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Did the first year of say on pay reveal that stockholders are mad as hell and not going to take it anymore? Or did it reveal that, frankly, stockholders don't give a damn about executive compensation? If you kept up with the media headlines, you saw an almost continuous flow of articles and columns that expressed dismay at excessive executive compensation, conveyed alarm at the increasing disparity in pay between executives and the rest of the work force and lamented times past when it would have been almost unseemly for executives to accept such enormous hikes in pay. However, the vote tallies from this proxy season seem to belie those headlines: to date, less than 2% of say-on-pay proposals have failed. So what have we learned from the debut of say on pay?

It is still too early to fully recognize or appreciate the effect of say on pay on executive compensation. Advocates of say on pay have long argued that these proposals would be a catalyst for dialogue with stockholders and drive meaningful changes to executive compensation practices. In 2011, we saw say on pay do both. Notably, however, many responsive changes have been to the *types* of compensation rather than the *amount* of compensation, leaving say on pay open to the criticism that its impact on compensation was largely at the margin. Whether say on pay will ever materially affect the levels of executive compensation is not yet clear.

This past proxy season may well be just a prelude to a more consequential season next year and beyond. Although the Dodd-Frank Wall Street Reform and Consumer Protection Act requires companies to hold say-on-pay votes only every three years, based on the results of this year's say-on-frequency proposals, most companies will be holding annual votes. To date, stockholders at approximately 76% of the companies that have reported results have favored annual votes, and most of those companies have indicated that they intend to hold votes in accordance with the preference expressed by stockholders.

Although say on pay involves a non-binding advisory vote, there is an expectation among the stockholder community and its advisors that the results of the votes and the information received in connection with related stockholder outreach will be taken into consideration when companies make future executive compensation decisions. Whether and how companies do so, and how stockholders subsequently react, will play out over the next couple of years. In the meantime, we present below five observations on the inaugural say-on-pay season and offer recommendations based on what we learned.

1. Media bark has been worse than stockholder bite

A number of media commentators and governance experts have expressed disappointment with the results of the past proxy season because the anticipated widespread stockholder challenge to perceived out-of-line pay packages did not materialize. Of the more than 2,500 public companies that have disclosed results so far, less than 2% have reported failed say-on-pay votes. Nevertheless, it would be a mistake to conclude that this statistic reflects overwhelming stockholder satisfaction with—or indifference to—executive compensation programs as they existed. This statistic does not reflect the serious efforts that companies made to prevent failed votes by enhancing compensation disclosure, modifying compensation practices and stepping up stockholder engagement. Similarly, it does not reflect proposals that passed according to a majority vote standard but were opposed by a significant percentage of votes.

One possible explanation for the low level of rejection of executive pay packages may be found by analyzing who actually voted. Individual stockholders may be unwilling to devote the time or may lack the expertise and resources necessary to analyze complicated pay structures and are generally less likely to vote. In most cases, institutional stockholders do vote and are more likely to analyze the disclosure, focus more on specific pay practices that they deem to be problematic and engage in serious dialogue with their portfolio companies.

Moreover, judging the efficacy of say on pay by the percentage of failed proposals overlooks the fact that say on pay is an "advisory vote." It often requires a more refined analysis to understand the results, even if more votes were cast for than against the proposal. Each company should carefully analyze the results of its first say-on-pay proposal, particularly in the event of a meaningful level of opposition. To the extent specific feedback about executive compensation was received from stockholders before the annual meeting, that feedback should be shared with the compensation committee. If the reason for significant opposition is unknown, targeted post-meeting stockholder outreach may be necessary to understand the results of the vote. In some cases, it is possible that the level of opposition could have been mitigated by stockholder outreach prior to the annual meeting. The compensation committee should be encouraged to enhance its level of involvement, including, where appropriate, active involvement in post-meeting stockholder outreach efforts.

There may be negative consequences to failing to respond to concerns expressed by stockholders. Next year, companies will need to comply with a new CD&A disclosure obligation that will require them to report whether and how the compensation committee took into account the results of this year's say-on-pay vote when making subsequent executive compensation decisions. We anticipate that institutional stockholders and proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass Lewis, will expect compensation committees to respond to any concerns expressed this year—regardless of whether the proposals passed or failed—and failing to do so may spur additional opposition and challenges next year. We are currently witnessing stockholder derivative litigation based on claims of breach of fiduciary duty and corporate waste following some of the failed say-on-pay proposals. Regardless of how these actions fare in court, if concerns are not addressed, we may well see in coming years a larger percentage of negative say-on-pay votes, together with potential challenges to compensation committee members up for re-election and perhaps additional efforts through the courts.

