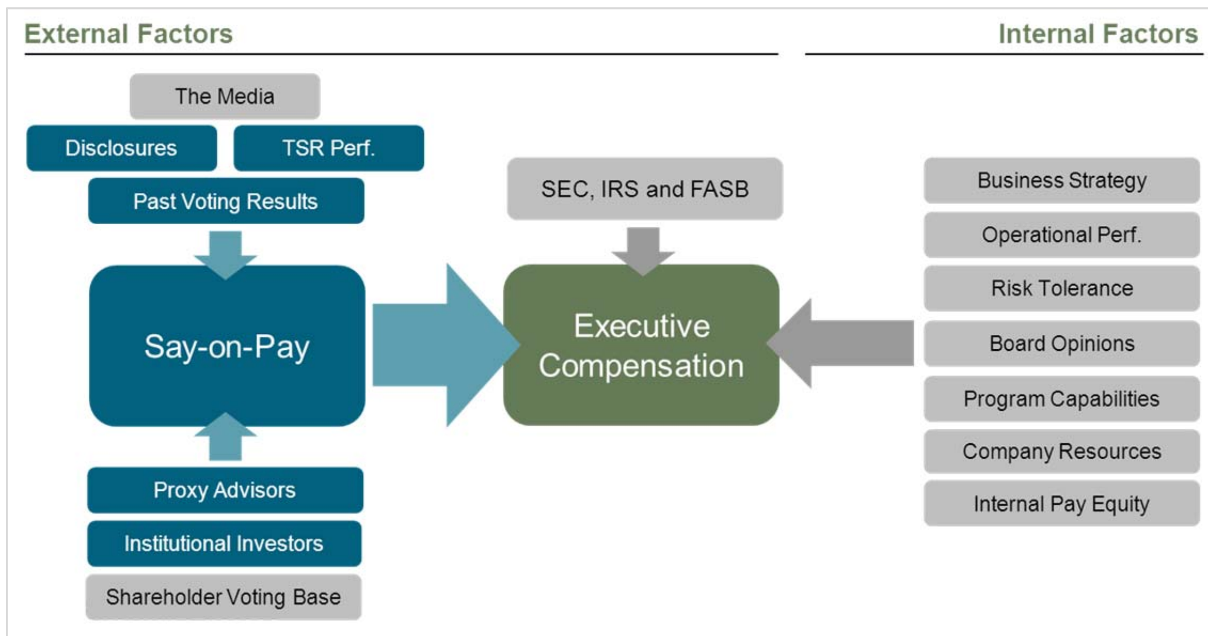
RADFORD REVIEW

Proxy Season 2013: A Renewed Focus on Disclosure

By Ed Speidel and Ram Kumar

Continued focus on key corporate governance issues like pay-for-performance alignment and Say-on-Pay results has dramatically altered the environment in which we all operate. For example, in 2008, one could easily have viewed the media as a central player in the executive compensation debate. Meanwhile, proxy advisory firms like Institutional Shareholder Services (ISS) and Glass Lewis were important players, but they did not sway conversations in the same manner as they do today. In contrast, as we enter the 2013 proxy voting season, ISS and Glass Lewis carry considerable weight, which they collectively wield through voting recommendations on Say-on-Pay proposals. The result, at least for now, is an increasingly complex and unbalanced executive compensation landscape.

Although every company will have a unique perspective, at Radford, we generally believe the current mix of issues influencing executive compensation is decidedly tilted toward external factors. Per the diagram below, items in blue carry the most heft today, while items in gray are arguably less important (or at least less visible) than in past years. Thus, while business strategy and operational performance remain important factors in the design of executive compensation programs, the world increasingly seems to revolve around Say-on-Pay.



