Shareholders Defeat Mandatory Deferral Proposal

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Background

Many large U.S. based multinational banking and financial services corporations have implemented executive compensation clawback policies that require the cancellation and forfeiture of unvested deferred cash awards or performance share unit awards. These policies typically condition the cancellation of deferred compensation if it is determined that an executive engaged in misconduct, including failure to supervise or monitor individuals engaging in inappropriate behaviors that caused harm to the organization's operations. Policies also apply to unvested deferred awards that could be vested and paid based on inaccurate financial statements. Most of the clawback policies have been implemented in response to the Dodd-Frank financial legislation of 2010 that requires public companies to adopt clawback policies to protect shareholder interests. The Securities and Exchange Commission is expected to release final guidance with respect to clawbacks later this year.

In one situation that has received media attention, a proposal was placed before shareholders in the proxy leading up to the company's annual meeting regarding a stringent policy of mandatory deferral of executive compensation and potential forfeiture in the event of financial misstatement or material wrongdoing. The proposal was submitted by a nonprofit, nonpartisan public advocacy organization to request the Board of Directors to revise the design of the current executive compensation program "to provide that a substantial portion of annual total compensation of Executive Officers, identified by the board, shall be deferred and be forfeited in part or in whole, at the discretion of Board, to help satisfy any monetary penalty

Key Takeaways

- *Shareholders of a large financial services institution were subject to an advisory vote on an unusual mandatory deferral proposal from a financial policy advocate during the most recent proxy season.*
- *The terms of the proposal include a requirement that executives be required to defer a percentage of earned incentive compensation for a period of 10 years, and that the executives would forfeit such deferred funds if the organization incurred a financial penalty for any violation of applicable law during the deferral period.*
- *An unusual provision of the proposal was the required forfeiture of deferred funds even if such executives were not individually responsible for the misconduct during the deferral period.*
- *Many institutions have previously established clawback policies that require the cancellation and forfeiture of any unvested deferred cash awards or performance share unit awards.*
- *Research of the 50 largest financial institutions and 100 largest public companies shows that very few organizations require a mandatory deferral of incentive compensation awards subject to harsh forfeiture provisions.*

associated with any violation of law regardless of any determined responsibility by any individual officer; and that this annual deferred compensation be paid to the officers no sooner than 10 years after the absence of any monetary penalty; and that any forfeiture and relevant circumstances be reported to shareholders." In support of the proposal, the shareholder cited prior settlements regarding the bank's conduct in the issuance of residential mortgage-backed securities prior to January 2009.

Two aspects with respect to this particular proposal that depart from normal practice are the time frame associated with the deferral pool and the conditions for potential forfeiture of deferred compensation (clawbacks). The proposal requires that executives keep their deferred compensation in the pool for a minimum of 10 years, and that their deferred funds could be forfeited and returned to shareholders even if such executives were not guilty of misconduct while such compensation was deferred.

Current Program Design and Competitive Practice

With respect to current market practice, such mandatory deferrals of annual incentive payments are currently a minority practice, even among the largest and most prominent organizations. Of the 50 largest financial services institutions in the U.S., only seven (14%) require mandatory deferrals. This practice is even less prevalent in general industry – for example, only four companies (all of which are either banking or insurance organizations) out of the Fortune 100 (4%) reported such a practice. Most of the aforementioned companies require only a portion of earned annual incentives to be deferred. This portion is often expressed as a fixed percentage of earned amounts, or a fixed percentage of the incremental payouts above a certain dollar amount. Deferral periods also range from one to four years, with three years being the most common. Further, it is atypical for the deferred amounts to be subject to additional performance hurdles during the deferral period – only one company reported such requirements.

Rather than instituting mandatory deferrals, we are finding selected institutions implementing several practices that strengthen the alignment of pay and performance that result in performance periods for equity awards that are longer than typical practice, and performance scorecards that are broader. Annual incentive compensation may be split between cash and deferred stock that vests over a three- to four-year period, and may be coupled with a backward-looking reduction in shares vesting if pre-tax losses are incurred.

Our Perspective and Conclusion

It is our view that this shareholder proposal was extreme because of its 10-year deferral period and failed to recognize the prevalence of policies most companies have in place to return unearned compensation to shareholders as well as protect long-term shareholder interests. Most large public companies have already implemented clawback policies. As soon as the SEC releases its final guidance on clawbacks, all public companies will be required to implement such policies. Other shareholder protection mechanisms such as stock ownership guidelines are in place at the majority of companies. Competitive practice data show that mandatory deferrals of annual incentives are not a popular element of current compensation program design and not meaningful. Our judgment is that this proposal should be considered redundant and not necessary in the current governance arena.

The proposal is an advisory vote and nonbinding to this institution, and 95 percent of shareholders voted to defeat the proposal.

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