TAI
The Activist Investor

A Guide to Executive Compensation in the Dodd-Frank Act

The Dodd-Frank Act (DFA) contains a wide range of changes pertaining to executive compensation of US corporations. We divide all these provisions into three general areas:

1. Shareholder votes on exec comp
2. Other provisions, including disclosure, independence, and clawback provisions.
3. Investor disclosure of their exec comp votes

The SEC has promulgated draft regulations on the shareholder votes and investor disclosure areas, with final regulations expected later in 2010 or early in 2011.

Below we summarize the three areas, and provide links to details on each.

Shareholder Votes
DFA now requires US corporations to submit three compensation matters to a vote:

- **Compensation of the top five executives** ("say-on-pay"). The frequency of this vote will depend on the outcome of another vote (below).
- **Frequency of the say-on-pay vote** ("say-on-frequency"). Investors can choose a say-on-pay vote cycle of every one, two or three years. Companies must have a say-on-frequency vote at least every six years.
- **Employee termination agreements**, such as golden parachutes ("say-on-severance").

These three votes are non-binding on the company, though.

Click here for detail and a checklist for investors on these shareholder votes, and for guidance on evaluating a company's executive compensation plans.

Other Exec Comp Provisions
DFA also requires several new executive compensation disclosures beginning in 2011. These other provisions pertain to a wide range of items:

- New exec comp disclosures and analyses
- Independence requirements for BoD compensation committees and exec comp consultants
- Compensation clawback in the case of a financial restatement.

Click here for detail and a checklist for investors on these other exec comp provisions.

Disclosure of Exec Comp Votes
DFA now requires **most US asset managers to disclose how they vote** on the three matters

noted above. **If an asset manager files a Form 13F disclosure of their holdings, then they generally need to comply with this requirement.** This will work similarly to how mutual funds now disclose all shareholder votes, on Form N-PX, with the same timetable.

Click here for detail and a checklist for investors on shareholder disclosure of exec comp votes.

Compliance timetable
These requirements begin with votes that will take place on or January 21, 2011, and apply to shareholder meetings (annual and special meetings) beginning then. So, investors with portfolio companies whose fiscal year ends in the last quarter of 2010, and thus with annual meetings earlier in 2011, can expect to see proxy materials soliciting executive compensation votes in the next several weeks.

Asset managers (13F filers) will report votes annually. They report votes on Form N-PX for each July 1-June 30 period, with Form N-PX due on or before August 31. So, for 2011, they will report votes for period January 21-June 30, 2011 on or before August 31, 2011.

Shareholder Votes

DFA requires US corporations to submit three exec comp matters to a shareholder vote. These votes will take place at shareholder meetings (annual and special) that take place on or after January 21, 2011.

Exec Comp Vote (Say-on-Pay)
Shareholders will vote on the compensation of the named executive officers (NEOs) of the company.

4. The NEOs are the top five executives, including the CEO and CFO, and the next three most highly-compensated employees. Corporations already disclose extensive compensation information for them.
5. The vote is advisory, and thus does not obligate the company to respond to the outcome of the vote in any way.
6. The vote will take place every one, two or three years, depending on the outcome of the say-on-frequency vote (below).
7. The “pay” or compensation on which shareholders vote includes all tabular compensation information, narrative explanations of this information, and the compensation disclosure and analysis (CD&A), which corporations disclose in the proxy materials for annual and special meetings.

Frequency of Exec Comp Vote (Say-on-Frequency)
Shareholders will vote on the frequency of the say-on-pay vote.

- Shareholders will choose from among every one, two, or three years.
- Shareholders vote at least every six years.
- The vote is advisory, as with the say-on-pay vote.

Employee Severance Comp (Say-on-Parachutes)
Shareholders will vote on employee severance agreements of NEOs.

- Applies to votes on various transactions, such as merger, acquisition, consolidation, or asset sale.
- Corporation must disclose all severance-related comp agreements with NEOs, including present, deferred or contingent.
- When shareholders vote on the transaction, they will vote separately on severance comp.
- The vote is advisory, as with the say-on-pay vote.
- If shareholders voted previously on severance comp, typically as part of the annual say-on-pay vote, the corporation need not submit severance comp to the separate vote with the vote on the transaction.

Investors obviously should research exec comp before voting. Click here for guidance about how to evaluate company executive compensation plans.

Other Exec Comp Provisions

DFA changes a number of other elements of how companies disclose and police exec comp.

Disclosures
Corporations have three new disclosures:

CEO Pay Equity Disclosure: annual total compensation of the CEO, median annual total compensation of all the company's employees except the CEO, and the ratio between the two.

