THE NEW RULES FOR EXECUTIVE COMPENSATION

The Impact of Shareholder Say and Beyond

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As the global financial crises of 2008 subsided, it was clear that rules related to executive compensation and corporate governance were set to change. As of July 2010, with the passage of the Dodd-Frank Act, it was clearer *what form* some of those changes were going to take. And as Institutional Shareholder Services (ISS) updated its policies for 2011, the new policy and regulatory environment became clearer still. What is crystallizing now, in the early weeks and months of 2011, as most companies ramp up for their annual shareholder meetings, is that shareholders are taking seriously the vote they have been given by virtue of Dodd-Frank.

Early voting both on Say-on-Pay (SOP) frequency, and on executive pay, is coming as something of surprise to many observers, and no doubt, many boards. If early trends are any indication, this newly found higher level of shareholder engagement will amount to a more persistent voice in executive pay. The trends supporting this, aside from the still-recent sting of the recent financial crisis, include the move toward majority voting for directors, the rise in influence of proxy advisors like ISS and Glass Lewis, and the removal of broker discretionary voting.

This Radford Review focuses on the near-term considerations for companies approaching their first shareholder SOP voting cycle, and the changes that might be set into motion in the wake of those votes. The paper will also more broadly review the regulatory and investor policy changes that boards and compensation committees will deal with through the remainder of 2011 and beyond. Radford has released numerous articles and alerts, as changes to Dodd-Frank have become known and as ISS finalized its 2011 policy updates; those can be found at http://www.radford.com/home/press_room/index.asp.

Say on Pay (SOP)

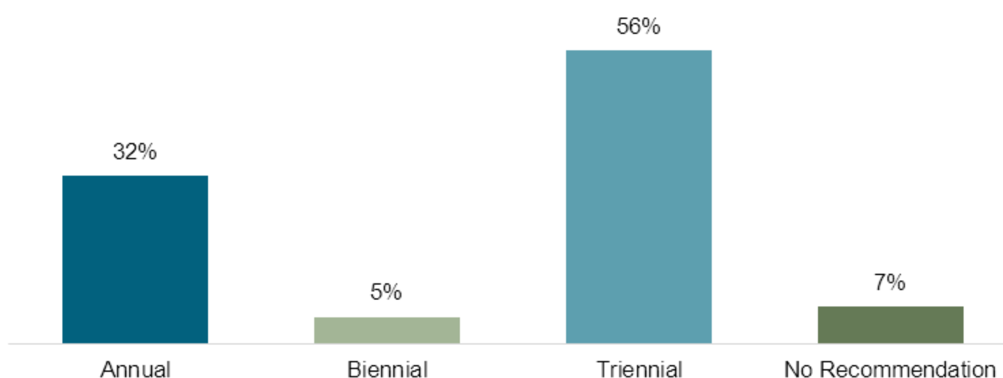
SOP has three distinct components: a vote to determine the frequency of the vote on pay, the actual vote on executive pay, and a vote on the pay executives will receive as the result of a change in control (aka, "golden parachutes"). All votes are non-binding, but the reaction of the company to those votes will have definite consequences.

Frequency

As enacted, the rules related to SOP allow shareholders to determine whether they'd like a say on executive compensation packages every year, biennially or triennially (or abstain). In terms of the recommendations, most companies (57%) are recommending a triennial vote, with an annual recommendation occurring at 32% of companies (biennial and no recommendation roughly divide the remainder). These data are based on public filings of 260 cross-industry companies, as of February 23, 2011.

As Figure 1 depicts, technology and life sciences companies have recommended triennial votes in about equal proportion to their broad industry counterparts. The preference for triennial in life sciences companies can be particularly compelling; it can be viewed as more closely aligning with business models that are dependent on long product cycles. In fact, in the case of Avanir Pharmaceuticals, shareholders selected the triennial option even though the company had not offered a recommendation (though with a small, 53%, approval vote).

Figure 1: Technology and Life Sciences SOP Frequency Recommendations (n = 57)



Source: Radford analysis of public data compiled by Aon Hewitt.

One interesting phenomenon that has occurred around SOP, at least in these early days, is the extent to which shareholders are pushing back on company recommendations for three-year votes, and voting instead for an annual say on management pay.

In voting as of February 22, of the 46 companies that recommended a three-year frequency, shareholders voted for an annual frequency 22 times (48%). That said, shareholders voted to turn down the thee-year recommendation with only an average of 65% of votes. Overall, of the 83 companies that have held a vote, 53 of them (64%) voted for the annual SOP vote.