Importantly, none of the familiar forces impacting executive compensation have completely faded into the background, hence the growing complexity of today's landscape. In 2013, companies simply have more to deal with, and now must be cognizant of how the balance of power between various factors shifts over time. For example, thanks in large part to policies adopted by ISS, total shareholder return (TSR) measured over one-, three- and five-year periods is now the viewpoint of choice for assessing CEO pay-for-performance. This serves to supplant more traditional year-over-year metrics like net income and earnings. Similarly, the concept of pay-for-performance is expanding well beyond views of annual bonus payouts to include all forms of compensation. Of course, last but not least, Say-on-Pay votes serve as lightning rod events to bring all of the factors depicted above into sharp focus.

What's Next for Say-on-Pay?

With Say-on-Pay votes now serving as a major focal point for executive compensation and corporate governance issues at most companies, the question of how Say-on-Pay will continue to evolve is paramount. At Radford, we believe the notion of Say-on-Pay "success" is a constant work in progress, with the bar rising higher each year. Looking back to the 2011 proxy voting season, when widespread Say-on-Pay voting arrived in the US for the first time, most actors – from companies to proxy advisory firms to shareholders – moved very cautiously. This all changed in 2012, as proxy advisory firms aggressively sought ways to enhance their pay-for-performance analytics and introduced new thresholds for adding extra scrutiny in the years following poor Say-on-Pay results. Certainly, the trend of Say-on-Pay pressure ratcheting upward is not exclusive to the US. Binding Say-on-Pay votes are now on the horizon in the United Kingdom, and serious political pressure is building in several key European Union countries to cap executive pay.

For companies watching the Say-on-Pay pressure gauge rise, the question of what to do next likely boils down to increased, and perhaps more "proactive" disclosure. In this case, we use the term proactive to imply a more impactful, communicative and preemptive way of writing proxy statements; writing in such a way that disclosures reach and thoroughly speak to the issues shareholders care most deeply about. The elements of the proxy required for creating such disclosures are usually not new, but the manner in which they can be disclosed is often ripe for improvement. Indeed, it is not so much what companies should disclose, but how they disclose it.

Why Focus on Disclosure?

Aside from the overall complexity of explaining the inner workings on many of today's executive compensation programs, or the energy required to successfully combat a proxy advisor challenge, five key forces appear to be driving companies to consider a more proactive approach to compensation disclosures. These forces include:

Key Forces Shaping Future Compensation Discussion & Analysis (CD&A) Disclosures:	
Realized and Realizable Pay	> With ISS and Glass Lewis both moving to incorporate realizable pay into their voting analyses, companies will likely feel pressure to provide information on realized and/or realizable pay in their own disclosures.
Pay-for-Performance	> Although the SEC has yet to define a standard approach to pay-for-performance disclosure, the spreading use of proxy advisor pay-for-performance assessments is forcing companies to address the issue head-on in disclosures. Increasingly, shareholders also expect to see additional disclosures in this area.
Shareholder Litigation	> While the merits of many shareholder lawsuits on executive pay are certainly debatable, most cases come down to questions of omissions or inadequacies in CD&A statements. (In some cases, shareholders only seek revised disclosure.)
The Historical Record	> Most companies now have a track record of Say-on-Pay voting results; this creates new pressures to explain year-over-year changes in Say-on-Pay support. For example, if shareholder support for Say-on-Pay declines from 90% to 85%, how should a company respond?
Marketing Via Your CD&A	> A growing number companies are embracing the concept of using CD&A statements as a marketing vehicle to highlight positive performance and well-liked governance practices. This approach certainly carries some risks, but it should not be overlooked as more companies move in this direction.

Increasingly, clients should consider addressing the issues listed above through a more proactive approach to disclosure, including discussions covering corporate performance highlights, graphical displays of the link between pay-and-performance, detailed comparisons of the very real differences between reported or target compensation and actual realized or realizable compensation, as well as any actions taken by the Compensation Committee in light of prior Say-on-Pay voting results. We believe 2013 could very well serve as a tipping point for many of the disclosure areas above. Someday soon, the risks of staying mum could potentially be more significant than jumping into the fray.

