

TELECOM ITALIA S P A
Form 6-K
October 03, 2016
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 6-K

REPORT OF FOREIGN PRIVATE ISSUER
PURSUANT TO RULE 13a-16 OR 15D-16
UNDER THE SECURITIES EXCHANGE ACT OF 1934
FOR THE MONTH OF OCTOBER 2016

TELECOM ITALIA S.p.A.
(Translation of registrant's name into English)

Via Gaetano Negri 1
20123 Milan, Italy
(Address of principal executive offices)

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Indicate by check mark whether the registrant files or will file annual reports under cover of Form 20-F or Form 40-F:

FORM 20-F FORM 40-F

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(1):

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(7):

Indicate by check mark whether by furnishing the information contained in this Form, the registrant is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

YES NO

If Yes is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b): 82-

Table of Contents

HALF-YEAR FINANCIAL

REPORT AT

JUNE 30, 2016

Table of Contents

CONTENTS

INTERIM MANAGEMENT REPORT AT JUNE 30, 2016	
<u>The Telecom Italia Group</u>	3
<u>Highlights – Half-Year 2016</u>	5
<u>Consolidated Operating Performance</u>	8
<u>Financial and Operating Highlights – The Business Units of the Telecom Italia Group</u>	14
<u>Discontinued operations/Non-current assets held for sale</u>	23
<u>Consolidated Financial Position and Cash Flows Performance</u>	24
<u>Consolidated Financial Statements – Telecom Italia Group</u>	32
<u>Events Subsequent to June 30, 2016</u>	40
<u>Business Outlook for the Year 2016</u>	40
<u>Main risks and uncertainties</u>	42
<u>Main changes in the regulatory framework</u>	45
<u>Corporate Boards at June 30, 2016</u>	48
<u>Macro-Organization Chart at June 30, 2016</u>	50
<u>Information for Investors</u>	51
<u>Related Party Transactions</u>	53
<u>Alternative Performance Measures</u>	54
<u>Sustainability section</u>	56
<u>Digitization, connectivity and social innovation</u>	56
<u>Research and development</u>	57
<u>Environmental protection</u>	60
<u>Digital culture</u>	61
<u>Telecom Italia people</u>	62
<u>The commitment of Fondazione TIM</u>	71
<u>TELECOM ITALIA GROUP HALF-YEAR CONDENSED CONSOLIDATED FINANCIAL STATEMENTS AT JUNE 30, 2016</u>	74
<u>Contents</u>	75
<u>Consolidated Statements of Financial Position</u>	76
<u>Separate Consolidated Income Statements</u>	78
<u>Consolidated Statements of Comprehensive Income</u>	79
<u>Consolidated Statements of Changes in Equity</u>	80
<u>Consolidated Statements of Cash Flows</u>	81
<u>Notes to the Consolidated Financial Statements</u>	83
<u>Certification of the half-year condensed consolidated financial statements at June 30, 2016 pursuant to Article 81-ter of the Consob Regulation 11971 dated May 14, 1999, with amendments and additions</u>	169
<u>Auditors – Review Report on Consolidated Condensed Interim Financial Statements</u>	170
<u>USEFUL INFORMATION</u>	170

This document has been translated into English solely for the convenience of the readers. In the event of discrepancy, the Italian language prevails.

Table of Contents

THE TELECOM ITALIA GROUP

THE BUSINESS UNITS

DOMESTIC

The Domestic Business Unit operates as the consolidated market leader in the sphere of voice and data services on fixed and mobile networks for final retail customers and other wholesale operators.

CORE DOMESTIC

Consumer

In the international field, the Business Unit develops fiber optic networks for wholesale customers (in Europe, in the Mediterranean and in South America).

Business

Wholesale

Other (INWIT S.p.A. and support structures)

Olivetti, which is now part of the Business segment of Core Domestic, operates in the area of office products and services for Information Technology.

INTERNATIONAL WHOLESALE

Telecom Italia Sparkle group

INWIT S.p.A. operates in the electronic communications infrastructure sector, specifically relating to infrastructure for housing radio transmission equipment for mobile telephone networks, both for Telecom Italia and other operators.

Telecom Italia Sparkle S.p.A.

Lan Med Nautilus group

BRAZIL

The Brazil Business Unit (Tim Brasil group) provides services in the area of UMTS, GSM and LTE

Tim Brasil Serviços e Participações S.A.

technologies. Moreover, with the acquisitions and subsequent integrations into the group of Intelig Telecomunicações, Tim Fiber RJ and Tim Fiber SP, the services portfolio has been extended by offering fiber optic data transmission using full IP technology such as DWDM and MPLS and by offering residential broadband services.

Tim Participações S.A.

Intelig Telecomunicações Ltda

Tim Celular S.A.

Interim Management Report

The Telecom Italia Group 3

at June 30, 2016

Table of Contents

BOARD OF DIRECTORS

Chairman	Giuseppe Recchi
Deputy Chairman	Arnaud Roy de Puyfontaine
Chief Executive Officer	Flavio Cattaneo
Directors	Tarak Ben Ammar
	Davide Benello (independent)
	Lucia Calvosa (independent)
	Laura Cioli (independent)
	Francesca Cornelli (independent)
	Jean Paul Fitoussi
	Giorgina Gallo (independent)
	Félicité Herzog (independent)
	Denise Kingsmill (independent)
	Luca Marzotto (independent)
	Hervé Philippe
	Stéphane Roussel
	Giorgio Valerio (independent)
Secretary to the Board	Antonino Cusimano

BOARD OF STATUTORY AUDITORS

Chairman	Roberto Capone
Acting Auditors	Vincenzo Cariello Paola Maiorana Gianluca Ponzellini Ugo Rock
Alternate Auditors	Francesco Di Carlo Gabriella Chersicla

Piera Vitali
Riccardo Schioppo

Interim Management Report
at June 30, 2016

Board of Directors and Board of Statutory Auditors 4
of Telecom Italia S.p.A.

Table of Contents

HIGHLIGHTS HALF-YEAR 2016

The second quarter of 2016 saw the revision and acceleration of the Cost Recovery Plan, relating to the Domestic Business Unit, and already envisaged in the 2016-2018 Strategic Plan, aimed at improving efficiency and business performance and providing the Company greater operating and financial flexibility. This plan is based on a significant change in approach to controlling costs, simplifying and transforming all the processes and production sectors, and optimizing sourcing policies, through continuously monitored programs and action plans. Specifically, the efficiency savings, totaling 1.6 billion euros in the three-year period, will be achieved in terms of operating costs, by:

optimizing purchasing and advertising costs, while maintaining the same level of purchasing performance, quality, presence and visibility in the media;

increasing productivity and simplifying the network and IT platforms;

simplifying the organization and the processes through digitization and by encouraging the use of automation tools, with the reassignment of personnel to insource activities that have been outsourced;

containing energy, support and lease expenditure, by optimizing spaces and implementing a zero based budget approach;

reducing labor costs, also by reviewing rewarding policies.

The efficiency savings on capital expenditure, while maintaining the levels of Ultra BroadBand coverage and the quality of the service, will be achieved by simplifying the network architectures to optimize the expenditure through targeted allocation based on return on investment.

