RADFORD ALERT

THE POST-REFORM WORLD: WHAT COMPENSATION COMMITTEES CAN DO NOW TO PREPARE FOR 2011

New laws create need for comprehensive executive compensation and governance review

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With the passage of some of the most sweeping financial reform legislation since the Great Depression – in the form of the Dodd-Frank bill – the rules surrounding executive compensation and governance have become more pervasive and concrete. While some of the specifics of implementation are to be determined by the SEC later in the year, it is clear that boards will want to think through how these new rules affect their executive compensation strategies and other governance-related issues now. It is critical to remember that while the impetus of the bill was to address specific practices in the financial service industry, the governance aspects of the bill apply to *all* public companies, not just financial services.

This paper focuses on the key areas of executive compensation and governance touched by the legislation, and what Compensation Committees must do to prepare for the 2011 proxy season. (A table of the executive compensation reforms created by Dodd-Frank is included at the end of this article).

Say on Pay

At least in terms of visibility, the say-on-pay provision of Dodd-Frank has perhaps the most far-reaching consequences in terms of the process changes and reexamination it will likely set into motion in public boardrooms. Beginning in 2011, all public companies must allow shareholders a non-binding advisory vote on executive pay. The only notable twist in the legislation is that it seeks shareholder input on how frequently these votes are held after 2011 (they can be annual, biannual or every three years). The say-on-pay vote is advisory only.

Different companies and different Compensation Committees will have different perspectives on how frequently they want shareholders to voice their opinions.

On the one hand, the three-year shareholder advisory cycle more closely aligns with the notion that pay and performance are better understood and evaluated over a longer period of time than a one-year period. Some companies will argue that the longer advisory cycle will help executives focus on producing results sustained over the longer term. But other companies might well look to annual voting to foster a good working relationship with shareholders, and ensure they are able to establish the trust that would be required to implement any potentially

controversial practices later. The technology and life sciences companies that already have implemented say-on-pay (e.g., Motorola, HP, Pfizer, Intel) have largely favored the two- or three-year models.

The actual impact of the legislation on company behavior is unclear at this time. Looking at experience in the United Kingdom, the effect has been to moderate some of the more high-profile disconnections between pay and performance.

Radford Perspective*: Compensation Committees should begin preparing for say-on-pay by focusing on three aspects of their compensation programs. First, is the absolute level of compensation reasonable? While the vote ideally reflects the totality of the program, most commentators agree that foremost in the view of shareholders will be the* amount *of pay. Second, is there a demonstrable link between pay and performance? To the extent that executive pay does not vary with performance – especially remaining stable or growing when the company performance lags – there is a greater likelihood of a negative reaction from shareholders. Finally, are there elements of the pay package that are likely to draw negative attention – gross ups to change-of-control agreements, outlier perquisites, etc.? To the extent that these three areas create issues, Committees should be looking to modify their programs now, rather than after a "no" vote.*

Clawbacks

Dodd-Frank has widened the existing SOX regulation concerning clawbacks by expanding the list of employees covered to any current or former executive officer. The new law includes a three-year look back period (from the time a restatement is required), and will apply to any restatement triggered by a material lack of compliance with reporting rules, not just when there is a case of fraud. The SEC will be working on how to define specific requirements for the policy and its disclosure. Some of the open questions include how to deal with taxes paid on any pay recovered after a restatement, and how to deal with situations where incentive pay was not tied to a specific metric.

Radford Perspective: *More guidance is required from the SEC in order to understand the full implication of the new law; however, the Compensation Committee will likely work closely with the Audit Committee on this issue.*

Change-of-control-related Payments

The new law addresses pay received by executives related to a merger/acquisition by allowing shareholders to vote separately on that pay at the same time as they are given a vote on the transaction.