While there is no penalty to companies for recommending a three-year voting frequency, these early results are instructive as to the reception they could receive, and as such, a shift in the recommendations going forward would not be surprising. (Note: companies must disclose the vote results within 150 calendar days after the date of the meeting in which the vote was held, or 60 calendar days prior to the deadline for shareholder proposals for the following meeting, whichever is earlier).

In those cases where a company has adopted what the majority of shareholders voted for in terms of frequency, it can exclude future shareholder proposals to provide a SOP or seek a change in the frequency. What this means on a practical level is that, for example, if a company recommends a three-year frequency, and that frequency is voted in by fewer than 51% of shareholders, future proposals to change the frequency to an annual vote can be put up for a shareholder vote.

ISS's policy guidelines for 2011 explicitly endorse annual voting, and ISS has recommended in favor of an annual vote for every company it has analyzed year-to-date. Glass Lewis supported a triennial vote at one company with a unique profile, but it is clear that in the majority of cases, proxy advisors will side with an annual vote; at companies where investors are clients of one or both of advisors, strong votes for annual say are likely to result. Although these are non-binding votes and companies are not compelled to implement them, we expect that ISS and Glass Lewis will recommend against the re-election of members of the Compensation Committee at companies that do not implement the frequency approved by a plurality of shareholders.

Approval on the Executive Compensation Program

Votes on the pay packages themselves have gone somewhat more smoothly, although two companies in that group of 83 received an Against vote on the pay package (Jacobs and Beazer Homes). However, in 13 of those 83 companies, shareholders voted 20% or more Against, a clear indication that a meaningful proportion of investors are prepared to vote against companies' executive compensation programs on a regular basis, and that high levels of support can by no means be assumed.

Of companies in the technology and life sciences industries, a small handful have completed their vote. In the case of Rochester Medical, a medical devices company, shareholders rejected the two-year frequency recommendation in favor of an annual vote, but approved the executive compensation program with 79% For; 3.0% Against; and 17.6% Abstain. On the technology side, Kulicke & Soffa's SOP vote easily passed, and 84% of shareholders sided with the company's recommendation for an annual vote.

Figure 2: Technology and Life Science SOP and Frequency Voting (as of February 23, 2011)

	SOP		Frequency		
Company	Pass/Fail	Percent	Recommended	Voted	Percent
Avanir Pharmaceuticals Inc	Pass	94%	No Recommendation	Triennial	53%
Becton Dickinson	Pass	95%	No Recommendation	Annual	81%
Integrated Silicon Solution Inc.	Pass	93%	No Recommendation	Annual	72%
Key Technology Inc.	Pass	96%	Biennial	Annual	64%
Kulicke & Soffa Industries, Inc.	Pass	91%	Annual	Annual	84%
Rochester Medical	Pass	79%	Biennial	Annual	37%
Super Micro Computer, Inc.	Pass	97%	Triennial	Triennial	61%
Surmodics Inc	Pass	59%	Annual	Annual	86%
Tech Ops Sevcon Inc	Pass	69%	Annual	Annual	68%
Varian Medical Systems	Pass	96%	Triennial	Annual	76%
Zoll Medical Corp	Pass	95%	Triennial	Annual	63%

In creating the new rules, the SEC did not provide concrete guidance on how companies should craft the SOP resolution; however it did provide an example. *"RESOLVED, that the compensation paid to the company's named executive officers, as disclosed pursuant to Item 402 of Regulation S-K, including the Compensation Discussion and Analysis, compensation tables and narrative discussion is hereby APPROVED."*

While on the one hand, the lack of a requirement for specific language allows companies some liberty for determining how to shape their SOP resolutions, the outcome of a vote against such an example (which is expected to be used by the majority of companies) does not provide a lot of guidance as to shareholder disagreement in those cases where an AGAINST vote either prevails or receives a large share of votes. Therefore, Compensation Committees will be left with the understanding that the pay packages might not meet a high level of approval, but not necessarily a good understanding of why. Looking at the limited history of voluntary SOP votes prior to Dodd-Frank, in many cases the vote appears to be more of a "say on the size of pay" as opposed to a more nuanced validation of the structure, purpose or philosophy of the executives' pay.