Realizable and Realized Pay

Among the chief factors forcing companies to consider more detailed disclosures is the rising use of realizable and realized pay analyses. Though these concepts are not new, the market has historically resisted adopting disclosures in this area for good reason. At a minimum, it is a complicated and somewhat onerous task. Most importantly, standardized methods for viewing and considering realizable and realized pay do not yet exist, which certainly subjects early adopters in this area to some risk.

Still, despite these challenges, a growing number of companies used realized and/or realizable pay data to defend against adverse proxy advisor recommendations in 2012. And now, with both ISS and Glass Lewis starting to consider realizable pay in their 2013 pay-for-performance assessments, disclosure in this area is inching closer and closer toward common practice. If pay methodologies become more consistent (which will likely be driven by future ISS and Glass Lewis policies) disclosure of realized or realizable pay tables and charts could certainly accelerate.

In the absence of firm methodology standards, the table on the following page lists the basic elements of Summary Compensation Table (SCT) vs. realizable pay vs. realized pay calculations.

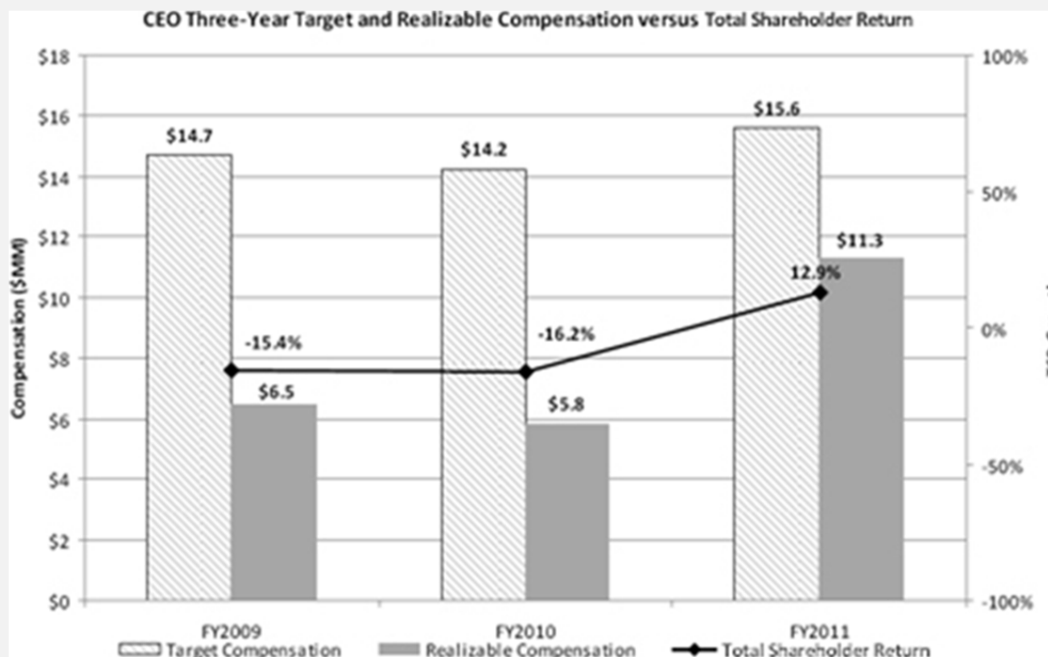
Summary Compensation Table Disclosure	Realizable Pay Elements	Realized Pay Elements
> Actual cash compensation - Base salary - Annual cash payouts - Long-term cash payouts > Stock options and time-based shares granted, as valued on their date of award > Performance shares granted, as valued at target	> Actual cash compensation - Base salary - Annual cash payouts - Long-term cash payouts > Stock options and time-based shares granted, as valued at year-end > Performance shares outstanding at year-end	> Actual cash compensation - Base salary - Annual cash payouts - Long-term cash payouts > Value of stock options exercised > Value of time-based stock vested > Value of performance shares earned and vested

To further help companies understand how realizable and realized pay disclosures can function within the context of proxy statements, several recent disclosure examples are provided below:

