you should proactively engage them to understand their views. Many investors clearly want annual say-on-pay votes and perceive annual votes as a governance best practice. For example, Fidelity Management & Research Company, the investment advisor to the Fidelity family of mutual funds, has just announced that it will generally support annual say-on-pay votes. However, you may be surprised to find that institutional investors do not universally support annual votes and that some prominent institutional shareholders, such as the United Brotherhood of Carpenters, have reportedly even favored triennial votes. This preference may, in part, be attributable to the substantial work necessary to analyze say-on-pay proposals and related concerns regarding resource allocation. In addition, because registered institutional investment managers will now have to report to the SEC on their compensation-related votes, some may view reporting annually on votes at every portfolio company to be an overwhelming burden. You may also may find that some of your significant investors are open to making case-by-case determinations and will consider well-reasoned arguments in favor of triennial or biennial votes.

What are proxy advisory firms recommending?

The impact of proxy advisory firms, such as ISS and Glass Lewis, will likely be magnified as a result of the Dodd-Frank prohibition on brokers' discretionary voting of proxies on compensation-related proposals (such as say on pay and say on frequency) in the absence of voting instructions from the beneficial owners. If your significant shareholders are heavily influenced by the recommendations of ISS or other proxy advisors, you should familiarize yourself with the vote recommendation policies of those advisors. For example, for 2011, ISS will recommend annual say-on-pay votes in all cases because it believes that annual votes provide the highest level of accountability and direct communication between the company and its shareholders.

What is your risk of an unfavorable vote?

Each time you solicit the vote of your shareholders on executive compensation, you run the risk of an unfavorable vote and resulting reputational issues. While shareholder support for most say-on-pay votes has, to date, been overwhelmingly high—an average of 89.6% in 2010 according to a recent ISS report—some notable failures to achieve majority support have occurred, and, in light of the elimination of discretionary broker voting on compensation matters, negative votes may be more prevalent in the future. Although say-on-pay votes are only advisory, that does not mean that they are necessarily without consequence: as reported in *The Wall Street Journal,* one CEO whose company received a negative say-on-pay vote was compelled to "[bow] to investor outcry" by relinquishing his position as CEO and accepting a significant pay reduction.

What is the potential impact on the election of directors?

We expect that institutional shareholders (based on the advice of proxy advisory firms or otherwise) will, at least initially, use their say-on-pay votes as the primary vehicle to express dissatisfaction with companies' compensation practices. However, in the absence of a say-on-pay proposal, we expect institutional shareholders to express that displeasure by "withholding" votes from (or perhaps even actively seeking to unseat) compensation committee or other board members, who may be especially vulnerable if elected by majority rather than plurality voting. In addition, if you have a classified board, you may want to opt for biennial instead of triennial votes to stagger the say-on-pay vote relative to your class elections and thus avoid repeatedly subjecting the same classes of directors to heightened investor scrutiny in years when a say-on-pay proposal does not offer shareholders another avenue to express their concerns.

Does your choice of frequency limit your flexibility with regard to other compensation proposals?

If you are forecasting the need to seek shareholder approval of any equity, golden parachute or other compensation plans or arrangements in the near future, you may want to avoid a contemporaneous say-on-pay vote and the risk of potential negative cross-influences on your shareholders' decisions. An annual vote could limit that flexibility.

Will the effort and expense be excessive or involve an inappropriate allocation of resources?

Including a say-on-pay proposal in your annual proxy statement involves time and expense, not simply in preparing the proxy materials, but also in corralling the vote. That process could potentially include the use of a proxy solicitation firm, additional engagement with shareholders (*e.g.,* meetings, conference calls, surveys, etc.) and the diversion of management's attention from other pressing corporate needs.

What is the impact of observing compensation practices generally considered "best practices"?

If you already follow executive compensation practices that are generally recognized to be best practices (for example, the use of performance-based awards, capped bonuses, double-trigger change-in-control benefits and stock ownership guidelines), you may, depending on your shareholder base, face little opposition if you recommend a triennial vote. On the other hand, if you recommend an annual vote, you may incur little additional expense or risk and you could highlight the annual vote itself as a best practice and perhaps, as some contend, even turn it into a non-event.

What is the impact of employing compensation practices considered "problematic" by proxy advisory firms or shareholders?

If any of your compensation practices are viewed by the investor community to be significantly problematic (such as option repricing in the absence of prior shareholder approval, tax gross-ups or excessive perquisites), you may encounter resistance if you recommend a triennial vote. In that case, an annual vote may be a more pragmatic choice. Moreover, if you receive a less-than-satisfying response to your initial say-on-pay vote and you plan to address any of the challenging issues that surfaced, you might welcome another say-on-pay vote in the next year to overcome the otherwise three-year taint of the initial vote.

Will your preferred frequency lead to confusion among your shareholders?

A number of commentators have suggested that biennial or triennial say-on-pay votes are likely to create shareholder confusion because the vote would cover compensation over a multi-year period. As a result, they contend, shareholders may not have a clear idea of precisely which compensation is the subject of the vote, and the communication intended by the vote would be muddled. The same could be said, however, for annual votes: a negative vote on a say-on-pay proposal indicates only general dissatisfaction with a company's executive compensation practices, but does not identify the specific element of compensation to which the shareholders object, *i.e.,* whether the opposition is to bonus targets too easily achieved, tax gross-ups or some other aspect of the company's compensation program.

Does the structure of your compensation programs require a long-term perspective?

If your cash bonus or other compensation plans are structured to reward multi-year performance, providing for a triennial or biennial vote would enable your shareholders to evaluate the long-term effect of executive compensation practices at the conclusion of the performance cycle and discourage them from reaching judgments based only on interim results. Additionally, providing for a triennial or biennial vote would allow you more time to understand and respond effectively to a prior year's voting results.

What if you have misgivings about your potential for success with a triennial vote recommendation?

If you are inclined to recommend a triennial vote but have concerns that your shareholders are likely to disagree, one approach may be to include an undertaking that could mitigate the result from the shareholders' perspective. For example, as part of your frequency proposal, you could undertake that, if shareholders approve the recommended triennial vote frequency but you then receive less than a majority vote (or less than a specified super-majority vote) for your say-on-pay proposal, you would resubmit the say-on-pay proposal to another shareholder vote in the subsequent year (presumably having addressed any identified shareholder concerns). Alternatively, some investors have reportedly been amenable to the concept of a triennial vote if the company agrees to resubmit to shareholders in year three, not just the say-on-pay proposal, but also the say-on-frequency proposal, even though another say-on-frequency vote would otherwise not be required until year six. Shareholders may also be convinced to support less frequent votes if you commit to engage with them in another manner (for example, surveys or meetings) in the years in which you do not submit a say-on-pay proposal. These types of measures may be enough to tip the frequency vote in favor of a triennial say-on-pay vote.

Because say-on-frequency votes are novel and the SEC has not yet issued final rules on say-on-pay or say-on-frequency disclosure, companies with September fiscal year-ends that have scheduled meetings on or soon after January 21, 2011 will be pioneering this terrain. Although it may be a while before trends emerge, companies with calendar year-ends will be able to benefit from their predecessors' experience and, fortunately, final SEC rules are expected to be in place for the 2011 proxy season. We plan to keep you posted when final rules are issued and as trends and practices evolve.

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