In addition to leaving Compensation Committee's disadvantaged to understand the specific nature of shareholder disagreement, they are also somewhat hamstrung when it comes to disclosing how they reacted to the vote. The SEC rules require disclosure as to whether the Compensation Committee considered the vote in its future executive pay decisions and if so, how the vote impacted the compensation committee's policies. Given that most companies are likely to end up with annual SOP votes, Compensation Committees will likely have fresh motivation to improve the favorability level in future years by providing detailed and enhanced disclosure of the prior year's votes, and what actions (if any) they have taken in response to the vote. As such, Compensation Committees should consider (if not submit) resolutions that provide shareholder feedback on discrete aspects of the pay program, so that both their reaction and the disclosure of such can be tailored to align with shareholder wishes.

Finally, there are some potential timing issues to consider. By the time shareholders provide feedback, the Compensation Committee will be in the middle of the company's current fiscal year/compensation planning cycle. Therefore, unless mid-year changes are considered in the Fall of the vote year in response to the shareholder vote, the Committee will have to make compensation plan changes, in anticipation of the next vote, explaining what was done in the current year and what will be done in the coming year in response to shareholder concerns.

Golden Parachutes

Companies have been compelled to disclose the details of pay associated with a transaction in the CD&A since 2007. The new SEC rules require a non-binding vote on those compensation arrangements – to be held either prior to or at the time of the transaction – as well as more detailed narrative and tabular disclosure of golden parachute payments.

The tabular disclosure will include, for each named executive officer (NEO):

- Severance-related cash payments
- Tax gross-ups
- The dollar value of equity awards accelerated by the transaction
- Additional pension or deferred compensation payments
- Health and welfare and other benefit and perquisite payments
- Other compensation and total compensation related to the transaction for each NEO

The narrative disclosure section must include descriptions of the circumstances surrounding the payments, including the details of triggering events, who will be making the payments, and the period of time during which payments will be made (whether they will be lump sum or installment). Terms of non-compete agreements must also be disclosed.

Companies will have to also disclose the specific triggers for these payments, whether they are single trigger (require only the completion of the transaction) or double-trigger (require both the transaction and the presence of other factors, such a meaningful reduction of responsibilities or termination of employment).

Additionally, ISS's 2011 policies summarize certain "problematic" features that may lead to negative vote recommendations on the new advisory votes on golden parachutes in M&A transactions:

- Recently adopted or newly amended agreements that include excise tax gross-up provisions (adopted/amended since the prior annual shareholders' meeting);
- Recently adopted or materially amended agreements that include modified single triggers (since prior annual shareholders' meeting);
- Single-trigger payments that will happen immediately upon a change-in-control (CIC), including a cash payment and such items as the acceleration of performance-based equity despite the failure to achieve performance measures;
- Single-trigger vesting of equity based on a definition of a CIC that requires only shareholder approval of the transaction (rather than consummation);
- Recent amendments or other changes that may make packages so attractive as to influence merger agreements that may not be in the best interests of shareholders;
- In the case of a substantial gross-up from pre-existing/grandfathered contract, the element that triggered the gross-up (i.e., option mega-grants at low point in stock price, unusual or outsized payments in cash or equity made or negotiated prior to the merger); or
- The company's assertion that a proposed transaction is conditioned on shareholder approval of the golden parachute advisory vote.

The vote on golden parachutes, like approval of the broader executive compensation program and selection of the frequency of SOP, will be an advisory, non-binding vote. If held at the time of a specific transaction, the golden parachute vote would be presented separately from any vote on the transaction itself.

Alternatively, a company can avoid the potential distraction of asking shareholders to approve golden parachute compensation at the time of a transaction by providing the expanded golden parachute disclosures as part of the SOP at the time of the regular annual meeting. For companies that do this, the vote on the overall executive compensation program will be deemed to include the required vote on golden parachutes. However, any material change to a covered executive's potential severance pay that occurs after the time of the vote, including normal merit increases or annual equity grants that would be subject to acceleration upon a change-in-control (or the introduction of new NEOs) will need to be approved in a second golden parachute vote.

Currently, regulators, proxy advisors and investors at-large have not taken a position on the optimal timing or structure of the golden parachute vote. Although it appears reasonable to assume that the latter two groups, at least, would tend to support regular inclusion of golden parachutes in an annual SOP vote, we do not expect most companies to go this route in 2011. Golden parachutes are typically among the most controversial aspects of executive pay programs and could easily drive increased numbers of shareholders to vote against the broader executive compensation program if bundled into the SOP proposal.

