



DODD-FRANK ACT: THE IMPORTANCE OF PUTTING CEO PAY MULTIPLES INTO CONTEXT

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The Dodd-Frank Wall Street Reform and Consumer Protection Act – as the name implies – is a sweeping reform of multiple aspects of financial regulation. Of interest to Human Resource professionals are the Act’s executive compensation provisions, ranging from “say on pay” shareholder advisory voting to increased disclosure of executive compensation policies and practices that are expected to take effect in the 2011 and 2012 proxy seasons.

One new provision in particular captured our attention here at Radford – the requirement to disclose the CEO’s total compensation as a multiple of the median total compensation of all other employees (hereby referred to as the “CEO pay multiple”). This requirement is a reaction to the increasing gap between CEO and “rank-and-file” pay. But it is clear to many that this pay ratio is an overly simplistic means of illustrating that gap.

Many executive compensation and business experts have speculated that any ratio that appears to be out of line will be a prime target for attack by shareholders, employees, the media and politicians. However, there is no easy answer to what is “out of line” when it comes to this ratio. Organizations that otherwise appear to be comparable in terms of size and industry may have radically different CEO pay multiples for rational reasons embedded in their business models and operating requirements. A company involved only in semiconductor chip design will have a much lower CEO pay multiple than a similar entity that designs and fabricates the chips because the latter has a large workforce of lower-paid manufacturing workers. A company that has moved a segment of its workforce to lower-cost countries will have a higher CEO pay multiple than one whose workforce is based solely in the United States.

Will shareholders, the media, politicians, employees and the public at-large have the necessary information to place CEO pay multiples into business context before commenting on their appropriateness? One thing is evident: without a clear industry and business understanding and the impact this has on staffing models, most shareholders will not have the information or the context to make an appropriate evaluation. This is why Radford is advising clients to proactively explain these considerations in their proxy disclosures to insure this ratio is not viewed in isolation.

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As of this writing, we are still awaiting SEC clarification on many aspects of Dodd-Frank implementation, including exactly how the CEO pay multiple is to be calculated and disclosed. However, Radford is in a unique position to provide preliminary statistics on this metric for the technology sector by leveraging our Global Technology Survey. In this Radford Review, we will:

- > Share results of proprietary research into CEO pay multiples based on data collected from the Radford Global Technology Survey
- > Review our advice on developing a CEO pay multiple disclosure strategy in preparation for the 2012 proxy season

CEO Pay Multiple Research

Methodology

The Dodd-Frank Act has left the details for calculating the CEO pay multiple to the SEC to define; as of this writing (Fall 2010) we are still awaiting guidance. However, most experts anticipate CEO pay to be commensurate with total compensation as defined in the Summary Compensation Table of the proxy filing. While the Summary Compensation Table includes items such as executive benefits premiums, top hat retirement contribution, and other perquisites that are not captured in Radford's survey data, these rewards are relatively rare in the technology sector. The vast majority of CEO compensation in technology is delivered via salary, annual bonus and long-term (equity) incentives. Therefore, in calculating our CEO pay multiples we have compared the CEO's actual total direct compensation to the median total direct compensation of all other employees. Total direct compensation, for the purposes of this analysis, consists of:

- > Annual fixed compensation (base salary, guaranteed allowances)
- > Actual bonus payout from last fiscal year
- > Grant date value of all equity awards made in the last fiscal year (Black-Scholes value of options and face value of time- and performance-based restricted stock) plus target value of long-term cash awards

We identified 253 companies from the Radford database that were qualified for inclusion in this study. Only companies that are US-based, independent, publicly-traded organizations were studied. Further, we eliminated any company that did not also submit data to the Radford Global Sales Survey so that we were sure to capture sales force incumbents. Figure 1 provides industry, revenue and headcount information for the companies analyzed.

It is important to note that we have assumed for this research that the CEO pay multiple is to be calculated vs. the median pay of all global employees at each organization. There has been much discussion and comment to the SEC that a requirement to calculate median pay worldwide would be overly burdensome and that the intent of the Act would be suitably addressed with only a comparison to US-based employees. We at Radford generally agree with this point of view and await further SEC direction on the matter.

