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BOARD ADVISORY LLC

2014 Trends in Executive Compensation and Governance

The following represents our assessment of executive pay, governance and how these factors impact the role of the board member in 2014.

Our Environment in 2013

Pay. In 2013 the S&P 500 total return was 31.9%, the strongest since 1997. The rapid climb in value resulted in substantial wealth gains by investors as well as many CEOs and directors. The S&P gains also highlight two longstanding issues with executive pay that directors must confront. First, that pay plans often fail to differentiate relative performance, where "all ships rise with the tide", second, and related, that a single measure such as total return may measure results, but the results may be unrelated to management's actual contribution and success in their roles.

In 2013 we saw generally conservative executive pay actions. The average CEO salary increased by roughly 1%, with 2 of 3 CEO's seeing no increase at all. Option usage declined slightly, offset by a corresponding increase in the use of performance-based restricted stock or stock units. Perhaps the result of modest economic growth and the maturity of the Say-on-Pay regulation, restraint was evident. It will be interesting to see how this general trend is affected by the equity market escalation; I expect 2014 pay disclosures will reflect more aggressive pay actions.

Regulation. Regulatory and pseudo-regulatory bodies were more reserved than prior years. Heavyweight pay influencers such as ISS and Glass-Lewis refined benign issues such as peer group methodologies and danced around more volatile issues such as pay-for-performance standards.

The SEC, with 4 major regulations outstanding from the 2009 Dodd-Frank legislation, effectively told the market they would address the CEO pay ratio and punt on the remaining issues (i.e., pay-for-performance disclosure, hedging and claw-backs[1]). SEC changes announced in 2012 becoming effective in 2013 and 2014 such as Compensation Committee member and advisor independence, were generally not disruptive to most companies.

The IRS established no new landmarks. Taxation of carried interest plans as ordinary income (currently treated as capital gain) remains a target. The IRS refine its thinking on the timing of deductibility of annual bonus plans. Similarly, no new accounting changes impacting executive pay were implemented in 2013.

In all, it was a quiet year for the traditional players in executive pay.

[1] The outstanding claw-back regulation involved compensation erroneously earned, as opposed to the specific financial services industry regulations finalized in 2011 impacting claw back liability in the instance of failed financial institutions.

Investors. For many compensation committee members 2013 distinguished itself as a year of change in the role of the shareholder. In 2013 we saw continued evolution of the role of shareholder litigation in executive pay, where the derivative litigation industry used failed Say-on-Pay votes, 162(m) disclosures, as well as minor pay reporting errors as grounds for derivative suits against the company and the board. While very few of the fiduciary-based derivative lawsuits were successful, companies and Compensation Committees were often involved in prolonged, expensive and distracting efforts to defend themselves.

Takeaway from 2013. In 2013 we saw what is likely the waning of relative influence of ISS and Glass-Lewis[2]. Several large institutional investors such as Vanguard, Fidelity and Blackrock developed their own proxy analysis/governance groups, with some explicitly stating they no longer followed ISS recommendations. In addition, statements from both Canadian and US securities regulators indicate a willingness to regulate[3] the proxy advisor industry in reaction to what was perceived as heavy-handed practices by the industry leaders.

Also in 2013, as mainstream institutional investors proved they were willing to join, or sometimes lead, shareholder efforts to drive change in companies[4], compensation committee members found themselves much more involved in shareholder outreach programs. For 2013 Georgeson reported 58% of large public companies undertook a formal outreach effort[5]. The single most "popular" reason for the effort was to explain CEO pay, followed by company strategy.

Looking Into 2014

At the macro level, it is reasonable to believe several trends will be of consequence to compensation committee members and their companies in 2014.