The effects of this plan were already seen in the second quarter of 2016, and will strengthen in the second half of 2016, to then continue over the entire duration of the 2016-2018 Plan.

On July 25, 2016 the Tim Brasil group announced that it had updated its 2016-2018 Industrial Plan, which has set an efficiency savings target, expressed in terms of the reduction in cash costs by 2018 compared to 2015, of 1.5 billion reais (of which 0.6 billion reais of lower operating expenses and 0.9 billion reais of lower capital expenditures), an improvement of 1.6 billion reais compared to the old plan. An overall reduction of the cash costs is envisaged within the three-year plan period, which differs from the previous plan and amounts to 4.5 billion reais (of which 3.4 billion reais of lower operating expenses and 1.1 billion reais of lower capital expenditures). The main efficiency improvement actions will involve organizational adaptation, improving E2E processes and systems, and digitizing a number of commercial processes. In terms of the offering, the focus will continue on the Mobile segment, supported by innovative and differentiated offerings, and by the enhancement of mobile broadband coverage.

In the first half of 2016 and 2015, the Telecom Italia Group recognized non-recurring operating expenses connected to events and transactions that by their nature do not occur continuously in the normal course of operations and have been shown because their amount is significant. They include expenses resulting from corporate restructuring and reorganization processes, expenses resulting from regulatory disputes and penalties and the liabilities related to those

expenses, expenses for disputes with former employees, and liabilities with customers and/or suppliers.

The impacts of the following non-recurring income/expenses on the main lines of result are detailed below.

Interim Management Report

Highlights Half-Year 2016 5

at June 30, 2016

Table of Contents

(millions of euros)	1st half 2016	1st half 2015
Employee benefits expenses		
Expenses related to restructuring and rationalization	(75)	(30)
Sundry expenses and provisions		
Expenses related to disputes and regulatory penalties and liabilities related to those expenses, and expenses related to disputes with former employees and liabilities with customers and/or suppliers	(16)	(369)
Impact on EBITDA	(91)	(399)
Gain from Brazil Towers disposal	9	277
Impact on EBIT	(82)	(122)

Lastly, you are reminded that on March 8, 2016 the sale was completed of the controlling interest still held in the Sofora Telecom Argentina Group, classified under Discontinued Operations.

FINANCIAL HIGHLIGHTS

In terms of equity and income, for the first half of 2016:

Consolidated revenues amounted to 9.1 billion euros, down by 9.9% on the first half of 2015 (-4.9% in organic terms).

EBITDA amounted to 3.7 billion euros, up by 2.4% on the first half of 2015 (+7.0% in organic terms). The organic EBITDA margin stood at 41.0%, 4.6 percentage points higher than the corresponding period of the previous year. EBITDA in the first half of 2016 was pulled lower by a total of 91 million euros in non-recurring expenses (399 million euros in the first half of 2015), without which the organic change in EBITDA would have been -1.7%, with an EBITDA margin of 42.0%, up 1.4 percentage points compared to the first half of 2015. EBITDA amounted to 2 billion euros in the second quarter of 2016, up 25.4% on the second quarter of 2015 and 17.6% on the first quarter of 2016.

Operating profit (EBIT) came to 1.7 billion euros, down 5.6% compared to the first half of 2015 (+0.7% in organic terms), pulled down by non-recurring net expenses of 82 million euros (122 million euros in the first half of 2015), without which the organic change in EBIT would have been -1.6%, with an EBIT margin of 19.4%, up 0.6 percentage points on the first half of 2015.

The profit for the period attributable to Owners of the Parent amounted to 1 billion euros (33 million euros in the first half of 2015).

Capital expenditures in the first half of 2016 amounted to 1,983 million euros (2,146 million euros in the first half of 2015). The efficiency program for capital expenditures, which will significantly improve the effectiveness of the capital expenditures for maintaining the levels of UBB coverage and the quality of the service, was launched in the second quarter. In domestic market, the capital expenditure program for developing next-generation network (NGN) infrastructure enabled the fiber-optic coverage to reach 51% of the population, while the 4G (LTE) network now covers 94% of the population.

Adjusted net financial debt amounted to 27,514 million euros at June 30, 2016, up 236 million euros compared to December 31, 2015 (27,278 million euros). In the first half of 2016, the benefits from the completion of the sale of the Sofora Telecom Argentina group with the receipt of the sale proceeds and the consequent deconsolidation of the relative net financial debt, together with the cash inflow from business operations, only partially offset the cash requirements arising from financial operations, the payment of dividends and the effect of several disputes, the payment of regulatory penalties, the real estate project and the renegotiation of lease contracts. The level of debt was also negatively affected by the exchange rate fluctuation of the Brazilian real.

Interim Management Report

Highlights Half-Year 2016 6

at June 30, 2016

Table of Contents

Financial highlights (*)

(millions of euros)		2nd Quarter 2016	2nd Quarter 2015	1st Half 2016 (a)	1st Half 2015 (b)	% Change Reported (a/b)	Organic
Revenues		4,656	5,047	9,096	10,101	(9.9)	(4.9)
EBITDA	(1)	2,014	1,606	3,726	3,639	2.4	7.0
<i>EBITDA Margin</i>		43.3%	31.8%	41.0%	36.0%	5.0pp	
<i>Organic EBITDA Margin</i>		43.3%	31.9%	41.0%	36.4%	4.6pp	
EBIT	(1)	983	807	1,687	1,788	(5.6)	0.7
<i>EBIT Margin</i>		21.1%	16.0%	18.5%	17.7%	0.8pp	
<i>Organic EBIT Margin</i>		21.1%	15.1%	18.5%	17.5%	1.0pp	
Profit (loss) from Discontinued operations/Non-current assets held for sale			161	47	330	(85.8)	
Profit (loss) for the period attributable to owners of the Parent		585	(49)	1,018	33		
Capital expenditures (CAPEX)		1,039	1,182	1,983	2,146	(7.6)	
Adjusted net financial debt	(1)			6/30/2016 27,514	12/31/2015 27,278	Change Amount	236

(*) Within the Brazil Business Unit, Management recently identified that incorrect accounting entries were made in prior years in connection with the recognition of service revenues from the sale of prepaid traffic. Such incorrect accounting entries, which did not have any impact either in terms of net financial position nor on cash and cash equivalents, resulted in the early recognition of revenues with respect to prepaid traffic not yet consumed. The comparative financial information as of December 31, 2015 and for the six-month period ended June 30, 2015, have been therefore revised, with no material impact.

(1) Details are provided under Alternative Performance Measures .

at June 30, 2016

Table of Contents

CONSOLIDATED OPERATING PERFORMANCE

REVENUES

Revenues amounted to 9,096 million euros in the first half of 2016, down 9.9% from 10,101 million euros in the first half of 2015. The decrease of 1,005 million euros was mainly attributable to the Brazil Business Unit (833 million euros) and the Domestic Business Unit (128 million euros).

In terms of organic change, consolidated revenues fell by 4.9% (-472 million euros), and were calculated as follows:

(millions of euros)	1st Half 2016	1st Half 2015	Change	
			amount	%
REPORTED REVENUES	9,096	10,101	(1,005)	(9.9)
Foreign currency financial statements translation effect		(533)	533	
Changes in the scope of consolidation				
ORGANIC REVENUES	9,096	9,568	(472)	(4.9)

Exchange rate fluctuations ⁽¹⁾ were attributable to the Brazil Business Unit. No changes arose in the scope of consolidation ⁽²⁾.