2. Forewarned is forearmed

A number of companies were caught off guard by the votes of institutional stockholders and the vote recommendations of proxy advisory firms, perhaps not having fully comprehended the extent of the influence of the proxy advisory firm recommendations on their stockholders. But these recommendations and votes need not come as a surprise. An informed and thorough analysis of its stockholder base should allow a company to assess with some accuracy its chances of receiving an unsatisfactory vote on say on pay before proxy season even begins.

We recommend first determining the particular influences on each major institutional stockholder—whether it be a proxy advisory firm or the institution's internal policy guidelines. Only then can the relevant voting guidelines be analyzed to predict any company-specific issues, following which a focused and persuasive strategy can be developed. This type of in-depth analysis can also help a company avoid being misled by the voting results at other companies and inappropriately presuming levels of influence by proxy advisory firms that may not be applicable to any particular case. For example, while ISS has so far recommended against 11% of say-on-pay proposals, less than 2% of proposals have failed to achieve majority support. That discrepancy is attributable to differences in the composition of each company's particular stockholder base and, in some cases, to the targeted efforts made by the company to overcome the negative vote recommendation.

While decisions regarding executive compensation should always be made by directors in the best interests of the company and its stockholders and not dictated by the policies of proxy advisory firms, the results of the stockholder influence analysis and the substantive policies that affect voting should be presented to the compensation committee to assist in its decision-making process

prior to the time determinations regarding compensation are made. Compensation committees may want to be mindful of common stockholder concerns when structuring and setting executive compensation.

The proxy advisory firms and institutional investors are now in the process of analyzing the results of this proxy season and revising their policies accordingly. Even though the composition of each company's stockholder base may change over time, it is still worthwhile to proactively monitor modifications to those policies in preparation for next year's proposal to avoid surprises and last minute scrambles.

3. Disclosure does matter—more than you might think

While many individual stockholders may toss their proxy statements in the recycling bin unread, there are plenty of avid proxy statement readers at institutions and proxy advisory firms. As a result, a carefully crafted discussion of the rationale for certain executive compensation decisions can actually influence vote recommendations and votes. During 2011, inclusion of executive summaries in CD&A or supporting statements in say-on-pay proposals became *de rigueur* in proxy statements. A number of companies also experimented successfully with graphic presentations. We recommend that companies continue to use these formats as vehicles to state their cases, with particular focus on highlighting best practices, explaining the pay-for-performance philosophy, using tables and bar and pie charts when a visual presentation is likely to be more effective, and noting the absence of any particular pay practices that stockholders find problematic.

We also saw the unprecedented use of supplemental proxy filings this year as another format for responding to criticism and negative votes. Some companies made more than one supplemental proxy filing: an initial filing following a negative vote recommendation from a proxy advisory firm intended to convince stockholders to support the proposal despite the negative recommendation and a second filing to disclose a change in compensation practices that was adopted to reverse the negative recommendation. These companies might, in some instances, have been better served by including in the proxy statement their rationales for the questioned pay practices. We recommend *proactively* addressing areas of vulnerability and explaining in the proxy statement *why* those questioned practices are appropriate for the company and in the best interests of stockholders. The most effective use of supplemental filings is most likely in the implementation of a well-developed strategy rather than as a remedy for failure to anticipate an issue or address its merits in advance in the proxy statement.

4. Targeted communication is effective communication

An effective stockholder communication strategy often makes the difference between passing with significant support and barely passing (or not passing at all). Recognizing the influences on the company's key stockholders is often a necessary predicate to successful communications. One of the unintended consequences of say on pay has been the substantial increase in influence—or perhaps only the recognition of the existing substantial influence—of the proxy advisory firms. Certain institutional stockholders always follow the recommendations of a particular proxy advisory firm: to persuade those stockholders to support a proposal, it is necessary to persuade their proxy advisory firm to support the proposal. In the event of a negative vote recommendation, stockholder outreach efforts may be more productive if focused on institutional stockholders that follow internal guidelines or that take a less dogmatic approach in applying advisory firm recommendations; certain institutions can sometimes be convinced to support a proposal with the right outreach or by a sound and logical rebuttal to the analysis supporting a negative recommendation. Direct communications with institutional stockholders should be addressed to the proxy analyst who makes the proxy voting decisions as well as to any portfolio managers who will have any sway over the vote.

5. Pay for performance is the predominant concern

Absence of pay for performance was the most common stated reason for negative recommendations from proxy advisory firms

on say-on-pay proposals and the most common problem underlying failed proposals in 2011. However, issues raised in connection with pay for performance may reflect either an *actual* failure to adequately link pay to company performance or only a *perceived* misalignment resulting from the application by proxy advisory firms of their own one-size-fits-all tests and measurements.