Pay-for-Performance Disclosure: the relationship between compensation paid to named executive officers and the company's financial performance. The disclosure may include a graphic representation of this relationship similar to that of the "performance graph" required in the annual report.

Hedging by Directors and Employees: whether the corporation allows any employee (or director) to purchase financial instruments (including derivatives such as prepaid vehicle forward contracts, equity swaps, collars and exchange funds) that the employee will use to hedge or offset any decrease in the market value of any equity securities granted by the corporation to the employee.

These new disclosures will appear in the annual proxy materials, in the compensation section.

Incentive Compensation Clawback Policy
Companies must implement and disclose policies to recoup incentive compensation from current and former NEOs that the company awarded:

8. based on erroneous data;
9. received by the NEOs in the three-year period preceding a financial restatement; and
10. in excess of what the company would have paid if calculated under the restated financial results.

The company does not need to prove NEO “misconduct” to claw-back the affected compensation. It merely needs to restate financial results. The SEC will enforce this provision through stock exchange listing requirements, so companies face delisting if they don’t comply

Independence Requirements
Corporations have two new independence standards, for the BoD Compensation Committee, and for compensation consultants.

Independence of Compensation Committee Members: All members of the Comp Committee will need to be independent.

- The SEC delegates to stock exchanges the specific independence standards.
- The standards must consider relevant factors, including the receipt of consulting or advisory ‘fees’ and ‘affiliate’ status.

Most observers expect the standard to resemble the current independence standards that exchanges impose on BoD audit committees. If so, directors who own 10% or more of the company’s shares cannot serve on the comp committee.

Independence for Compensation Committee Advisors: Comp consultants will also need to be independent. The SEC delegates to stock exchanges the specific independence standards, which must include:

- Other services that the consultant provides to the company
- Amount of fees that the company pays to the consultant
- Policies and procedures that seek to prevent conflicts of interest
- Business or personal relationships between comp committee members and the consultant; and
- Company stock that the consultant owns.

Companies must also disclose information about comp consultants in annual proxy materials:

- If the comp committee retained a consultant;
- If the consultant's work raised a conflict of interest; and
- If it raised a conflict, the nature of the conflict and how the company addressed it.

Again, because the SEC delegates these standards to stock exchanges, companies that fail to comply face delisting.

Disclosure of Shareholder Exec Comp Votes

DFA now requires many asset managers to disclose how it votes on the three exec comp matters subject to a vote: say-on-pay, say-on-frequency, and say-on-parachutes.

Who files: The requirement pertains to asset managers that file Form 13-F, which is of course the quarterly disclosure of a fund's individual holdings. Form 13-F filers in general have assets of at least $100 million.

Similar to mutual fund vote disclosure: This requirement works in essentially the same way as one that applies to institutional fund managers, mostly mutual funds. Since 2006 mutual fund managers have disclosed how they vote at all annual and special meetings, including on director elections, shareholder resolutions, appointment of auditors, and approval of equity issuance for incentive compensation plans.

Disclosure filing format: Fund managers will disclose votes on Form N-PX. Mutual funds already disclose all votes on Form N-PX, so they know this form well. The SEC has proposed some minor revisions to Form N-PX to reflect the new exec comp votes. So, mutual fund managers will continue to report all votes on Form N-PX, on all corporate matters. Asset managers that are not mutual funds, but which file Form 13-F, will report exec comp votes, again on Form N-PX.

Timetable: In general, asset managers file Form N-PX annually:

11. Form N-PX pertains to votes for the one-year period July 1-June 30.
12. Asset managers file Form N-PX by August 31 following that one-year period.
13. Seeing as shareholders will vote on exec comp starting at meetings that occur on or after January 21, 2011, the vote disclosure obligations begin then.
14. Asset managers will file Form N-PX for the January 21 – June 30, 2011 period, with that filing due by August 31, 2011.

For subsequent periods, asset managers will file Form N-PX for the July 1-June 30 period by August 31, so for July 1, 2011 - June 30, 2012, they will file Form N-PX by August 31, 2012.

How to Evaluate Exec Comp

Responsible investors will take the three votes (say-on-pay, say-on-frequency, and say-on-severance) seriously, even though they are non-binding. Asset managers may have clients that review how the fund votes, and in many cases (for Form 13F filers) will need to disclose publicly these votes in annual SEC filings.

So, how should a thoughtful portfolio manager evaluate compensation? Below we provide some guidance, in these sections: general principles, the typical components of exec comp, and questions to ask about exec comp.