The breakdown of revenues by operating segment is the following:

(millions of euros)	1st Half 2016		1st Half 2015		Change		
	amount	% of total	amount	% of total	amount	%	% organic
Domestic (*)	7,247	79.7	7,375	73.0	(128)	(1.7)	(1.7)
<i>Core Domestic (**)</i>	6,736	74.1	6,893	68.2	(157)	(2.3)	(2.3)
<i>International Wholesale</i>	649	7.1	635	6.3	14	2.2	2.2
Brazil	1,858	20.4	2,691	26.6	(833)	(31.0)	(13.9)
Other Operations	9	0.1	57	0.6	(48)		
<i>Adjustments and eliminations</i>	(18)	(0.2)	(22)	(0.2)	4		

Name	Restricted Stock Units	Shares Underlying Stock Options
Edward G. Murphy, M.D.	6,541	76,788
Warner Dalhouse	28,010	120,000
John B. Williamson, III	28,348	120,000
Jonathan M. Cool		120,000
Richard W. Roedel	61,463	429,853
Michael W. Wise	6,969	120,000
Kent A. Murphy		51,290

- (2) Amounts represent the aggregate grant date fair value for stock options granted in 2011, as calculated in accordance with ASC Topic 718, but excluding the effect of estimated forfeitures. The fair value of the awards was determined using the valuation methodology and assumptions described in Note 8 of the Notes to our Consolidated Financial Statements included in our annual report on Form 10-K for the fiscal year ended December 31, 2011. The options granted during 2011 have an exercise price equal to the closing price of our common stock on the NASDAQ Capital Market on the date of grant and generally vest over a period of three years from the date of grant.
- (3) Upon his election as a director in May 2011, Mr. Wise was granted an option to purchase 120,000 shares of common stock at an exercise price of \$2.05 per share, which was the only option held by him as of December 31, 2011.
- (4) Represents amounts paid to Dr. Kent Murphy in 2011 in connection with our separation agreement with him, as described in more detail below under Certain Relationships and Related Person Transactions.

We also reimburse our non-employee directors for all reasonable out-of-pocket expenses incurred in the performance of their duties as directors, which expense reimbursements are not included in the foregoing table.

Retainers and Meeting Fees: During fiscal year 2011, the chairmen of the standing committees of our board of directors were paid retainers as follows: \$10,000 per year for the chairman of our Audit Committee, \$10,000 per year for the chairman of our Compensation Committee, \$10,000 per year for the chairman of our Strategy Committee, and \$5,000 per year for the chairman of our Nominating and Governance Committee. Mr. Roedel, as chairman of the Nominating and Governance Committee, elected to forego any compensation in such capacity for the fiscal years 2011 and 2012. These retainers were paid quarterly.

In addition, for the first half of fiscal year 2011, outside directors were eligible to receive the following meeting fees: (1) \$1,000 per meeting for attending board meetings in person; (2) \$500 per meeting for attending board meetings telephonically and for attending committee meetings in person; and (3) \$250 per meeting for attending committee meetings telephonically. These meeting fees were paid quarterly.

Effective July 1, 2011, the Company ceased paying meeting fees to outside directors who are neither employees nor consultants with an annual retainer of \$10,000. In an effort to minimize the cash impact of

these amounts, these retainers have been paid, at the election of the director, in either shares of common stock or restricted stock units issued pursuant to our non-employee directors' deferred compensation plan. This retainer is payable on July 1 of each year. Effective July 1, 2012, this annual retainer will increase to \$15,000.

Under the terms of our non-employee directors' deferred compensation plan, the number of restricted stock units issued to a director is equal to the amount of the annual retainer divided by the closing price of our common stock on July 1 (for periods prior to July 1, 2011, meeting fees were similarly payable, at the election of the director, in either shares of common stock or restricted stock units, which amounts were determined quarterly based on the then prevailing common stock price). Restricted stock units represent rights to receive shares of our common stock at a later date. A participating director may elect to receive up to the number of shares of our common stock equal to the number of whole restricted stock units then credited to that director's restricted stock unit account, in either (i) a lump sum, or (ii) substantially equal annual installments over a period not to exceed five years. Participating directors may elect to receive their common stock due under the plan upon either (a) separation from service with us, (b) a change of control, (c) an unforeseen emergency or (d) a time or fixed schedule as specified at the time of their initial deferral election.

Other Equity-Based Compensation. Non-employee directors are also eligible to receive stock awards and option grants under our 2006 Equity Incentive Plan. Under this plan, newly elected independent directors are eligible to receive an option to purchase up to 120,000 shares of our common stock upon election to the board, of which one-third vests on the first anniversary of the grant date and the remaining two-thirds vests in 24 equal monthly installments thereafter. Independent directors who are re-elected for a new term also receive an option to purchase 120,000 shares of common stock, which vests in 36 equal monthly installments from the date of grant, unless they were initially elected for a partial term, in which case they are treated as follows. The Nominating and Governance Committee believes that directors should have stock options vesting over each month of service, so that stock options should be granted to any director whose current stock options will become fully vested prior to the expiration of his term. Therefore, a new director elected to a partial term is initially granted an option for 120,000 shares, the vesting of which would conclude at some point during the director's second term, if re-elected. A pro-rata stub period option is then granted to such a director so that the director has stock options vesting over each month of service during his second term. If re-elected again to a third term, such a director then would receive an additional option to purchase 120,000 shares of common stock, which vests in 36 equal monthly installments from the date of grant.

All options issued to directors are granted with an exercise price equal to the closing price of our common stock on the NASDAQ Capital Market on the grant date.

Compensation Committee Interlocks and Insider Participation

During 2011, our Compensation Committee consisted of Mr. Dalhouse, Dr. Anderson and Mr. Williamson until May 24, 2011, at which time Mr. Wise replaced Dr. Anderson and Mr. Roedel replaced Mr. Williamson. None of the members of our Compensation Committee during 2011 is or was a present or former officer or employee of the Company, nor did such members engage in any transaction or relationship requiring disclosure in this proxy statement under the section titled "Certain Relationships and Related Person Transactions."

No executive officer of the Company served as a director or member of the Compensation Committee (or other board committee performing equivalent functions) of any other entity during the last fiscal year, one of whose executive officers served on our board of directors or Compensation Committee.

Code of Business Conduct and Ethics

We have adopted a Code of Business Conduct and Ethics that applies to all our directors and employees, including our principal executive officer, principal financial officer and principal accounting officer or controller. The full text of our Code of Business Conduct and Ethics is posted on our website at www.lunainnovations.com in the "Investor Relations" section. If we make any substantive amendments to the Code of Business Conduct

and Ethics or grant any waiver from a provision of the Code to any executive officer or director, we will promptly disclose the nature of the amendment or waiver on our website.

EXECUTIVE OFFICERS

The following table sets forth certain summary information concerning our executive officers as of April 1, 2012.