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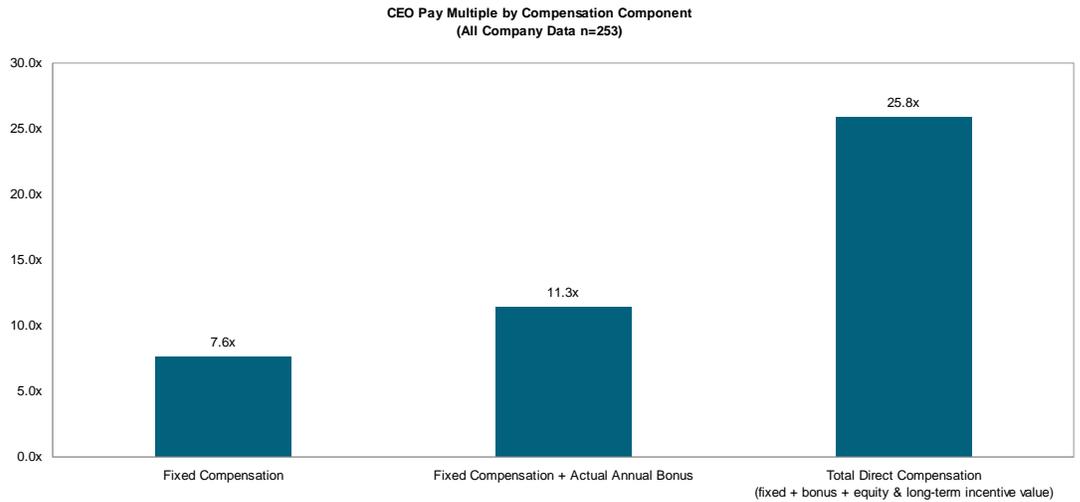
Figure 1

| Breakout Categories | Percent of Companies |
|--------------------------------|----------------------|
| Semiconductor (n=52) | 21% |
| Hardware (n=98) | 39% |
| Software/Internet (n=76) | 30% |
| Other Hi-Tech (n=27) | 11% |
| | 100% |
| Under \$200.0M Rev (n=49) | 19% |
| \$200.0M - \$499.9M Rev (n=64) | 25% |
| \$500.0M - \$999.9M Rev (n=49) | 19% |
| \$1.0B-\$3.0B Rev (n=50) | 20% |
| Over \$3.0B Rev (n=41) | 16% |
| | 100% |
| Under 500 Emps (n=33) | 13% |
| 500-999 Emps (n=53) | 21% |
| 1,000-5,000 Emps (n=97) | 38% |
| Over 5,000 Emps (n=70) | 28% |
| | 100% |

Findings

While the Dodd-Frank Act has specified that total compensation be used to calculate the CEO pay multiple, we believe it is important to look at individual components of total compensation as well. Figure 2 illustrates that the cash compensation multiples are significantly lower than total direct compensation. This clearly illustrates the disparity in the relative amount of long-term incentive (primarily equity-based awards) being used at the CEO level vs. all other employees.

Figure 2

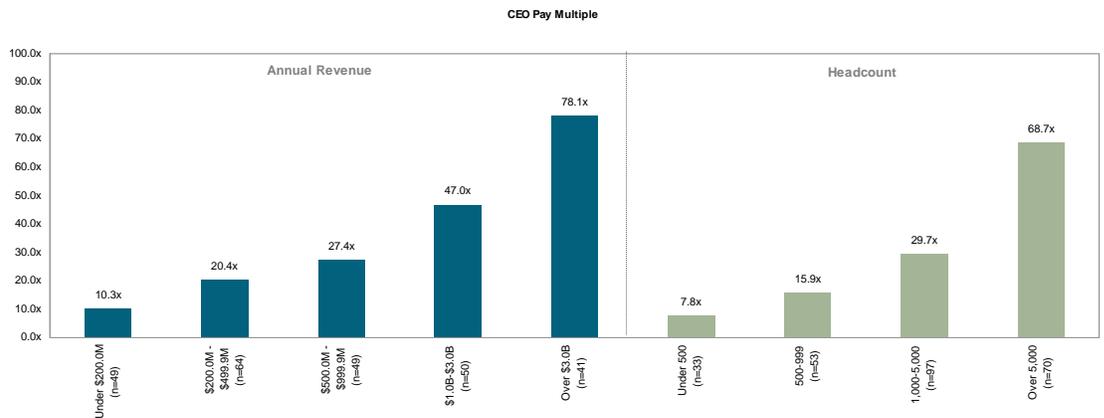


CEO pay multiple is most closely correlated to organizational size

For total direct compensation overall we find that the median CEO pay multiple among all companies studied is 25.8x, although there was considerable variability within the studied companies. [Figure 3] While we saw no compelling differences between industry groupings, we found that the CEO pay multiple is most closely correlated to organizational size; the larger the company the higher the multiple. Figure 3 illustrates that companies with less than \$200 million in annual revenue demonstrate a median CEO pay multiple of only 10.3x, while organizations with more than \$3 billion in revenue have a median multiple of 78.1x.

