Executive remuneration is an issue which attracts the considerable focus in many parts of the world by investors, regulators, the analytical community and others. It can also be quite an emotive issue.

The article by Brendan Sheehan which follows summarises the key areas of focus within the wider debate on executive remuneration in the United States. Beyond the specific facts in the article, we are reminded of the underlying importance of several of the core concepts of good governance, including the importance of transparency, the availability of timely and accurate information, the ability of stakeholders to readily understand remuneration models and practices free of unnecessary complexity and the key role played by good communication between various stakeholders.

The article touches on further issues, which are also relevant in Australia — the broader governance aims of ensuring that executive remuneration outcomes are linked to long-enough time periods and to formulae which best represent the interests of the shareholders concerned.

I hope you find the article interesting and useful.

Peter Turnbull FCIS
International Representative

The shifting sands of US remuneration practices

By Brendan Sheehan, Principal, Global Governance Advisors

Setting, managing and communicating executive pay has never been more sensitive. Thanks to a slew of regulatory changes, shareholders have greater access to corporate pay information than ever before. With this great transparency comes significant challenges — legal, financial and strategic.

Compensation committees and the HR director balance the interests of key stakeholders and reach pay arrangements that stand up to close scrutiny from shareholders, regulators and others. Satisfying shareholders, motivating employees and retaining and attracting future talent is made all the more complicated when done under the intense focus of the public eye and, often, the plaintiff's bar.

2013, like the year before, was an eventful year for US executive remuneration. Of particular interest was the continued evolution of disclosure requirements, predominantly focused on the annual proxy statement. Further, a more sophisticated approach to say-on-pay voting and a wave of compensation-related lawsuits and plaintiffs' law firm 'investigations' has driven most US companies to shift their pay structures to create a stronger and more obvious alignment between pay and performance.

Accordingly, many companies are taking steps to evaluate how they are compensating executives for actual (achieved) performance. These evaluations can take many different forms but most often companies are measuring performance based on a comparison to an external benchmark, typically the self-defined peer benchmarking group as defined in the proxy statement.

This approach to measuring and rewarding achieved performance makes sense and is easily understood by most participants in the market. The challenge, however, is to ensure that remuneration policies and structures are not just effective at rewarding past performance but also effective in driving future performance through motivating executives and other employees to take actions that are in line with the corporate strategy both currently and in the future.

In some ways the setting of pay to reflect (or to preferably drive) performance is the easy part. It is the measuring of performance, both short- and long-term, that usually proves the complicated and contentious part of the compensation conversation.

But let's focus on what companies are actually doing and what pay trends are likely to emerge in the coming year.

Say on pay gains support

Looking at voting results for 2013, the first thing to note is that say-on-pay became mandatory for a much wider number of companies as smaller companies that had previously been

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exempt fell under the mandate. Overall, companies received a slightly higher level of support for pay practices than in 2012. This is true both for those companies that secured high levels of support in the previous year and also for those that 'failed' or received lower levels of support. The data, while still preliminary, shows that companies that secured 50 per cent to 70 per cent of the vote in 2012 have seen an increase in support of almost 20 per cent. The vast majority of companies achieved 90 per cent or greater support and interestingly, 40 companies that failed to get more than 50 per cent in 2012 have reversed the result in 2013.

This is an indication of two things.

First, some companies have responded to negative votes by altering their approach to compensation and implemented changes to pay structures. In many cases the changes may not have been those specifically sought by shareholders, but the mere fact changes were made is an indication of board engagement and oversight.

This links to the second reason for the increase in support — companies in general are doing a much better job of 'telling their compensation story' and relating remuneration strategy to overall corporate strategy and achieved performance. Pay for performance is the key element to pay disclosure and the root cause of activism in the field. Thus the increased engagement has allowed companies to address issues that may have previously resulted in a negative vote.

It is clear that fewer companies have failed their say-on-pay votes in 2013, although this may be an anomaly since many investors will not have had adequate time to have evaluated the pay practices of the 2,000 or so smaller companies that are now subject to the vote. There is a real possibility that 'failure' rates will increase in 2014 as these smaller firms tend to have less sophisticated approaches to pay design and have far smaller vote solicitation budgets. Support for pay practices at larger companies is likely to continue to increase.