Name	Age	Position
My E. Chung	59	President and Chief Executive Officer
Dale E. Messick	48	Chief Financial Officer
Mark E. Froggatt, Ph.D.	43	Chief Technology Officer
Scott A. Graeff	45	Chief Commercialization Officer and Treasurer
Talfourd H. Kemper, Jr.	43	Vice President, General Counsel and Secretary

Information about Mr. Chung is set forth above under Class III Director Nominees for Election for a Three-Year Term Expiring at the 2015 Annual Meeting of Stockholders.

Dale E. Messick has served as our Chief Financial Officer since August 2006, except during the period from August 2010 to April 2011 when he served as our interim President and Chief Operating Officer. Prior to joining us, Mr. Messick served in various capacities at Worldspan, L.P., a provider of transaction processing and information technology services to the global travel industry, including as Chief Financial Officer from 1997 to 2004 and Senior Vice President - Finance from 2004 to 2005. At Worldspan, Mr. Messick managed a staff of 160 people in the United States, Mexico, and Europe and was responsible for accounting, financial reporting, budgeting, financial planning and analysis, and internal audit operations. Previously, Mr. Messick worked in the audit practice of PricewaterhouseCoopers. Mr. Messick received a B.B.A. degree in accounting from the College of William and Mary and is a Certified Public Accountant.

Mark E. Froggatt, Ph. D. has served as our Chief Technology Officer since September 2005. Prior to joining us, Dr. Froggatt co-founded Luna Technologies in 2000 to develop instrumentation for fiber optic devices and served as its chief technology officer until our acquisition of Luna Technologies in September 2005. Dr. Froggatt is the primary inventor of the technology used in our OVA product and is a leader in the field of interferometric measurement. Before founding Luna Technologies, Dr. Froggatt worked at the NASA Langley Research Center, developing ultrasonic and optical instrumentation. He received B.S. and M.S. degrees in electrical engineering from Virginia Polytechnic Institute and State University (Virginia Tech) and a Ph.D. from the University of Rochester Institute of Optics.

Scott A. Graeff has served as our Chief Commercialization Officer since May 2010 and as our Treasurer since July 2005. He served as our interim Chief Financial Officer during the period from August 2010 to April 2011. He previously served as our Chief Operating Officer from March 2009 to May 2010, as our Chief Commercialization Officer from August 2006 to March 2009, and as our Chief Financial Officer and Executive Vice President, Corporate Development, from July 2005 to August 2006. Mr. Graeff was also a member of our Board of Directors from August 2005 until March 2006. From 1999 to 2001, Mr. Graeff served as Chief Financial Officer of Liquidity Link, a software development company. From 2001 to 2002, Mr. Graeff served as President and Chief Financial Officer of Autumn Investments. From 2002 until 2005, Mr. Graeff served as a Managing Director for Gryphon Capital Partners, a venture capital investment group. From 2003 until July 2005, Mr. Graeff also served as the Acting Chief Financial Officer of Luna Technologies, Inc., which we acquired in September 2005. Mr. Graeff holds a B.S. degree in commerce from the University of Virginia.

Talfourd H. Kemper, Jr. has served as our Vice President, General Counsel and Secretary since November 2008. Prior to joining us, Mr. Kemper was an equity Principal with the law firm of Woods Rogers PLC in Roanoke, Virginia from 2003 until 2008, where his legal practice focused on corporate and securities law,

venture capital financing, mergers and acquisitions and intellectual property and licensing. Mr. Kemper received an A.B. degree in economics from Duke University and a J.D. degree from the University of Virginia School of Law, where he served on the Editorial Board of the *Virginia Law Review*.

CERTAIN RELATIONSHIPS AND RELATED PERSON TRANSACTIONS

Policies and Procedures for Transactions with Related Persons

Related person transactions, which we define as all transactions involving an executive officer, director, nominee for director or a holder of more than five percent of our common stock, including any of their immediate family members and any entity owned or controlled by such persons, are reviewed and approved by the Audit Committee of our board of directors and a majority of disinterested directors on our board.

In any transaction involving a related person, our Audit Committee and board of directors consider all of the available material facts and circumstances of the transaction, including:

the direct and indirect interests of the related persons;

in the event the related person is a director or director nominee (or immediate family member of a director or director nominee or an entity with which a director or director nominee is affiliated), the impact that the transaction will have on a director's or director nominee's independence;

the risks, costs and benefits of the transaction to us; and

whether any alternative transactions or sources for comparable services or products are available.

After considering all such facts and circumstances, our Audit Committee and board determine whether approval or ratification of the related person transaction is in our best interests. For example, if our Audit Committee determines that the proposed terms of a related person transaction are reasonable and at least as favorable as could have been obtained from unrelated third parties, it will recommend to our board of directors that such transaction be approved or ratified. Alternatively, if a related person transaction will compromise the independence of one of our directors or director nominees, our Audit Committee may recommend that our board of directors reject the transaction if it could affect our ability to comply with securities laws and regulations or NASDAQ listing requirements.

Each transaction described below was approved or ratified by our Audit Committee or the disinterested members of our board of directors after making a determination that the transaction was on terms no less favorable than those we could have obtained from unrelated third parties.

The policies and procedures described above for reviewing and approving related person transactions are not set forth in writing. The charter for our Audit Committee, however, provides that one of the committee's responsibilities is to review and approve in advance any proposed related person transactions.

Transactions and Relationships with Directors, Nominees for Director, Executive Officers and Five Percent Stockholders

Other than compensation described in *Executive Compensation* and *Director Compensation* elsewhere in this proxy statement and as described below, we believe that there has not been any other transaction or series of transactions during 2010 or 2011 to which we were or are to be a participant in which the amount involved exceeds \$120,000 and in which any director, nominee for director, executive officer or holder of more than five percent of our common stock, or members of any such person's immediate family, had or are expected to have a direct or indirect material interest.

Carilion Lease

We have entered into a lease agreement with Carilion Medical Center, an affiliate of Carilion Clinic, for our corporate headquarters in Roanoke, Virginia. Under the terms of the lease agreement, as amended to date, we lease a total of 24,057 square feet of office space. During 2010 and 2011, we paid Carilion Medical Center rent of \$605,627 and \$612,708, respectively.

As a part of the 2010 transaction with Carilion described below, we agreed to extend this lease on customary and reasonable terms through December 31, 2015, and we also agreed not to exercise our right to terminate the lease prior to expiration of its term.

Carilion Clinic is the beneficial owner of more than five percent of our outstanding common stock. Until June 30, 2011, Dr. Edward Murphy, a current member of our board of directors, served as the Chief Executive Officer of Carilion Clinic.

Carilion Notes, Warrants and the Exchange of Carilion Notes for Preferred Stock

On May 21, 2008, we and Carilion Clinic amended each of the five Senior Convertible Promissory Notes dated December 30, 2005 and held by Carilion Clinic. The amendments extended the maturity dates of those notes from December 30, 2009 to December 31, 2012.

As consideration for the amendments to these notes, we granted Carilion Clinic a warrant to purchase 10,000 shares of our common stock. The exercise price of the warrant was \$7.98 per share, the closing price of our common stock as reported on the NASDAQ Global Market on May 21, 2008. The warrants are exercisable beginning December 31, 2012 and originally had an exercise period through December 31, 2017.