Radford Summary: *Gilead's 2012 proxy graphically displays targeted and realizable pay vs. total shareholder return (TSR) over three fiscal years. Their disclosure shows that the company's realizable pay is below SCT reported values, and that compensation realizable by the CEO is more closely aligned with shareholder value creation.*

Gilead Sciences (DEF 14A – April 23, 2012)

"Gilead's executive compensation program aligns pay with performance. **The Compensation Committee believes that realizable pay – rather than potential pay – is the most relevant measure of pay-for-performance alignment as it represents the value actually earned by the executive.** Equity Compensation is Performance Based: Because Gilead's equity compensation is delivered entirely in the form of performance-based shares and stock options, 100% of the value realized by an executive officer from his or her equity awards is performance-based."



__Radford Summary:__ Synaptics choose to display total realizable CEO pay vs. total shareholder return (TSR) performance over one year and five years periods relative to peers. Although key methodology decisions differ from ISS, this view of the data generally mirrors the ISS relative degree of alignment (RDA) test.

Synaptics (DEF 14A – September 12, 2012)

"When reviewing the alignment of our company's performance and the compensation of our named executive officers, **the Compensation Committee focuses on the amounts that our named executive officers have realized as well as the unrealized appreciation**, if any, in their outstanding stock-based compensation awards in determining whether their compensation arrangements are fulfilling their desired purpose. **The following tables represent the alignment of Chief Executive Officer realizable pay for performance relative to our peer group**."

__Radford Summary:__ Brooks Automation added a supplementary Summary Compensation Table (SSCT), which displays total realized pay vs. SCT reported pay for its named executive officers.

Brooks Automation (DEF 14A – December 19, 2012)

"Realized Pay – The table below is a supplement to the Summary Compensation Table shown on page 34. This table shows the actual compensation delivered during the 2012 and 2011 fiscal years to the chief executive officer and other named executive officers."

Name	Year	Salary	Stock Awards Realized(1)	Non-Equity Incentive Plan Compensation	Change in Pension Value	All Other Compensation	Total Realized	Summary Compensation Table Total
Stephen S. Schwartz	2012	$575,000	$ 1,244,110	$ 103,500		$ 38,332	$ 1,960,942	$ 4,458,332
	2011	$563,461	$ 587,441	$ 525,000		$ 33,522	$ 1,709,424	$ 3,860,233
Martin S. Headley	2012	$425,000	$ 762,073	$ 68,000		$ 27,665	$ 1,282,738	$ 2,284,515
	2011	$425,000	$ 441,475	$ 407,596		$ 11,025	$ 1,285,096	$ 1,587,021
Mark D. Morelli	2012	$310,577	-	$ 85,000		$ 58,895	$ 454,472	$ 2,670,472
Steven A. Michaud	2012	$315,000	$ 631,478	$ 35,438	$ 32,517	$ 35,337	$ 1,049,770	1,059,692
	2011	$310,961	$ 111,558	$ 168,759	$ 13,753	$ 16,282	$ 621,313	$ 831,895
Thomas R. Leitzke	2012	$280,000	$ 93,437	$ 33,600		$ 49,501	$ 456,538	$ 1,111,401
	2011	$271,923	$ 46,000	$ 149,612		$ 69,004	$ 536,539	$ 800,289