A number of companies and their advocacy groups have challenged as inaccurate the assessments resulting from the application of pay-for-performance models. There is no single definition of either "pay" or "performance" among proxy advisory groups or institutional stockholders, and all of these definitions are likely to characterize performance and measure pay for performance differently from most companies and their compensation committees and compensation consultants. For example, ISS measures performance by reference to one- and three-year total stockholder return relative to the company's Global Industry Classification Group, not the company's selected peer group; analyzes only CEO pay, not the pay of all of the named executives; calculates option values based on its own valuation models, not the SEC-mandated models used in proxy statements; and mechanically links CEO pay decisions to certain performance periods that may differ from the performance periods used by the compensation committee when the committee applies its own methodology. Glass Lewis uses its proprietary model to award pay-for-performance letter grades based on 36 measurement points. Companies that have performed in-depth analyses of their stockholder bases and the firms and factors that influence them will be better positioned to refute actual or potential negative recommendations with rebuttals specific to the particular tests and definitions employed. As noted below, under Dodd-Frank, the SEC must issue regulations requiring proxy disclosure of the relationship between the executive compensation actually paid and the financial performance of the company. Whether the SEC's definitions provide clarity to the mix or just add to the cacophony remains to be seen.

We expect pay for performance to continue to be the most prominent issue next year. As a result, we recommend that each company critically review its pay-for-performance philosophy, practice and disclosure to assess whether there may in fact be an *actual* misalignment between pay and performance. If discretionary payments are made in the absence of material company performance achievements, companies should look critically at whether the pay-for-performance policy described in the proxy statement is accurate or whether it is boilerplate language that fails to describe actual practices. To the extent negative recommendations and votes were received on the basis of a "pay-for-performance disconnect" that, viewed with a healthy skepticism, cannot reasonably be ascribed to inappropriate tests and definitions, the company's compensation committee should revisit the company's pay-for-performance philosophy and pay practices. To better align pay and performance, this review should include consideration of features or practices such as the company's ratio between guaranteed and at-risk compensation, extent of its use of performance-based equity awards, the composition of the peer group it uses for benchmarking and the difficulty level of its performance goals.

On the Horizon

Say on Pay for Smaller Reporting Companies. Although the requirements to hold say-on-pay and say-on-frequency votes do not become effective for "smaller reporting companies" until their first annual meetings on or after January 21, 2013, we recommend that smaller reporting companies begin now to examine their compensation practices and programs in light of the recent voting results for larger companies. Because "scaled disclosure" requirements apply to smaller reporting companies and, consequently, they are not required to provide CD&A disclosure, it may be even more important for smaller reporting companies to provide supporting statements in their say-on-pay proposals explaining their rationales for their executive compensation programs and policies. By taking advantage of the wealth of information now available, while keeping an ear to the ground for changes in the policies of proxy advisory firms and institutional stockholders, smaller reporting companies may be able to avoid negative votes and other unfortunate consequences when the time comes.

Further SEC Rulemaking. There is much more that Dodd-Frank served up on the SEC's rulemaking plate related to executive compensation. The SEC has continued to modify its rulemaking schedule, including recent delays announced at the end of last week:

- **Independence of compensation committee members, consultants and advisers.** Most likely, the next rulemaking on the SEC's agenda will be the adoption of final rules that attempt, through new exchange listing requirements, to tackle the issue of independence of compensation committee members, consultants and advisers. The SEC's proposal, issued in March, closely tracks the provisions of Dodd-Frank and leaves to the exchanges the discretion to formulate definitions or other requirements. We anticipate that the definition of "independence" for compensation committee members will be patterned after the strict definition applied to audit committee members, but will permit greater flexibility and focus more intently on relationships between compensation committee members and management that could taint decision-making. Although final SEC rules are currently expected between August and December, it may be quite a while before any definitive guidance is available because the exchanges must propose, and the SEC must approve, new listing standards to implement these rules. Proxy statement disclosure regarding compensation consultants and advisers will also be enhanced under the proposed rules, and those changes should be in place for next proxy season.
- **Clawback policy.** Also on the SEC's agenda for the August–December timeframe is the proposal of a mandate, through new exchange listing requirements, to develop and implement an executive "clawback" policy, defined for this purpose as a policy requiring the company to recoup from current or former executives incentive compensation that was paid on the basis of erroneous financial information. The SEC has recently delayed expected adoption of this rule until the January–June 2012 timeframe. The policy would apply, regardless of fault, in the event the company were required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement. How the SEC will define "incentive" compensation is still unknown, but we expect the definition to include both cash and equity compensation. However, because the recovery will be calculated based on the difference between the amount the executive actually received less the amount that would have been received in the absence of the error, we expect that compensation affected will involve performance targets or conditions. As a result, the rule could potentially have the perverse effect of motivating companies to backtrack on their increased use of performance-based compensation.
- **Mandatory disclosure regarding internal pay equity.** The proposal of new rules requiring internal pay equity disclosure is also on the SEC's August–December rulemaking agenda, with adoption now anticipated between January and June 2012. As mandated by Dodd-Frank, this rulemaking will require disclosure of the ratio of the annual total compensation of a company's CEO to the median of the annual total compensation of all other employees of the company, determined in accordance with the provision governing the disclosure of "total compensation" in the Summary Compensation Table as in effect on the day before the date of enactment of Dodd-Frank. However, as discussed below, these provisions are in some jeopardy of being repealed. In light of the prospect of repeal, the SEC's heavy rulemaking workload arising out of Dodd-Frank, and the controversy surrounding the potential rules, we would not be surprised to see this rulemaking effort even further postponed.
- **Pay-for-performance disclosure.** The SEC has also placed proposal of pay-for-performance proxy disclosure on the August–December calendar, with adoption now scheduled for January–June 2012. These new proxy rules will require a "clear description" of the relationship between executive compensation "actually paid" and the "financial performance" of the company, taking into account any change in the value of stock and dividends of the company or other distributions. It remains an open question whether the SEC will define "financial performance" on the basis of corporate or market performance or both.
- **Hedging policy disclosure.** We also expect to see the proposal, within the currently proposed timeframe of August–December, of rules mandating proxy disclosure of whether any employee or director is permitted to purchase financial instruments (such as prepaid variable forward contracts, equity swaps, collars and exchange funds) designed to hedge or offset decreases in the market value of equity compensation. The SEC has recently delayed expected adoption of this rule until the January–June 2012 timeframe. Many companies are taking advantage of these impending requirements to review their existing insider trading policies and strengthen prohibitions against hedging instruments.