Dodd-Frank Update

While the shareholder say issues are currently taking a front seat in the minds of companies and their boards, other regulatory changes set into motion by Dodd-Frank are looming later in the year. Several key Dodd-Frank-related SEC regulations are expected, as per the following schedule:

Policies	Schedule
Compensation Committee and Advisor Independence	Rules to be proposed by March 2011 and adopted by July 2011
Clawback Policies Pay-for-performance Disclosures CEO Pay Ratios	Rules to be proposed between August and December 2011

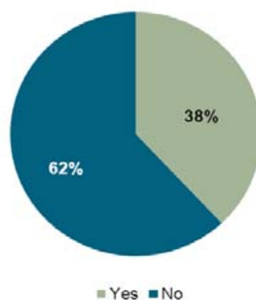
In the case of the latter three regulations, the SEC schedule was recently moved back somewhat. Nonetheless, we recommend companies begin now by reviewing their current policies, gaining an understanding of their CEO pay ratios and thinking through the implications of implementing clawback policies that include equity-based compensation.

Clawbacks

Dodd-Frank expands upon existing Sarbanes-Oxley clawback regulation by covering any current or former executive officer, adding a three-year lookback period (from the time a restatement is required), and broadening the trigger to include any material restatement (irrespective of whether fraud was involved). Implementing such clawback regulations could well prove difficult for many companies and there are still numerous open issues that SEC will need to chime in on, including the key ones of how discretionary awards will be treated and how stock-based compensation will be calculated.

There are, in fact, too many open questions for companies to begin recrafting their clawback policies; however, companies should use this time to gain an understanding of the differences between their current clawback policies and those expected under Dodd-Frank. Companies should also review their policies on disclosure of clawback policies. According to recent Radford research of 140 leading technology and life sciences companies, a relative few make such disclosures (See Figure 2), and doing so should help deepen shareholder understanding of the controls in place at the company. In contrast, according to 2010 research conducted by Aon Hewitt, about 75% of the Fortune 200 made such disclosures.

Figure 3: Top Technology and Life Sciences Companies 2010 Disclosure of Clawbacks



Source: Radford proxy research of 140 technology and life sciences proxies in July 2010.

Other Dodd-Frank Concerns

Dodd-Frank requires graphical reporting of executive officer pay, alongside company performance. In some respects, this concept is not new, and it is unclear the extent to which the SEC will expand the current requirements. Further, the CEO pay ratio disclosure requirements put into place are equally as mysterious at this time. (See Radford's white paper at http://www.radford.com/home/press_room/index.asp for our analysis of the difference that a company's size and industry can make on pay multiples). Finally, we anticipate clarity on rules around compensation committee member and advisor independence. Given that rules covering both of these concerns have been issued by SEC within the past couple of months, we do not anticipate comprehensive change.

Conclusion

As we have noted for the past couple of years, the standards for shareholder communications are rising, as are the stakes for getting that communication right. At the advent of SOP, shareholders are turning out to be anything but "hands-off" when it comes to voicing their opinions not just on the pay executives receive, but how often they get to chime in on those issues. The most recent financial fallout might well be mostly behind us; however, the impact it left on many shareholders is anything but forgotten. So, it is not surprising that they are proving to want a more active role in determining whether the executive leadership pay is in line with the value they as shareholders receive.

Companies, boards and compensation committees should consider the following in relation to SOP, governance and executive pay:

1. For companies that have not yet made a recommendation on frequency, provide a clear and specific rationale for the recommendation. ISS and many (though by no means, all) institutional investors prefer an annual frequency, which is at odds with the perspective of many boards. Note that while a *majority* of triennial vote recommendations have been rejected, it has not occurred in all cases – a compelling argument can be made.
2. Irrespective of the strength of the rationale, if companies choose to side-step shareholder wishes, they should be aware of the probable negative reaction of ISS. Also, bear in mind that if a triennial vote is accepted, but the pay program does not receive a majority vote, it can be put up for vote in the following year.
3. Contracts could well be a focus of attention among shareholders, so it is worthwhile to determine their potential for shareholder objection.
4. Evaluate clawback policies, CEO pay multiples and the independence of directors and compensation advisors. While not included as a new requirement, these issues will be coming up in next year.
5. Assess the company's ownership policies. Ownership requirements were not part of Dodd-Frank, however, ISS weights them heavily (in their GRId analysis).
6. Ensure that CD&A disclosure is full and complete. Include discussion of would-be "problematic" pay practices that are not part of the company's pay programs.
7. Finally, there is another perhaps more subtle message for technology and life sciences companies: shareholders are not defined along industry lines in the same way that business models and talent requirements are delineated. As such, reviewing best practices in governance, shareholder communication and pay across a broad cross-section of industries and company sizes can serve to ensure shareholders expectations are being met.

More Information

We encourage you to forward this Alert 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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