In January 2010, we entered into a transaction with Carilion Clinic in which Carilion agreed to exchange all of its Senior Convertible Promissory Notes, including all accrued but unpaid interest, for (i) 1,321,514 shares of our newly designated Series A Convertible Preferred Stock and (ii) an additional warrant to purchase 356,000 shares of our common stock at an exercise price of \$2.50 per share. This warrant is exercisable beginning February 1, 2013 and continuing until December 31, 2020. We also agreed to reduce the exercise price of a prior common stock warrant held by Carilion from \$7.98 to \$2.50 per share and to extend its expiration date to December 31, 2020. As of the date of the exchange, the outstanding principal balance of the Senior Convertible Promissory Notes was \$5.0 million, and the aggregate accrued but unpaid interest on the notes was \$1.2 million.

Separation and Consulting Agreement with Dr. Kent Murphy

On August 10, 2010, we and Dr. Kent Murphy mutually agreed to terminate his employment with the Company, and Dr. Murphy resigned his position as our President and Chief Executive Officer. On that date, we entered into a separation and consulting agreement providing that, for a period of 18 months beginning August 10, 2010, Dr. Murphy would provide certain consulting services to us as our Senior Strategic and Technology Advisor, and we would compensate him at a fixed rate of \$22,500 per month, plus business expenses as may be approved by us. We also agreed to pay group healthcare coverage continuation premiums for Dr. Murphy and his covered dependents during the term of the consulting arrangement, which had a value of approximately \$1,212 per month. We also paid Dr. Murphy \$72,500 in respect of his accrued paid time off and any legal fees incurred by Dr. Murphy in connection with the preparation of the separation and consulting agreement and related agreements. In May 2011, we and Dr. Murphy amended the agreement to extend the period of reimbursement of health insurance premiums through August 10, 2012, up to an amount equal to \$1,250 per month. In addition, by this amendment, we agreed to accelerate an aggregate of \$80,000 in monthly payments that were already payable to Dr. Murphy under the agreement. The aggregate value of the amounts paid to Dr. Murphy under this agreement during 2010 and 2011 were \$181,738 and \$289,740, respectively.

As part of the consulting agreement, Dr. Murphy agreed not to compete with us or to solicit specified customers of ours during the term of his consultancy. We and Dr. Murphy also agreed to customary covenants relating to non-disparagement and to our confidential information and intellectual property.

Dr. Murphy has also agreed that through December 31, 2012, he will not hire, retain the services of or recruit (or attempt to do any of the foregoing) any employee or representative of ours, either directly or indirectly, on his own behalf or on behalf of any other person or company. He also cannot encourage, prompt, induce or solicit any of our employees or representatives to (i) end their relationship with us or (ii) become affiliated with or perform any work for any business that is competitive with our business. This applies to any employee or representative of ours as of August 10, 2010, or as of any time during the term of the consulting arrangement, except for employees that may be terminated in connection with any general reduction in force of more than five individuals at the same time.

Contemporaneously with the execution of the consulting agreement, and again upon its amendment, we and Dr. Murphy entered into a mutual release of any potential claims, including any arising out of Dr. Murphy's employment with us.

Letter Agreement with Dr. Kent Murphy Relating to Registration Rights

In connection with the separation and consulting agreement entered into with Dr. Murphy described above, we and Dr. Murphy also entered into a letter agreement relating to Dr. Murphy's registration rights for his shares of common stock under that certain Amended and Restated Investor Rights Agreement, dated as of January 13, 2010, by and among us, Carilion Clinic and certain of our other stockholders, including Dr. Murphy, which we refer to as the Rights Agreement. Under the Rights Agreement, Dr. Murphy has specified rights to cause us to effect the registration of his shares in certain circumstances.

Under the letter agreement, Dr. Murphy agreed, through the period ending December 31, 2011, that he would not sell or otherwise make certain transfers of his shares of common stock and, subject to certain exceptions, would not exercise his registration rights under the Rights Agreement.

Indemnification Agreements with Officers and Directors

We have entered into indemnity agreements with certain of our officers and directors that provide, among other things, that we will indemnify such officer or director, under the circumstances and to the extent provided for therein, for expenses, damages, judgments, fines and settlements he may be required to pay in actions or proceedings that he is or may be made a party by reason of his position as a director, officer or other agent of the Company, and otherwise to the fullest extent permitted under Delaware law and our bylaws.

PROPOSAL NO. 2**RATIFICATION OF APPOINTMENT OF INDEPENDENT REGISTERED PUBLIC****ACCOUNTING FIRM**

Our Audit Committee has appointed Grant Thornton LLP as our independent registered public accounting firm for the year ending December 31, 2012 and has further directed that management submit the selection of our independent registered public accounting firm for ratification by the stockholders at the annual meeting. Grant Thornton has served as our independent audit firm since 2005. A representative of Grant Thornton is expected to be present at our 2012 annual meeting of stockholders and will have an opportunity to make a statement and respond to appropriate questions from stockholders.

Ratification of the appointment of Grant Thornton as our independent registered public accounting firm is not required by our bylaws or other applicable legal requirements. However, our board of directors is submitting the appointment of Grant Thornton to the stockholders for ratification as a matter of good corporate practice. If our stockholders fail to ratify the appointment, the Audit Committee will reconsider whether or not to retain that firm. Even if the appointment is ratified, the Audit Committee at its discretion may direct the appointment of a different independent registered public accounting firm at any time during the year if it determines that such a change would be in our best interests and the best interests of our stockholders.

The affirmative vote of a majority of shares of our common stock present at the 2012 annual meeting of stockholders in person or by proxy and entitled to vote is required to ratify the appointment of Grant Thornton as our independent registered public accounting firm for the year ending December 31, 2012. Abstentions will have the same effect as a vote against this proposal. Broker non-votes are counted towards a quorum, but are not counted for any purpose in determining whether this matter has been approved.

THE BOARD OF DIRECTORS UNANIMOUSLY RECOMMENDS YOU VOTE FOR PROPOSAL NUMBER 2.**Audit and Related Fees for Fiscal Years 2010 and 2011**

The following table sets forth a summary of the aggregate fees billed to us by Grant Thornton LLP for professional services for the fiscal years ended December 31, 2010 and 2011, respectively. All of the services described in the following fee table were approved by the Audit Committee.

Name	2010	2011
Audit Fees	\$ 324,145	\$ 331,247
Audit-Related Fees		
Tax Fees		
All Other Fees		
Total Fees	\$ 324,145	\$ 331,247

The Audit Committee meets regularly with Grant Thornton LLP throughout the year and reviews both audit and, if applicable, non-audit services performed by Grant Thornton LLP as well as fees charged for such services.

Pre-Approval Policies and Procedures

The Audit Committee has adopted, and the board of directors has approved, a policy that sets forth the procedures and the conditions pursuant to which services proposed to be performed by the independent auditors may be pre-approved. The policy generally pre-approves all audit services and non-audit services by our independent auditors, except in the case of non-audit services where subsequent approval is necessary and

permissible. Pursuant to its pre-approval policy, the Audit Committee may delegate pre-approval authority for non-audit services to one or more of its members. The member to whom such authority is delegated must report, for informational purposes only, any pre-approval decisions to the Audit Committee at its next scheduled meeting. During 2010 and 2011, all services provided by Grant Thornton LLP were pre-approved by the Audit Committee in accordance with this policy.