Activity in Congress and the Courts. Congress and the courts have also been playing a continuing role in the unfolding regulatory environment:

- **Internal pay equity.** In June, the House Financial Services Committee ordered to be reported out for a vote of the full House the "Burdensome Data Collection Relief Act" (H.R. 1062), which would repeal the provision in Dodd-Frank requiring internal pay equity disclosure and make any regulations issued pursuant to it of no force or effect. The burden of collecting and analyzing all of the data required for the internal pay equity calculation, especially for large multinational corporations with complex pension and other compensation arrangements, triggered an outcry among companies and their advocates. Moreover, the broad application and prescriptive nature of the provision made unclear the extent to which the SEC could, through regulation, mitigate

its more onerous aspects. While the new bill seems likely to pass in the House, its prognosis in the Senate, where it may meet significant opposition, is less clear.

- **Proxy access.** Finally, a three-judge panel of the D.C. Circuit Court of Appeals has just ruled that the SEC's proxy access rules are invalid. Proxy access, the requirement for a company to include director nominees submitted by certain of its stockholders in its proxy solicitation materials, was probably the most controversial corporate governance provision to survive in Dodd-Frank. However, Dodd-Frank only *authorized*, but did not *mandate,* proxy access. Final rules providing for proxy access were adopted by the SEC in August 2010, and in September, the U.S. Chamber of Commerce and the Business Roundtable filed suit against the SEC, claiming, among other things, that the rule was arbitrary and capricious and that the SEC failed to adequately assess the rule's impact on efficiency, competition and capital formation. The Circuit Court agreed. The Court found that the SEC "inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters." As a result, issuers will have a reprieve on proxy access, at least temporarily, unless the SEC decides to reissue proxy access rules after performing a new cost-benefit analysis. As part of its proxy access rulemaking, the SEC had also adopted an amendment to the stockholder proposal rules (Rule 14a-8) that would preclude companies from relying on the "election exclusion" in those rules to exclude from their proxy materials certain stockholder proposals relating to proxy access. That amendment was not the subject of the litigation, although its implementation was stayed by the SEC, along with the general proxy access rules, pending the outcome of the case. If the SEC elects not to run the entire proxy-access gauntlet again, it might decide just to lift the stay on this amendment to Rule 14a-8.

If you have any questions about this *Alert,* please contact one of your Cooley team members or one of the attorneys identified above.

Key Contacts

Kenneth Guernsey San Francisco	kguernsey@cooley.com +1 415 693 2091
Cydney Posner San Francisco	cposner@cooley.com +1 415 693 2132
Eric Jensen Palo Alto	ejensen@cooley.com +1 650 843 5049

Sam Livermore San Francisco	slivermore@cooley.com +1 415 693 2113
Tom Reicher San Francisco	treicher@cooley.com +1 415 693 2381
Thomas Welk San Diego	twelk@cooley.com +1 858 550 6016
Darren DeStefano Reston	ddestefano@cooley.com +1 703 456 8034
Francis Wheeler Colorado	fwheeler@cooley.com +1 720 566 4231
Miguel J. Vega Boston	mvega@cooley.com +1 617 937 2319