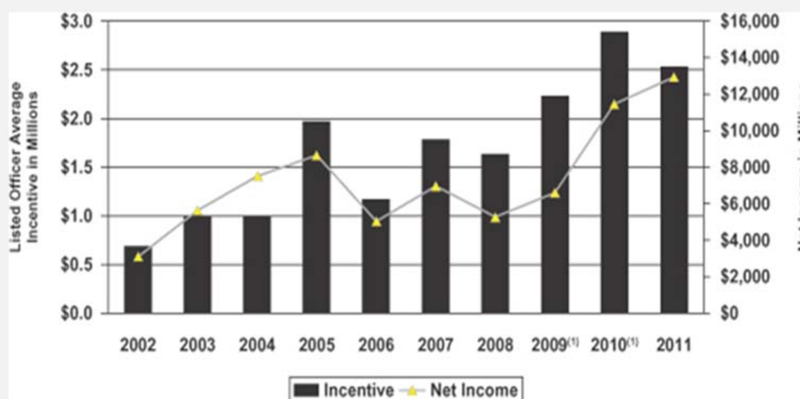
Pay-for-Performance

The rise of proxy advisor pay-for-performance assessments has forced companies to address the issue of performance disclosure head-on. Yet, the SEC's delay in developing a standardized approach to pay-for-performance opened the door to a wide array of experimentation in this area. As such, examples in the market come in many forms, and include displays pay vs. total shareholder returns and/or operational metrics over three-, five-, and ten-year look-back periods.

Radford Summary: *Intel's pay-for-performance disclosure displays the relationship between incentive pay and net income over a ten year period, and highlights the company's strong recent performance.*

Intel (DEF 14A – April 4, 2012)

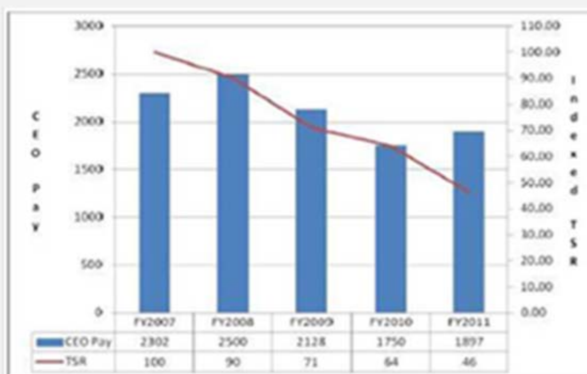
"As shown in the table below, **2011 was the most profitable year in Intel's history, with record revenue, operating income, net income, and earnings per share, and it was the second year in a row with revenue growing over 20%.** Intel's strong financial performance during 2011 has allowed the company to make significant investments in its business, including its people, as well as increase the return of cash to Intel's stockholders through common stock repurchases and dividends."



Radford Summary: *Filed as part of a supplemental proxy, the chart below serves to defend against proxy advisor criticism.*

Isis Pharmaceuticals (DEFA14A – May 30, 2012)

"As noted in our proxy statement and displayed in the following graph, **our executive compensation generally tracks total stockholder return and our chief executive officer's compensation has generally decreased when our stock price has decreased.** The following graphs show the relationship of our chief executive officer's compensation ($ in thousands) compared to the total return (TSR) on $100 invested on December 31, 2007 in our common stock through December 31, 2011."



	FY2007	FY2008	FY2009	FY2010	FY2011
CEO Pay	2302	2500	2128	1750	1897
TSR	100	90	71	64	46

Shareholder Litigation

The onset of Say-on-Pay not only allows shareholders to be more vocal, it gives them a specific metric to point to when considering litigation tied to excessive executive compensation and corporate governance failures. Not surprisingly, compensation-related lawsuits are on the rise since the advent of regular Say-on-Pay voting in 2011. While the majority of shareholder derivative suits are nuisance cases, they can tarnish corporate and Board reputations, as well as drain a company's time and resources.

Many recent shareholder derivative cases focus on supposed breaches of fiduciary duty on the part of Boards (i.e., wasting corporate assets with excessive pay or exit packages), non-compliance with §162(m), the lack of effective claw back provisions and opaque compensation disclosures. While the nature and genuineness of the complaints associated with each case vary, many ultimately flow back to disclosure concerns. As such, companies are right to explore ways to improve disclosures as a potential safeguard against future lawsuits.

Below are several disclosure examples citing shareholder derivatives cases tied to concerns over the quality of CD&A disclosures:

Monolithic Power Systems (10-Q – October 27, 2011)

"On September 16, 2011 and September 29, 2011, two nearly identical shareholder derivative actions were filed in the United States District Court for the Northern District of California and the California Superior Court for Santa Clara County, naming as defendants certain of the Company's current and former directors and officers and the Company's compensation advisory firm. The complaints assert claims for, among other things, breach of fiduciary duty in connection with the directors' approval of compensation for the Company's executive officers during 2010. The complaints each seek an award of damages in favor of the Company, equitable relief, costs and attorney's fees. The matters are at a preliminary stage; the defendants have not yet responded to the complaint and no discovery has taken place."