AUDIT COMMITTEE REPORT

As described more fully in its charter, the purpose of the Audit Committee is to assist the board of directors with its oversight responsibilities regarding the integrity of our financial statements, our compliance with legal and regulatory requirements, assessing our independent registered public accounting firm's qualifications and independence and, if applicable, the performance of the persons performing internal audit duties for the Company.

Company management is responsible for preparation, presentation and integrity of our financial statements as well as our financial reporting processes, accounting policies, internal audit function, internal accounting controls and disclosure controls and procedures. Our independent registered public accounting firm is responsible for performing an independent audit of our consolidated financial statements in accordance with generally accepted auditing standards and to issue a report thereon. The Audit Committee's responsibility is to monitor and oversee these processes. The following is the Audit Committee's report submitted to the board of directors for 2011.

The Audit Committee has:

reviewed and discussed our audited financial statements for the fiscal year ended December 31, 2011 with management and Grant Thornton LLP, our independent registered public accounting firm;

discussed with Grant Thornton LLP the matters required to be discussed by Statement of Auditing Standards No. 61, *Communications with Audit Committees*, as currently in effect and as adopted by the Public Company Accounting Oversight Board in Rule 3200T; and

received from Grant Thornton LLP the disclosures and a letter regarding their independence as required by the applicable requirements of the Public Company Accounting Oversight Board requesting Grant Thornton LLP's communication with the Audit Committee concerning independence and discussed the auditors' independence with them.

In addition, the Audit Committee has met separately with Company management and with Grant Thornton LLP.

Based on the review and discussions referred to above, the Audit Committee recommended to the board of directors that the audited 2011 financial statements be included in our Annual Report on Form 10-K for the year ended December 31, 2011 for filing with the Securities and Exchange Commission.

AUDIT COMMITTEE

John B. Williamson, III, Chairman
Michael W. Wise
Edward G. Murphy, M.D

The foregoing audit committee report is not soliciting material, shall not be deemed incorporated by reference into any filing of the Company under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof, and shall not otherwise be deemed filed under these acts, except to the extent we specifically incorporate by reference into such filings.

EXECUTIVE COMPENSATION

Compensation Discussion and Analysis

The following discussion and analysis of our compensation arrangements with our named executive officers should be read together with the compensation tables and related disclosures set forth elsewhere in this proxy statement. Actual compensation programs that we adopt may differ materially from currently planned programs as summarized in this discussion.

For 2011, our named executive officers consisted of:

My E. Chung, our President and Chief Executive Officer;

Dale E. Messick, our Chief Financial Officer, who served as our Interim President and Chief Operating Officer from August 2010 through April 2011;

Mark E. Froggatt, our Chief Technology Officer; and

Scott A. Graeff, our Chief Commercialization Officer, who also served as our Interim Chief Financial Officer from August 2010 through April 2011.

Executive Summary

We seek to closely align the interests of our named executive officers with the interests of our stockholders. Our compensation programs are designed to reward our named executive officers for the achievement of short-term and long-term strategic and operational goals and financial performance, without encouraging unnecessary or excessive risk-taking. Our performance-oriented compensation program consists of base salary, annual cash bonuses, long-term equity incentives, such as stock awards and stock option grants, benefits and, for certain senior executive officers, severance and termination protection.

For 2011, our primary corporate goals related to our net income or loss for the year, our earnings before interest, taxes, depreciation, amortization and stock compensation expense (which we refer to as adjusted EBITDA), our cash flow, our total revenue for the year, and various qualitative objectives. Our executive compensation policies for the year were, therefore, designed to incentivize our executive officers to execute against the most significant financial performance objectives and to focus on creation of value for our stockholders. We sought to incentivize this performance primarily through cash incentives that were based on our financial performance.

The highlights of our 2011 executive compensation program were as follows:

We established a cash incentive bonus program, which rewarded our named executive officers for our corporate financial performance, specifically our targeted net loss, our adjusted EBITDA, our net cash flow, and our revenue target. As a result of corporate financial performance in 2011, as well as the achievement of other qualitative objectives, each of our named executive officers serving as an executive officer as of the end of 2011 received a cash bonus equal to approximately 36% of his base salary.

In March 2011, we also paid discretionary bonuses to Dale Messick, our then interim President and Chief Operating Officer, and Scott Graeff, our then interim Chief Financial Officer and Chief Commercialization Officer, in recognition of their performance of additional responsibilities in 2010 as part of a management transition. Each bonus consisted of a \$35,000 cash payment and \$35,000 of restricted common stock, valued based upon the closing price of our common stock on the date of grant, which shares will vest ratably over a three-year period ending in March 2014, subject to the officer's continued service with us.

We hired and entered into an employment agreement with Mr. Chung, our President and Chief Executive Officer, as described below.

Our named executive officers received salary increases in amounts consistent with the overall percentage increase in salaries for our other employees in 2011.

Overview of Compensation Philosophy

Our overall compensation philosophy is to provide executive compensation packages that enable us to attract, retain and motivate highly qualified executive officers to achieve our short-term and long-term business goals. Consistent with this philosophy, the following elements provide a framework for our executive compensation program: base salary; a cash bonus program designed to reinforce desired performance goals; and non-cash compensation intended to align the interests of our executives with those of our stockholders.

Role of Compensation Committee and Compensation Consultant

Our executive compensation program is approved and monitored by the Compensation Committee of our board of directors. During most of 2011, the members of the Compensation Committee were Warner Dalhouse, Richard W. Roedel and Michael W. Wise. Mr. Wise replaced Dr. Anderson and Mr. Roedel replaced Mr. Williamson on the committee on May 24, 2011. Mr. Dalhouse served as chairman of the committee. All of the members of our Compensation Committee are independent, non-employee directors. Under the terms of its charter, the Compensation Committee is responsible for reviewing and approving compensation granted to our executive officers, including our chief executive officer, or CEO, and those executive officers who report directly to the CEO and any other officers as determined under Section 16 of the Securities Exchange Act of 1934, as amended. In particular, the Compensation Committee reviews and approves for the CEO and the other executive officers the following components of compensation:

annual base salary;

cash and equity bonuses, including the specific goals and amount;

other equity compensation, if any;

employment agreements, severance arrangements, and change in control provisions, as applicable;

signing bonus or payment of relocation costs, above normal Company policy, if applicable; and

any other material benefits, other than those provided to all employees.

The Compensation Committee also serves as the administrator for our equity incentive plans. All stock-based awards, including new grants to existing employees and executive officers, as well as grants to new employees, are approved by the Compensation Committee. The Compensation Committee is also responsible for annually evaluating the performance of our CEO.

We generally attempt to align our overall executive compensation with other publicly-traded peer companies who share similar characteristics. Because of our diversified product and service offerings, we believe our peer group includes a broad range of technology and growth companies with whom we compete for executive talent. Data on compensation practices at such companies has historically been gathered for us by our compensation consultant, Radford, through searches of publicly available information, including subscription databases and Securities and Exchange Commission filings. We use such information primarily to help guide decisions on base salary, target bonuses and equity-based awards.