Pay. Since 2008 we have seen a steady shift away from stock options, primarily to performance-vested RSU's (at least for post-TARP organizations). This aversion to stock options was driven by a number of sources, arguing that the asymmetric risk characteristics of an option were conducive to excessive risk taking and placed the executive in a market-timing conflict with other investors. These arguments coincided with a major market correction which at least temporarily wiped out nearly all option gains held by executives, resulting in little desire to contest the conclusions of pay critics. With the market now restored to pre-recession levels, a gradual return to stock options is likely. We can expect a shareholder-endorsed "Stock Option 2.0" will be granted with

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[2] For example, of the 261 "no" recommendations on Say-on-Pay from ISS, only 18% failed. In general, 2013 ISS recommendations tended to correlate with votes, but by no means dictate voting (source: Wachtell, at http://www.wlrk.com).

[3] There have been a number of statements, including statements by David Gallagher (SEC Commissioner) indicating potential SEC action (at NASDAQ request) to withdraw a no-action letter from 2003 that provided a fiduciary safe harbor to investment companies relying on proxy advisor counsel for voting shares. The Canadian Securities Administration has announced possible regulation of the industry.

[4] In 2013 Blackrock announced they are no longer following ISS recommendations regarding the voting of shares, and Fidelity's governance group initiated discussions directly with companies as a result of sending letters to 350 companies asking for direct information regarding problematic pay practices.

[5] Georgeson 2013 study of client companies.

share retention requirements as well as potential limitations on exercise timing, directly addressing prior investor and pay critic concerns.

In addition, we believe that companies will increasingly rely on some form of realized pay in addressing pay-for-performance concerns from investors. Compensation committee members are reminded that we still generally define "competitive" executive pay in terms of SEC reporting standards, where pay opportunity (e.g., Black-Scholes), not value received (realized pay), is the comparator. Committee members need to be mindful of the difference, and be certain this distinction is communicated to investors and other stakeholders.

Proxy Advisors. There is a good chance the SEC will withdraw the original 2003 no-action letter that provided institutional investors with fiduciary "cover" when they relied upon a recommendation from a proxy advisor[6] for voting their shares. Such a change, coupled with individual institutional investors fighting to directly establish their own agenda in the boardroom, may mean multiple standards for acceptance of pay actions and the end of what was previously an ISS "safe harbor".

Institutional Investors. We expect that "problematic pay practices" will remain a point of contention with institutional investors. However, we should expect they will address the problem with companies directly – and expect compensation committees to respond personally. Fortunately, the institutional investor approach is typically a negotiation, not a disruptive "no" campaign.

Regulation. The SEC has clearly shifted to the recalcitrant regulator with respect to public company executive pay. However, recent statements indicate the final three regulations dictated by Dodd-Frank will finally be introduced over the course of 2014, five years after the act was passed[7]. The pay-for-performance regulation (Section 953(b)) is potentially the most controversial of the three. It is our belief the SEC will follow the emerging trend of describing pay in terms of company performance over an extended period of time, consistent with contemporary realizable pay methodologies[8]. Independent of the SEC's eventual rule-making, we see an increasing number of companies embracing realized pay as a means of assessing long-term compensation committee effectiveness and as a tool for direct communication and justification of pay decisions with investors.

At this point there is little controversy surrounding the claw-back and hedging policies, particularly in light of the "problematic pay practice" standards of ISS, Glass-Lewis and

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[7] The Dodd-Frank legislation required agencies to establish 398 separate rules. As of July 2013, over half remain unresolved with 29.4% in pending form (since then, the CEO pay ratio was finalized) or not yet issued (32.2%). See DavisPolk, Dodd-Frank Progress Report (June 3, 2013), http://www.davispolkportal.com

[8] Voluntary disclosure of realizable pay calculations were presented by a minority of companies in 2013, including large cap companies. ISS began using a variant of realizable pay in assessing companies where there is "high or medium concern" regarding the relationship of pay and performance.

certain institutional investors[9]. While we expect any additional regulations to be burdensome, we do not expect the eventual rules to reflect any change in the current evolutionary path of executive pay and employment terms.