Our conclusion that the multiple is correlated to company size is reinforced by an analysis of headcount. Here we find that organizations with fewer than 500 employees demonstrate a median multiple of 7.8x while those with more than 5,000 employees have a median multiple of 68.7x. These larger company multiples may come as a surprise to some observers as it has become fairly commonplace for executive compensation professionals to speculate a range of 30x to 40x to be expected. For those larger companies expecting higher multiples, it becomes that much more critical to place the metric into context by citing such correlations found in research like this.

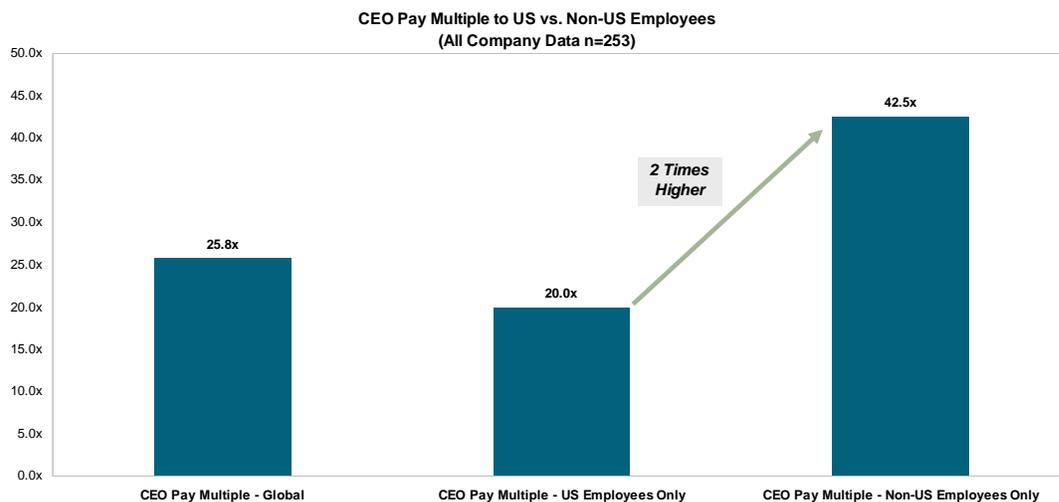
Figure 3



The CEO pay multiple to non-US employees is more than twice as large as the multiple to US employees

The second most influential factor for CEO pay multiples appears to be a company's degree of globalization. Figure 4 illustrates the CEO pay multiple to non-US employees is more than twice as large as the multiple to US employees. This is to be expected given one of the primary drivers of globalization is the search for lower-cost labor. But when it comes to the effect on CEO pay multiples, many have not yet considered the implications. Take two companies of similar size in the same industry. One has sought to control cost and improve profits by moving manufacturing operations to China while the second maintains US-based operations. In this scenario it is imperative the first company explain this nuance in their CEO pay multiple disclosure or risk drawing fire from shareholders and the members of the press who have overlooked the broader implications of the company's offshore manufacturing strategy.

Figure 4



We found this 2x relationship – CEO/non-US employee multiple compared to CEO/US employee – to be remarkably consistent across the various breakouts we studied with two notable observations:

- > Semiconductor companies demonstrated the exception to this rule with the outlying finding that their CEO/non-US pay multiple was slightly more than 3x higher than their CEO/US pay multiple
- > There is indication that, like the overall global multiple already discussed, this relationship too is correlated to company size. In the revenue breakouts we find that companies under \$500 million in annual revenue have CEO/non-US pay multiples of approximately 1.75x higher than CEO/US pay multiples, whereas companies above \$500 million come in at about 2.2x. Further, companies with less than 1,000 employees show a 1.6x relationship while those with more than 1,000 employees have CEO/non-US multiples approximately 2.2x higher than the CEO/US employee multiple.

By way of explanation for these two observations, it is reasonable to conclude that: (a) semiconductor manufacturers are probably more likely to rely on lower-cost labor and, (b) the larger a US-based organization grows the more likely they are to globalize. Still, the takeaway is relevant to any sized organization in any industry: the more global the workforce, the higher the CEO pay multiple. And as such, these organizations should proactively explain their globalization strategy, how this links to shareholder returns and the implications this has on CEO pay multiples in their proxy disclosures.