The Compensation Committee has the authority to retain its own compensation consultant and to obtain advice and assistance from internal or external legal, accounting or other advisors as it sees fit. The Compensation Committee engaged an independent third-party compensation consultant, Radford, in 2010 and 2011 to conduct a competitive review and analysis of our current executive compensation program and to

benchmark executive compensation and to

provide us with insights and market data on executive and director compensation matters, both generally and within our industry. In 2011, Radford compared the salary, target cash incentives, and equity compensation of our executive officers against an identified peer group of publicly traded companies. Radford determined our peer group based on its survey consisting of 81 public companies with less than \$50 million in revenues, with a technology industry focus on medical device and life science companies. As a result of its analysis, Radford made recommendations to the Compensation Committee that were intended to bring the compensation elements paid to our executive officers towards the median of the identified peer companies.

Executive Compensation Program

As described above, our performance-oriented compensation program consists of base salary, annual cash bonuses, long-term equity incentives, such as stock awards and stock option grants, benefits and, for certain senior executive officers, severance and termination protection. We believe that appropriately balancing the total compensation package and ensuring the viability of each component of the package is necessary in order to provide compensation that is competitive and to attract and retain talent. Accordingly, in 2012 we entered into new employment agreements with our executive officers towards these goals. As a small company, we also try to optimize the mix of components to make such compensation programs cost effective for us.

The Compensation Committee intends for our compensation program to provide basic elements that ensure that management is fairly remunerated and has reasonable security so that the management team can perform at its best and take prudent risks. The committee believes that it does not use highly leveraged short-term incentives that drive high risk investments at the expense of our long-term value.

Our Compensation Committee typically evaluates the performance of each executive officer annually, based on the achievement of both corporate goals and individual qualitative performance objectives and makes its compensation decisions accordingly. Total compensation for our executive officers may vary significantly from year to year based on Company, divisional and individual performance. Further, the value of equity-based awards to our executives will vary based on fluctuation in our stock price from time to time.

The following is a more detailed explanation of the primary components of our executive compensation program.

Base Salary

Base salary is generally determined by considering competitive salary data and individual job performance. In determining base salary, we primarily rely on factors such as job performance, skill set, prior experience, past levels of compensation, seniority, pay levels of similarly situated positions internally, alternative opportunities that may be available to executives, retention, and market conditions generally. Base salaries for executive officers are reviewed at least annually. In each case, we take into account the results achieved by the executive, his future potential, the scope of the officer's responsibilities and the depth of his experience. We do not apply specific formulas to determine annual pay increases, if any, and our Compensation Committee attempts to make decisions regarding changes in base salary in the context of other short-term and long-term compensation components. Approved increases in base salary are effective upon approval by the Compensation Committee, generally in the first quarter of the year.

Since we became a public company in 2006 and through June 2010, we generally did not provide annual increases in the base salaries of our executive officers. In July 2010, considering the factors noted above as well as the improvements experienced in the Company's cash flow and available cash on hand, and in consultation with Radford, our independent compensation consultant, we increased the base salaries of our executive officers in amounts generally consistent with the cumulative value that the officers would have received had they received previous annual increases at a rate approximating the annual merit increases provided to our employees overall. In March 2011 and in March 2012, the Compensation Committee approved further annual increases for

the executive officers in amounts consistent with the percentage increase provided to the rest of our employees in those years, as follows:

Name	2010 Base Salary	2011 Base Salary	% Increase	2012 Base Salary	% Increase
My E. Chung, Chief Executive Officer	N/A	\$ 305,000	N/A	\$ 315,000	3.3%
Dale E. Messick, Chief Financial Officer	\$ 205,000	\$ 210,000	2.4%	\$ 220,000	4.8%
Mark E. Froggatt, Chief Technology Officer	\$ 197,000	\$ 206,000	4.6%	\$ 216,300	5.0%
Scott A. Graeff, Chief Commercialization Officer	\$ 197,000	\$ 206,000	4.6%	\$ 210,200	2.0%

As Mr. Chung did not become our President and Chief Executive Officer until April 2011, his base salary was established by the Compensation Committee at the commencement of his employment, based upon negotiations with Mr. Chung. Mr. Chung also received a \$50,000 starting bonus under the terms of his employment agreement.

Incentive Bonuses

In December 2010, our Compensation Committee adopted a senior management incentive plan for fiscal year 2011. Under the terms of the incentive plan, certain of our employees, including all of our named executive officers, were eligible to receive bonus payments based upon a target percentage equal to 50% of their respective salaries earned in 2011 and the achievement of certain quantitative and qualitative performance objectives. For each of the named executive officers, the corporate objectives were weighted at 80% of the target bonus and the individual objectives were weighted at 20% of the target bonus. The specified corporate objectives, and their relative percentage weighting of the overall bonus for each named executive officer in 2011, were net loss attributable to common stockholders (20%), adjusted EBITDA (15%), net cash flow (excluding debt or equity financing transactions) (15%), total revenue (10% for Messrs. Chung, Messick and Graeff and 3% for Dr. Froggatt), revenues for our technology development segment, excluding our secure computing (SCC) group (2% for Messrs. Chung, Messick and Graeff and 1.5% for Dr. Froggatt), SCC (2% for Messrs. Chung, Messick and Graeff and 1.5% for Dr. Froggatt), and our product and licensing segment (2% for Messrs. Chung, Messick and Graeff and 10% for Dr. Froggatt), and voluntary employee turnover (14%). The qualitative objectives generally related to new product commercialization and process improvement activities. The Compensation Committee selected these corporate metrics because the committee believed them to be the appropriate indicators of success in the execution of our operating plan and achievement of key corporate goals and because these factors are critical to increasing the value of our common stock. No bonuses would be paid, however, unless our net loss for 2011 was less than a threshold amount of \$2.4 million.

For each of the quantitative objectives, minimum, target and maximum levels of achievement were possible. At the minimum level of achievement, the officer would receive a payout of 25% of the weighting for that component. At the target level of achievement, the officer would receive a payout of 100% of the weighting for that component. At the maximum level of achievement, the officer would receive a payout of 150% of the weighting for that component. For performance values falling between the minimum and target levels, or between the target and maximum levels, award amounts would be interpolated on a linear basis.

Our actual net loss attributable to common stockholders for 2011 was \$1.5 million. Accordingly, our performance exceeded the threshold requirement of the plan, and incentive compensation was earned by our executive officers based upon the company's performance against the plan metrics. For 2011, our targets, actual levels of achievement and payout percentages were as follows:

Metric	Percentage Weighting of Target Bonus for Chung, Messick and Graeff	Percentage Weighting of Target Bonus for Froggatt	Target Achievement Level	Actual Achievement Level
Net loss attributable to common stockholders	20%	20%	\$ 2.0 million	\$ 1.5 million
Adjusted EBITDA	15%	15%	\$ 2.6 million	\$ 2.6 million
Net cash flow	15%	15%	\$ 1.5 million	\$ 1.4 million
Total revenue	10%	3%	\$ 39.5 million	\$ 35.6 million
Technology development revenue, excluding SCC	2%	1.5%	\$ 16.8 million	\$ 15.7 million
SCC revenue	2%	1.5%	\$ 8.1 million	\$ 6.8 million
Product and licensing revenue	2%	10%	\$ 14.6 million	\$ 13.1 million
Voluntary employee turnover	14%	14%	<=9%	13%

With respect to the qualitative metrics focused on commercialization and process improvement activities, the Compensation Committee determined that the Company achieved 44% of the objectives. As a result of these performance levels, the incentive compensation earned approximated 36% of each participant's annual salary as for 2011 (or 72% of the target bonus). Under the 2011 senior management incentive plan, if our cash balance at December 31, 2011 exceeded \$8.5 million, the bonuses earned were payable in cash. Our cash balance at December 31, 2011 was \$8.9 million and, therefore, for the named executive officers, these incentive bonuses earned for 2011 were paid in cash and are reported in the Non-Equity Incentive Plan Compensation column of the Summary Compensation Table below.