Performance takes centre stage

There have been some material changes to the way companies are remunerating their senior executives. The most significant change has been a significant shift to performance-based equity pay. Most CEOs now receive a majority of compensation as part of short- or long-term performance packages. This was not the case only a couple years ago. Approximately 75 per cent of companies reviewed their pay for performance metrics in the past 12 months and many have altered metrics following the review.

One shift that is worth mentioning is the transition many leading companies have made to measuring pay for performance over a three-year period and using grant-date valuation of the long-term incentive plan in the definition of remuneration. The most common metric for measuring performance is total shareholder return (TSR). This mirrors the attitude of major institutional investors, which are asking companies to take a longer term view of pay and performance metrics. However, this does not shield companies from the media attention and accusations of 'pay for failure' that are based on short-term annual share price movements. Some activist investors and proxy advisory groups will use short-term share price fluctuations to make a public point against companies they are targeting. The broad shift to a three-year rolling TSR will likely allow companies to combat this with some effectiveness in 2014 and beyond.

The plaintiff's bar comes to the party

Before the Dodd-Frank Act of 2010, remuneration-related litigation was relatively rare. Since enacted, that has all changed and in the past few years shareholder litigation has steadily increased. This trend was no different in 2013. The jury is out on whether this trend will continue in 2014. One thing that is certain is that the type of suits being filed will be likely to see some considerable changes.

Early on, the remuneration-related lawsuits were mostly shareholder derivative suits accusing board directors of a breach in fiduciary duties when the company failed a say-on-pay vote but the board approved the pay package regardless. There were 22 of these suits and all bar four of them were dismissed by the courts. The four that were not dismissed were settled out of court.

Next came a spate of spurious class actions seeking to enjoin the target company's annual meeting on the grounds that it had not provided sufficient information in the proxy statement for shareholders to make an informed decision on compensation votes. These suits quickly became seen as nuisance suits and only one was successful in its aim of enjoining the meeting. Three were settled, most were dismissed outright and a handful resulted in the company making additional disclosures prior to the meeting — usually at significant expense to the company. It is worth noting that the majority of these suits were brought in a district court in California because it is widely acknowledged that any such suit brought in Delaware would be doomed to failure. Delaware is the legal home of 86 per cent of listed companies in the US and is regarded as the most 'corporate friendly' jurisdiction in the US. While some 'investigations' are said to be under way with a view to bringing such suits in the future it is unlikely

many actions will take place in 2014 given the low probability of success.

One new type of suit — also targeting the enjoining of the meeting — may appear in 2014. These actions will focus on a common management proposal to adopt or increase the number of shares reserved under equity compensations plans. Again, the validity of these suits is questionable but the major difference is that, unlike say on pay, these votes are binding and thus provide settlement leverage for the plaintiff.

Independence on the rise

Finally, the US Securities and Exchange Commission (SEC) approved the NYSE and Nasdaq proposed listing standards relating to independence requirements for compensation committee members and the selection of their advisers that took effect in July 2013. In short, there are now strict rules governing who may sit on the compensation committee. All members must be independent and both NYSE and Nasdaq listing standards set forth guidance regarding the receipt of payment for compensation committee members. The committee must also provide disclosure about the independence of any compensation consultants they use. The criteria from independence are defined in Rule 10C-1 and the Exchange Act of 1934.

Looking ahead, it is likely that companies will continue to evolve their views on the elements of their remuneration structures. Issues that are likely to attract particular attention from shareholders in 2014 will be the treatment of disclosures explaining realised versus realisable pay, relative performance vesting of equity shares (which the Federal Reserve is not a fan of) and further simplification of performance metrics in the equity plan.

The year ahead will be another challenging one and companies will need to ensure they understand the finer points of the compensation structure and strategy and, just as importantly, are able to clearly and accurately explain it to the public, the regulators and the shareholders.

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