Advice for Preparing Your CEO Pay Multiple Disclosures

Based on this research as well as Radford's ongoing discussions with legal advisors, clients and Compensation Committees around the country, we can offer the following advice on preparing your first CEO pay multiple disclosure:

- > **Begin Defining Your Disclosure Message Now** – don't wait until the last minute to share preliminary CEO pay multiple calculations – and discuss what is driving your multiple – with the Compensation Committee. Share research such as this Radford Review and begin forming the high points of your disclosure language. Schedule this on an upcoming Committee agenda as soon as possible.
- > **Consider Early Disclosure** – as of this writing (Fall 2010) it appears that CEO pay multiple disclosure will commence in the 2012 proxy season. However, that doesn't mean an organization can't start earlier, either by calculating the ratio in 2011 or by simply beginning to lay the groundwork in the CD&A for what proxy readers can expect in 2012. This may be particularly prudent for companies expecting higher ratios (e.g., above 30-40x) in that they can be disclosed and explained prior to peers providing comparable figures. Further, to the extent the ratio is expected to come down next year, the groundwork is already laid for demonstrating a positive year-over-year trend in 2012 while peers are grappling with their first year of disclosure (see tip below on providing annual trends).
- > **Anticipate Peer Comparisons to Proactively Address** – cast a critical eye on the likely comparators your proxy readers will reference when assessing your CEO pay multiple. If you suspect you may be an outlier among these organizations based on what we've learned from this Radford research (e.g., relatively larger, greater globalization) shape your disclosure accordingly. Consider providing more direct guidance for your readers on the appropriateness of referencing such comparator companies.
- > **Consider Providing Year-Over-Year Trends in Disclosures** – the natural tendency for proxy readers will be to compare CEO pay multiples to other companies (an external reference). But as discussed in this paper, such external comparisons that do not account for differences in size or business strategy may be flawed. A more beneficial strategy may be to direct attention to the company's own management of the CEO pay multiple over time (an internal reference). Such a trend discussion redirects proxy readers' attention from external comparisons against companies over which you have no control, to an internal comparison and a discussion of the company's own success in managing the multiple over time. Due to the difficulty in gathering the required information to calculate historic CEO pay multiples, this is likely a disclosure strategy that will need to be implemented on a go-forward basis only.

- > **Evaluate Greater Granularity Than is Minimally Required** – Dodd-Frank requires only the disclosure of a single ratio – the CEO compared to the median of all other employees. In some cases, it may behoove a company to disclose greater detail. For example, if the case has been made that globalization is driving up the multiple, there is a strong reason to disclose CEO/US employee and CEO/non-US employee ratios in addition to the required CEO/global employee result (see Figure 4 above). Further, all companies will be disclosing detailed compensation for the Named Executive Officers (NEOs) in the Summary Compensation Table. Many proxy users – especially institutional investors – are already looking at CEO multiples to the other NEOs. Proactively supplying these ratios may make your proxy that much more reader-friendly.
- > **Process Plan for Data Collection and Calculations** – all experts seem to agree on one thing: compliance with performing this seemingly simple calculation will be burdensome. Begin investigating from where the data will be sourced (multiple geographic regions, HRIS systems, stock plan administration service providers) and clearly defining the roles and responsibilities of each stakeholder in the process (human resources, finance, legal, Compensation Committee, outside advisors and auditors). Evaluate whether the calculation should be outsourced to third-party service providers.

This Radford Review does not discuss the impact of pay philosophy, company or individual performance on these ratios. We do not wish to overstate the importance or impact of these CEO pay ratios among proxy readers as the significance of the disclosure is still to be seen. While it is not prudent at this time to change your approach to CEO compensation just to manage this ratio, it is important to explain how pay philosophy and performance may impact the results in your proxy statement.

Conclusion

If there is one thing we'd like our readers to take away from this Radford Review it is this: Do not delay in understanding, or underestimate the significance of, your CEO pay multiple. It is a metric that appears deceptively simple to calculate, but the logistics of performing the computation can be surprisingly burdensome. It may be easy to dismiss as irrelevant, but criticism of high ratio could have lasting public relations effects.

We encourage companies to:

- > Educate themselves and their Compensation Committee on the regulation's implications
- > Gain agreement on disclosure messaging
- > Define the process and players required for complying with the calculations

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