CAPflash
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2014 Proxy Season: Changing Practices in Executive Compensation: Clawback, Hedging and Pledging Policies

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HIGHLIGHTS

- **Nearly all companies (94%) have adopted a clawback policy, even without SEC guidance on Dodd Frank requirements for clawbacks**
- **Consistent with our past findings, the most common forms of compensation that are potentially subject to recoupment are prior year's cash and stock incentives**
- **Hedging policies are in place at most companies, with 95% disclosing a hedging policy (vs. 91% in 2013)**
- **Pledging policies can vary in scope as companies, but 63% of companies have a policy of some type in place**
- **Some companies ban all pledging (68%), while others require advance approval for pledged shares (20%) or only prohibit pledging of shares subject to stock ownership guidelines (12%)**

CLAWBACKS

Although companies are still waiting for SEC guidance on Dodd Frank, many have already implemented clawback policies on their own. Dodd Frank requires a broader definition of clawback compared to Section 304 of SOX, which applies to CEOs and CFOs.

Similar to our findings last year, 94% of companies we studied have some form of clawback policy, compared to 86% and 80% in 2011 and 2010, respectively. Because the majority of companies have now adopted robust clawback policies, the number of changes made in 2013 as compared to prior years has decreased. In 2013, there were no companies that adopted a new clawback policy, while only 7 modified existing provisions. The most common changes made were to expand the compensation subject to clawbacks and expand the triggers for clawbacks beyond financial restatements.

As in prior years, a financial restatement (87%) and misconduct (77%) are the most common triggers for a clawback. For the first time in our study, fraud (50%) will trigger a clawback for a majority of the companies analyzed.

Under nearly all policies, it is most common for companies to include the ability to recoup compensation previously granted. Some companies will also have clawback provisions in place that allow them to either adjust the amounts of future incentive compensation given or cancel any outstanding performance-based stock or cash awards.

SURVEY SAMPLE

Compensation Advisory Partners ("CAP") reviewed 2014 proxy disclosures at a sample of 100 companies among the Fortune 500 representing nine industry groups. Industry groups included: Automotive, Consumer Goods, Financial Services, Health Care, Insurance, Manufacturing, Pharmaceutical, Retail, and Technology. For the companies studied, the median revenue size and market capitalization was $32B and $52B, respectively. The median 2013 total shareholder return (TSR // change in stock price plus dividends) was 43%.

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COMPENSATION SUBJECT TO CLAWBACK	2013 NO. OF COS.	% OF COS. N=94	2012 NO. OF COS.	% OF COS. N=94	2011 NO. OF COS.	% OF COS. N=98	2010 NO. OF COS.	% OF COS. N=89
Prior LTI	**91**	98%	**88**	95%	**95**	97%	**79**	89%
Prior Annual Incentive	**89**	96%	**86**	92%	**92**	94%	**81**	91%
Future Annual Incentive	**20**	22%	**19**	20%	**16**	16%	**20**	22%
Future LTI	**21**	23%	**18**	19%	**15**	15%	**14**	16%

Note: Percentages add up to greater than 100% due to multiple responses

Coverage extends to all NEOs in 97% of companies, which is higher than our findings in 2010, 2011, and 2012. Interestingly, many companies extend coverage beyond the NEO level, with 50% of companies having clawback policies in place for all Section 16 officers. Companies are not required to disclose the level of program detail in the proxy, but we expect most program provisions are more broad-based.

Similar to our findings in prior years, less than a quarter of companies indicate the length of the look-back period during which compensation can be recovered. Of the 21 companies that disclosed a time frame, the most common is 1 year (52% of companies) from date of restatement, followed by 3 years (38% of companies).

As we wait for the SEC to propose final rules, there are several practical challenges to clawing back compensation, such as how to clawback equity gains, how to claw back from former employees and the tax implications of clawbacks.

HEDGING AND PLEDGING

With increasing scrutiny from shareholder services such as ISS, hedging and pledging policies have become more significant governance / shareholder issues. ISS has taken the stance that any hedging and significant pledging by insiders to be indicative of a potential failure of risk oversight on behalf of a company's Board. The Board's policy regarding these practices is most commonly reflected in the company's insider trading policy, but it can be addressed through Board resolutions or a stand-alone policy.

Hedging is viewed as a poor practice as it insulates executives from stock price movement and reduces alignment with shareholders. Pledging, in modest amounts, may not be viewed as negatively, yet can become problematic if there were a significant decline in stock price which necessitated a sale of shares from a senior executive. Given the potential negative perception of insider hedging and pledging, as well as the pending Dodd Frank guidance, companies have begun to adopt policies to limit these provisions. Anti-hedging and pledging policies are in place at 95% and 63% of companies studied, respectively; 63% of companies have both policies in place and 32% only have a hedging policy.

HEDGING / PLEDGING POLICIES	2013 NO. OF COS.	% OF COS. N=100	2012 NO. OF COS.	% OF COS. N=100
Hedging Policy	**95**	95%	**91**	91%
Pledging Policy	**63**	63%	**59**	59%
Both	**63**	63%	**59**	59%
Hedging Only	**32**	32%	**42**	42%

Note: Percentages add up to greater than 100% due to multiple responses

An example of typical disclosure of a prohibition on hedging/pledging is reflected in 3M's proxy disclosure:

"The Company's stock trading policies prohibit directors and the Company's executive officers from (i) purchasing any financial instrument that is designed to hedge or offset any decrease in the market value of the Company's common stock, including prepaid variable forward contracts, equity swaps, collars and exchange funds; (ii) engaging in short sales related to the Company's common stock; (iii) placing standing orders; (iv) maintaining margin accounts; and (v) pledging 3M securities as collateral for a loan."

Our analysis of pledging policies was broken down further to show that there are variations to prohibit pledging. A company can ban all pledging (68% of companies with anti-pledging policies), prohibit pledging of shares unless an employee receives advance approval (20%) or prohibit any shares subject to stock ownership guidelines to be pledged (12%).

An example of the latter two anti-pledging policies can be found in Best Buy and ACE's proxy statements, respectively:

Best Buy: "…*our executive officers and Board members are prohibited from holding Company securities in a margin account or pledging Company securities as collateral for a loan, unless approved in advance by the Compensation Committee."*

ACE: *"The Company prohibits NEOs from pledging shares that are held in satisfaction of the share ownership guidelines."*

Pledging was not addressed in Dodd-Frank per se, and we do not know what the SEC's position will be in the future. We do however expect more companies to adopt pledging policies going forward given ISS' 2012 policy statement that identified pledging of company stock by executives as a poor practice.

CONCLUSIONS

We continue to see companies stay ahead of the curve and track "best practices" in order to satisfy shareholders and proxy advisory firms. This results in reevaluations of company pay and governance practices, and as our research shows, continued modification of clawback policies, and adoption of hedging and pledging policies. While formal guidelines have not been given to date, companies are adopting these policies as good governance, regardless of any final SEC guidance.