Radford Perspective: *This is an area where Compensation Committees can be proactive well before any transaction. For a number of years, the institutional investor community has focused on eliminating "egregious" contract provisions, such as 280G "Golden Parachute" gross-ups, and single triggers on severance and equity. To avoid creating any issues at the time of a transaction, companies should aggressively begin to move their change-of-control and employment contracts to a more shareholder-friendly basis – replacing gross-ups with best net benefit provisions and eliminating single triggers from their agreements and plans.*

Reviewing Compensation

Other notable aspects of Dodd-Frank include disclosure of executive pay compared to company performance, and disclosure related to pay ratios (or internal pay disparity). In terms of their impact on the need for boards to begin evaluating their executive pay strategies, all of these are related, and all ultimately go to the concern of ensuring that strategies are defensible to shareholders, as well as proxy advisors and other important stakeholders.

Therefore, the passage of these provisions suggests Compensation Committees begin considering a variety of steps, including a review of their executive compensation strategy and philosophy, as well as their shareholder communication strategy.

While Dodd-Frank creates a more constrictive environment for Compensation Committees, it also creates an opportunity for companies to revisit their compensation philosophies and the strategies that flow from those philosophies. In reviewing executive pay, committees should consider the following areas in light of the new regulations:

> *Target pay positioning and pay mix:* As mentioned above, the specific regulations governing how pay-for-performance will be disclosed are yet to be determined; likely the SEC will release those regulations later in the summer or fall. However, we know enough at this time to understand that targeting compensation above the median will attract a new level of scrutiny by shareholders, so, for example, pay set at above the median will need to be supported by performance targets above median. Companies will also need to ensure that their CD&As explain how the specific pay mix and the proportion of total pay "at risk" have been determined, and how they contribute to the company's overall pay-for-performance strategy.

> But Compensation Committees will also have to balance these issues with the need to ensure that in an effort to comply with the law, they don't leave their companies exposed to the risk of losing key senior employees to labor competitors. The point is not to avoid above median pay targets, but rather to ensure that the performance return on that pay is clearly reported.

> *Peer groups*: Current peer groups should be assessed to determine how well they match the company in terms of market/labor competition, size, industry, and risk profile. Once determined, companies should consider disclosing the selection criteria (including actual revenue, headcount, market cap, etc. data) for each peer, along with a rationale to answer any potential shareholder and proxy advisor concern about "cherry picking" peers.

> *Long-term incentives and metrics*: Compensation Committees will want to review their long-term incentive plans and the metrics that are used to set payouts against industry practice, their own corporate objectives and those of their primary talent competitors. Metrics should be evaluated relative to their ability to drive shareholder value, be impacted by direct management action, and be measureable.

> *Relative pay levels*: If say-on-pay is likely to have the most far-reaching impact on companies, the new requirement to report relative pay levels is likely to be the most cumbersome. Dodd-Frank requires the reporting of median annual total compensation for all employees and the ratio of that to the CEO's annual total compensation. The SEC will need to decide exactly what will be included in the calculation of total pay, but one reading of the legislation raises the prospect of having to calculate all pay elements (benefits, pensions, perquisites, equity) for all employees, in addition to factoring in currency exchange calculations. Irrespective of how pay is calculated, the numbers are likely to be inflammatory, given the absolute difference between the lowest and highest paid and the pace of increase in that difference over the past decade or two. In years to come, we may well see companies examining and reporting on how the level of disparity at their company compares with market and labor competitors.

> *Proxy disclosure practices*: In light of the numerous pay- and governance-related reforms and policy changes in the past six or so months, companies will want to do a thorough review of their disclosure practices for 2011. The SEC has strongly signaled its intention to hold companies to a high standard of disclosure, and that is likely to intensify as it seeks to ensure companies are complying with the spirit and letter of the new laws. Additionally, because companies will now be compelled to hold a say-on-pay vote in 2011, the CD&A will be the primary mode of communication between companies and their shareholders, and the primary marketing tool used to "sell" their executive compensation strategies.