Republic Services (DEF 14A – April 1, 2011)

"In late 2009, a stockholder sued us in Federal court in Delaware challenging our disclosures in our 2009 proxy statement with respect to the Executive Incentive Plan ("EIP") that was approved by our stockholders at the 2009 annual meeting. The lawsuit is styled as a combined proxy disclosure claim and derivative action. We are a defendant only with respect to the proxy disclosure claim, which seeks only to require us to make additional disclosures regarding the EIP and to hold a new stockholder vote prior to making any payments under the EIP. The derivative claim is purportedly brought on behalf of Republic against all of our directors and the individuals who were executive officers at the time of the 2009 annual meeting and alleges, among other things, breach of fiduciary duty."

The Historical Record

As we discussed at the onset of this article, the future of Say-on-Pay remains an open question— Say-on-Pay success is a moving target, which will likely get harder and harder to hit in the near future. However, we need not only look forward when it comes to Say-on-Pay. As successive years of Say-on-Pay results pile up at companies, new milestones for the health of overall executive compensation programs will be created. Over time, addressing the historical record on Say-on-Pay could become critically important. Potential questions that come to mind include:

- If shareholder support for Say-on-Pay at my company declines from 90% to 85%, what does this mean? Even though our company is above the ISS and Glass Lewis thresholds for success, how should we react?

> If 87% of shareholders support Say-on-Pay at my company, but our peers average 93% support, what does this mean?

> If support for Say-on-Pay at my company dips close to the 70% or 75% thresholds put in place by ISS and Glass Lewis respectively, how should we react?

Questions of this nature only serve to amplify the pressure on companies to create quality commentary on Say-on-Pay results, and to highlight follow-up steps taken to address issues raised by shareholders. While no company has directly addressed any of the questions listed above, disclosures suggesting consideration of the historical Say-on-Pay record are beginning to emerge more frequently, mostly at companies clearly below or near the ISS success threshold of 70%.

Radford Summary: *Johnson and Johnson's discussion of their recent Say-on-Pay results provides a frank assessment of the company's vote record and use this discussion as a spring board to speak directly to shareholders about actions taken as a result.*

Johnson & Johnson (DEF 14A – March 14, 2012)

"Approximately 61% of the votes cast voted in favor of our executive compensation as disclosed in our 2011 Proxy Statement. We realized that these results, while representing firm majority support for the named executive officer compensation, deviated significantly from those of the average of peer companies in 2011 and from what we would deem satisfactory. **We were disappointed in our vote result, recognized the need to better understand our investors' opinions, and initiated a review to gain further feedback** from key stakeholders on their perspectives of our executive compensation programs.

As a result of the review, we identified that shareholders and other key stakeholders wanted to see an enhanced link of pay and performance embedded in the design of our programs. **Consequently, the following actions were taken:**

> We significantly changed the architecture of the long-term incentive program – the largest component of compensation for our named executive officers

> We discontinued the use of cash-based long-term incentives that have been in place for over 60 years

> We introduced Performance Share Units ("PSUs") with payouts contingent on achievement of sales, earnings per share ("EPS"), and total shareholder return ("TSR") goal"

Marketing Via Your CD&A

Beyond addressing each of the specific issues listed above, perhaps the highest form of proactive disclosure is the concept of treating CD&A statements as a marketing document. Understandably, this can be a scary thought, and disclosures of this nature should be made with care.