General Principles

There are all sorts of frameworks for understanding and assessing exec comp. A particularly useful one comes from the Independent Directors Executive Compensation Project (IDEC), an initiative of over 40 directors, executives, academics, and other comp experts that The Delves Group helped to organize in 2009. IDEC advocates evaluating exec comp with respect to six principles:

15. Fairness
16. Accountability
17. Alignment
18. Transparency
19. Engagement
20. Objectivity

They elaborate on these principles here. The IDEC website also has numerous other resources for those interested in more detailed work on exec comp.

Exec Comp Components

While investors can refer to numerous exec comp frameworks, actual exec comp tends to fall into fairly standard areas.

Base salary: every executive of every company gets this, of course. Reported as an annual figure, it ranges from $1 for Steve Jobs at Apple to millions of dollars per year for many executives in the Fortune 500. Most observers think of base salary in terms of covering an employee's ongoing basic personal expenses.

Cash bonus: most every executive also receives some form of annual cash award. Companies typically use a formula for determining the minimum and maximum amount of cash bonus,

usually calculated as a multiple of base salary (i.e., 50% of base, 1.5x base). Companies frequently evaluate the formula, though, using subjective factors, such as “achieving personal goals” or something similar. A cash bonus rewards achieving individual goals more than company-wide financial results.

Long-term incentives: these include the whole range of equity and equity-like compensation, such as stock options, restricted stock, and many, many other similar plans. These seek to reward employees for the company’s financial results.

Perquisites and benefits: these sound exactly like what they are, additional things that companies provide to employees to attract and retain them. These include health benefit plans, pension and retirement plans, life and disability insurance, and all the other things that get publicity, such as automobile allowances, club memberships, and other stuff too numerous to list here.

Attentive investors will evaluate these components with respect to a set of principles, such as the IDEC principles. Well-run and governed companies also do other things:

- The more senior the executive, the more long-term compensation (and less cash) they receive.
- Set long-term compensation to reflect ambitious goals that make executives think and act more like investors.
- Use investor-oriented goals, such as cash flow returns or return on investment, and not conventional accounting goals such as EPS or EBITDA.
- Limit perquisites and benefits.
- Disclose all this in elaborate detail.

In general, investors should evaluate ***how*** the company pays its executives (compensation structure and goals), in addition to ***how much***.

Questions to ask about Exec Comp

Base Salary

- Why does any NEO have a base salary in excess of $1,000,000?
- What is the ratio (and relationship) between NEO base salary and cash bonus opportunity?

Cash Bonus

- How does the cash bonus link to individual, group, and company performance?
- How does the cash bonus align with the company’s short-, mid-and long-term strategy and objectives?
- Do the specific performance goals and metrics match the strategy and objectives?

- How can the cash bonus payout vary (e.g. threshold, target, maximum/caps)?
- How much of the cash bonus is guaranteed?
- How much discretion does the company have in determining the cash bonus based on non-financial measures?
- How does the minimum and maximum relate to the threshold and expected bonus, and are they balanced so that NEOs have similar opportunities to earn the minimum and maximum?
- How does the cash bonus vest following the performance period? Fully and immediately, or with accrual over time?

Long-Term Incentives

- Does long-term incentive comp depend on performance or merely on years served?
- If performance-based, do the performance metrics correspond to the company's relevant economic value drivers?
- What specific vehicles (stock options, restricted stock, etc.) does the company use, and do they serve both the NEOs' and company's objectives (retaining talent, tax effective, etc.)
- Do the long-term incentives promote appropriate NEO risk-taking?

Exec Comp Checklist for Investors

1. **Determine if you need to report exec comp votes,** in general because you file Form 13-F.
2. Identify an **exec comp framework** that you will use to evaluate each company's exec comp plan.
3. For investors that use a proxy advisor, assure that the **proxy advisor will evaluate exec comp** for your portfolio companies
4. Create a process for **filing Form N-PX.**
5. For each portfolio company, **identify any relevant exec comp benchmarks and databases** you want to consider in evaluating NEO comp.
6. **Allow sufficient time** to review a portfolio company's proxy materials, value equity compensation plans, review proxy advisor recommendations, and compare plans to benchmarks.
7. Decide your **vote on all compensation issues**, which in 2011 will include say-on-pay and say-on-frequency.
8. **Record your vote** in the same way that you vote on other annual meeting agenda items, including director elections, shareholder resolutions, and other corporate matters.
9. For investors that report exec comp votes, **record votes on Form N-PX** pursuant to your filing process.

We've worked extensively with The Delves Group, a leading independent executive compensation and corporate governance consulting firm based in Chicago, on this guide.

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