> *Compensation consultant independence*: Dodd-Frank made clear that the selection of a compensation consultant is the purview of the Compensation Committee, and has called for additional disclosure of both the selection and the degree of independence of the consultant. It did not change how the SEC had defined "independence" for compensation consultants for 2010; it reinforced that the determination of independence would be left up to Compensation Committees and shareholders (as outlined by the SEC). But the new law does suggest that companies will want to thoroughly disclose how the Compensation Committee determined that no conflict exists.

> *Board composition/Compensation Committee member independence*: Prior to Dodd-Frank, companies were required to disclose why the CEO and Chair positions were held by the same person; now companies must disclose why the roles are split when that is the case. The new law also now requires that Compensation Committees be composed solely of independent directors.

One other significant component of Dodd-Frank is the limits it places on broker voting in director elections, say-on-pay votes, and potentially other matters. Under the new law, broker/dealers will no longer be allowed to vote shares without instructions from their beneficial owners. This represents a meaningful departure from historical practice, in which brokers voted their shares under management, commonly resulting in 90%+ votes for directors. With beneficial owners chiming in more directly on director votes, it would not be unreasonable to expect far lower percentages of “For” votes. And in cases where companies have adopted majority voting, this could result in many more directors facing the threat of being voted off the board.

With this new voting rule (combined with the other provisions in the Dodd-Frank) we are likely to begin seeing a different tone and frequency of communications between boards and shareholders. The extent to which evolving communication requirements influence changes in the executive compensation plan strategies under discussion remains to be seen.

Appendix A
Dodd-Frank At-A-Glance

Dodd-Frank Provision	Details
Say-on-pay	• Companies will need to include two votes in 2011. The first will be a say-on-pay vote, and the second will be a vote on the frequency of future say-on-pay ballots (one, two or three years). The vote on the frequency of say-on-pay ballots will need to be held every six years. o Goes into effect six months after President's signature
Say on change-in-control compensation	• Companies will need to provide a separate vote on change-in-control compensation paid to named executives, if those arrangements were not previously voted upon, at the time of a transaction. o In effect for any meeting to approve change-of-control transaction that occurs six months after President's signature.
Pay-for-performance	• Requires graphic reporting of actual named executive officer paid alongside company financial performance. o The SEC will determine how both pay and company performance will be quantified for reporting purposes; there is no deadline for issuing its determination.
Pay ratios	• Companies must disclose in the proxy the median annual compensation of employees and of the CEO (and the ratio of the two). o The SEC will have rule on how compensation is defined in this context; there is no deadline for issuing its determination.
Compensation committee independence	• Companies must comply with exchange listing standards governing the source of committee member compensation or fees, including that provided for consulting/advisory services, as well as director affiliation with any subsidiary or affiliate of the company. o Rules to take effect within a year.
Compensation consultant independence	• Companies must provide boards with the funding necessary to secure their own compensation advisor. • Compensation Committee must be solely responsible for advisor selection, taking into consideration the factors SEC will identify as defining independence. (Advisors will not need to be independent.) • Disclosure must be made detailing the advisor selected, any conflicts of interest and how those conflicts have been addressed. o Rules governing advisory independence are to be issued within a year.
"Clawback" policies	• Companies must implement and disclose policies for recouping incentive pay based on material non-compliance with financial reporting rules. Policies will need to apply a three-year look back (from the date restatement is required). Applies to all current and former executive officers, not just CEO/CFO. o There is no deadline for the SEC to issue these rules.
CEO/Chair role rationale disclosure	• Companies must explain why CEO and Chair roles are held by the same, or different, persons. o SEC must issue these orders six months after signage of the bill.
Hedging	• Disclosure will be required detailing the hedging policies of the company. o There is no deadline for the SEC to issue the rules defining disclosure.
Broker Voting	• Broker-dealers to be prohibited from voting shares on executive pay and director elections without instructions from the owner. o The SEC will be allowed to expand this to other voting situations as it deems fit.

More Information

We encourage you to forward this document to your board members. And as always, we encourage you to contact us if you have questions. For more information, contact:

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