While it probably still makes sense to have legal counsel manage the effort, opening up the CD&A drafting process to include groups beyond human resources, finance and legal is increasingly important. These days, CD&A reports at large companies can easily exceed 30 pages in length and are reviewed by large and influential audiences, ranging from Wall Street analysts to top journalists. As such, many CD&A reports – filled to the brim with boilerplate language recycled from year-to-year – are wasted opportunities. Thinking about your end reader and the key messages you would most like them to walk away with has never been more important. For example, companies can highlight the progress they are making to improve governance policies and talk about big wins for the overall business. Furthermore, there is less and less need to shy away from the steps you are taking to prudently address shareholder concerns.

The disclosure example on the following page from Oracle presents just one approach from the growing cadre of companies treating their CD&As as marketing documents.

__Radford Summary:__ Oracle's most recent proxy statement does a good job of bundling items across multiple fronts into a single compact list of shareholder-friendly actions. The company made the effort to clearly highlight its policies and practices, along with explanations of how and why those policies and practices are consistent with good governance and stockholder interests.

Oracle (DEF 14A – September 21, 2012)

"Other Compensation Highlights

We have implemented the following principal compensation policies and practices to ensure that our executive compensation program achieves our objectives consistent with sound corporate governance:

- **Stockholder Outreach by our Compensation and Governance Committees:** Members of the Compensation Committee and Governance Committee meet with certain of our institutional stockholders throughout the year to receive feedback regarding compensation and corporate governance matters. We believe we have established an effective means for stockholders to communicate with directors.
- **Low Dilution Rates from Stock Options:** We recognize that stock options dilute the holdings of our existing stockholders. Both the Compensation Committee and the Finance and Audit Committee review our long-term incentive and equity compensation programs regularly to ensure that we balance the goal of compensating and motivating our employees with our stockholders' interest in limiting dilution from equity awards. As of May 31, 2012, our cumulative potential dilution since June 1, 2009 has been a weighted average annualized rate of 1.7% per year, which was significantly lower than the rates of the companies in our peer group.
- **Compensation Recovery ("Clawback") Policy:** In July 2012, we adopted an interim clawback policy for our executive officers. The policy states that if Oracle restates its reported financial results, we will seek to recover or cancel any cash bonuses paid which were awarded as a result of achieving financial performance goals that would not have been met under the restated financial results.
- **Stock Ownership Guidelines:** We endeavor to closely align the interests of our senior executive officers with the interests of our stockholders through good and bad economic times. We amended our Stock Ownership Guidelines last year to increase the number of shares of Oracle common stock that senior executive officers must own. For details, please see "Other Factors in Setting Executive Compensation—Stock Ownership Guidelines" below.

We have not implemented the following practices because we do not believe they would serve our stockholders' long-term interests.

- **No Employment Agreements or Change-in-Control Agreements:** Each of our named executive officers is employed "at will." Further, none of our offer letters or any other agreements with our named executive officers provides for termination, severance or change-in-control payments or benefits (other than potential "double-trigger" acceleration of vesting of outstanding and unvested equity awards under our broad-based equity plan, which is a benefit provided to all employees who participate in the plan).
- **No Repricing of Underwater Stock Options:** When our stock price declines or stays flat, our named executive officers realize little or no benefit from their outstanding stock options. We do not reprice or exchange underwater stock options, and our stock option plan requires stockholder approval to reprice stock options. We believe this is appropriate because our stockholders also would not have benefited significantly from owning shares of Oracle common stock at such a time."

Next Steps

Although the compensation disclosure landscape is increasingly wide-open and opportunities for more proactive disclosures are abundant, we encourage clients to tread carefully before diving in. Real risks remain, particularly in

areas such as realizable pay and pay-for-performance, where standard approaches (either via the SEC or proxy advisory firms) do not yet exist.

As company performance levels or pay practices shift from year-to-year, disclosure choices or methodologies may become obsolete, less informative, or less company-friendly. As a result, companies are encouraged to take a long view toward disclosure options, and should move forward only in cases where proactive disclosures will remain viable and relevant for multiple years. For example, companies with long-standing leadership teams and highly consistent pay practices will likely have an easier time maintaining a consistent approach in cutting-edge disclosure areas.

To discuss potential disclosure approaches, please contact a member of our team at **consulting@radford.com**.

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