Board Tenure and Board Refreshment. While not new, discussion surrounding director independence is increasing, particularly relating to age and tenure. A number of institutional investors have determined that an exceptionally long tenure of a director may jeopardize the independence of the director. The EU recommends terms no longer that 9-12 years. The UK considers directors with more than 9 years of board service no longer independent.

We do not expect any action on this subject in the US yet, but we believe continued discussion in governance circles will result in several leading companies reinvigorating prior retirement programs and considering new board refreshment programs. Institutional investors appear to endorse the board refreshment concept[10], in conflict with the general view of companies. However, it is unknown whether institutional investors will be willing to force a key director out or whether they will simply endorse the program as a tool to weed out lower-contributing directors. Independent of the outcome of the board refreshment issue, we believe board succession and diversity will remain a visible issue for 2014.

Litigation. We see no change in the pace of derivative shareholder litigation in 2013. Despite the relative failure of plaintiffs to win judgments, the industry remains profitable for certain law firms to conduct a form of economic extortion on those companies failing Say-on-Pay voting, failing to adhere to disclosure standards, and failing to adhere to their own shareholder-approved plans and Committee charters.

What This Means to the Compensation Committee

Our principal concerns for compensation committees in 2014 are the following.

1. The relative economic weakness on Main Street and its contrast with the success of the equity markets highlights an economic divide within the economy and provides popular support for arguments to address perceived inequities and abuses arising from executive pay. The level of discussion is now working its way into preliminary political statements as we prepare for mid-term elections, and will likely maintain social pressure on perceived executive pay abuses and potential future regulation. Committee members are advised to remember that only executives like executive compensation.
2. Committees will come under increased scrutiny if realized executive pay over a 3-5 year period is not correlating with investor outcomes. The data necessary for any analyst to perform the calculations is publicly available and is likely to

[9] Over half of public companies already disclose policies prohibiting executives and directors from hedging. SEC rules dating back to Sarbanes-Oxley (2002) require the SEC to pursue the claw back of compensation earned through fraud. As a result, most companies also have claw-back policies within their various incentive plans.

[10] In 2013 ISS surveyed investors and companies regarding exceptional board tenure. 74% of investors viewed long tenure as problematic, whereas 84% of companies said it was not problematic.

become a vehicle for activists to tell their story. Committees are advised to be prepared by understanding their CEO's realized pay relationship to performance.

3. Boards will see increased scrutiny from institutional investors to explain company strategy, and compensation committees (and their advisors) must be prepared to explain precisely how the existing pay arrangements advance that strategy. Quoting a "pay-for-performance" philosophy may be insufficient. Compensation Committee members should be prepared as investors will be seeking clarification of strategy and how pay relates.
4. Good management of compensation committee processes will remain important as the derivative litigation industry continues to thrive. Committees are advised to consider audits of plans and processes[11].

That said, we are optimistic about executive pay and its related governance in 2014 for a number of reasons.

1. The increased attention of institutional investors in understanding unique business strategies can support more rational pay decisions. Perhaps we are seeing an end to "data slavery" and the disproportionate focus on pay comparisons based on present-value methodologies.
2. The decreased emphasis on homogenizing executive pay and elimination of the one-size-fits-all governance model can help companies who are willing to differentiate themselves.
3. Greater sophistication of institutional investors in understanding executive pay arrangements will support concepts such as realizable pay being used to support good committee decision-making, and to protect committee members who commit to longer-term pay strategies.
4. SEC recalcitrance to issue regulations has created a void that is being filled by institutional investors who have a direct interest in value creation rather than a shifting political agenda.

\- Jeff McCutcheon

Jeff McCutcheon works with a number of Board Advisory clients addressing executive pay, governance, and the alignment of executive practices with long-term strategy. Mr. McCutcheon's bio is available at http://www.board-advisory.com/team.php. If you have any question or comments on this article, or want to speak with Jeff about any executive rewards, performance, or succession issue, he can be reached at jeff@boardadv.com, or at (904) 306-0907.

[11] See BoardMember Magazine, Q4 2013, "See the Forrest and the Trees" P. McConnell and J. McCutcheon.