As described above, in March 2011, in addition to the payments awarded under the 2010 senior management incentive plan, the Compensation Committee approved a discretionary bonus with a value in the amount of \$70,000 to each of Mr. Messick, our then interim President and Chief Operating Officer, and Mr. Graeff, our then interim Chief Financial Officer and Chief Commercialization Officer, in recognition of their performance of additional responsibilities in 2010 as part of a management transition. Each bonus consisted of a \$35,000 cash payment and \$35,000 of restricted common stock, valued based upon the closing price of our common stock on the date of grant, which shares will vest ratably over a three-year period ending in March 2014, subject to the officer's continued service with us. In accordance with SEC compensation disclosure rules, the cash portion of these bonuses is reported as 2010 compensation in the Bonus column of the Summary Compensation Table below, and the restricted stock portion of these bonuses is reported as 2011 compensation in the Stock Awards column of the Summary Compensation Table below.

Long Term Equity Incentives

Consistent with our compensation philosophy, our Compensation Committee believes that equity awards can be a significant motivator in attracting, retaining and rewarding the success of management employees by providing compensation with long-term vesting requirements and linking the ultimate value of those awards to stockholder returns. This component may include both grants of restricted common stock as well as stock options, although our compensation committee has historically favored the use of stock options only. Similar to base salary increases, options may also be granted in connection with promotions or significant changes in responsibility. Although grants of stock-based awards can impact our operating results, we believe that long-term equity-based compensation can be an important element of our overall compensation program because it helps

focus our executives on our long-term financial and operational performance and also aligns the interests of our executives with those of our stockholders. The potential financial value offered through such options is also an important retention tool.

To the extent that our Compensation Committee approves stock-based awards, the grants have historically vested over a period of five years, with 40% vesting on the two-year anniversary of the date of grant, and the remaining 60% vesting in 36 monthly installments thereafter. This vesting schedule was intended to help us maintain eligibility for Small Business Innovative Research, or SBIR, grants and also to minimize the short-term dilution to our stockholders caused by the exercise of employee stock options. To maintain our eligibility for SBIR grants, we must be at least 51% owned and controlled by U.S. citizens or permanent resident aliens, among other conditions. In February 2012, the Compensation Committee determined, following consultation with Radford, that future employee stock options should vest monthly over a period of four years (thus with no cliff vesting) in order for us to better incentivize and retain our employees. Stock options generally expire ten years from the date of the grant.

Stock option grants to new hires are generally determined within ranges established for each job level. The Compensation Committee, however, has the ability to award a significantly greater number of stock options if it deems doing so to be in our best interests and the best interests of our stockholders. As part of its report to the Compensation Committee in 2011, Radford recommended that we resume making periodic equity grants to our executives as part of moving total compensation toward the median for our peer group. In February 2012, the Compensation Committee granted a total of 285,370 stock options to our named executive officers.

Stock options are granted with an exercise price equal to the closing price of our stock on the grant date, except for options granted to employees who are beneficial owners of more than 10% of our common stock. Any incentive stock options granted to a holder of greater than 10% of our outstanding common stock have an exercise price equal to 110% of the closing price on the date of grant.

We do not time the granting of our options relative to any favorable or unfavorable news that we release. Stock options for new employees, including executive officers, are generally awarded at the first regular meeting of the Compensation Committee following the employee's hire date, or, in certain limited cases, at the first regular meeting of the Compensation Committee following the prospective employee's written acceptance of an employment offer. In the latter case, the grant date of the stock options is the date of the employee's first day of employment, with the exercise price equal to the closing price of the stock that day. All other option awards are also made at regularly scheduled committee meetings. The Compensation Committee's regular meeting schedule is established several months in advance of each meeting. Thus, proximity of any option or stock award to an earnings announcement or other market events is coincidental.

We do not have any requirements for our named executive officers to hold minimum amounts of our common stock.

Other Benefits

In general, our practice is to provide commensurate benefits to employees at all levels of our organization. Consistent with this practice, the following are the primary benefits provided to our full-time employees, including our named executive officers:

Health, vision and dental insurance including, at the employee's option, Flexible Spending Accounts and/or a Health Savings Account;

Term life insurance and optional supplemental life insurance;

Optional supplemental health coverage;

Short- and long-term disability benefits;

401(k) plan, under which we match 25% of an employee's contributions up to 10% of the employee's total cash compensation, which match vests over a period of three years; and

Paid time off and holidays.

We believe that these benefits are consistent with those offered by other companies and specifically with those companies with which we compete for employees.

Change in Control Benefits and Severance

We have entered into employment agreements, which were amended and restated in March 2012, with our named executive officers. The terms of these employment agreements are summarized below under the section Employment Agreements and Potential Payments upon Termination or Change-In-Control.

The Compensation Committee believes that change in control benefits play an important role in attracting and retaining valuable executives. The payment of such benefits ensures a smooth transition in management following a change in control by giving the named executive officer the incentive to remain with the Company through the transition period, and, in the event the officer's employment is terminated as part of the transition, by compensating the officer with a degree of financial and personal security during a period in which he is likely to be unemployed. The Compensation Committee believes that severance benefits also play an important role in attracting and retaining valuable executives.

Our Compensation Committee's analysis indicates that the change in control and severance provisions of our amended employment agreements with our named executive officers are consistent with the provisions and benefit levels of our peer companies, and it believes these arrangements to be reasonable.

Future Trends

We intend to continue our strategy of paying competitive short-term cash compensation and offering long-term incentives through equity-based compensation programs that align individual compensation with corporate financial performance. We believe that our total compensation package is reasonable in the aggregate. We also believe that, in light of our compensation philosophy, total compensation for our executives should continue to consist of base salary, annual bonus awards (consisting of cash, stock or a combination of both), long-term equity based compensation, and certain other benefits.

We anticipate that the competitive posture of our total direct compensation will vary year to year as a result of our performance, as well as the performance of peer group companies and the market as a whole. Accordingly, the magnitude and weighting of different compensation components will likely evolve as the Company grows and we come closer to achieving profitability on a consistent basis.

Tax Considerations

Section 162(m). Limitations on deductibility of compensation may occur under Section 162(m) of the Internal Revenue Code, which generally limits the tax deductibility of compensation paid by a public company to its chief executive officer and certain other highly compensated executive officers to \$1 million in the year the compensation becomes taxable to the executive officer. There is an exception to the limit on deductibility for performance-based compensation that meets certain requirements.

The portion of the compensation taxable to our chief executive officer and other executive officers in 2011 that did not qualify for an exemption from Section 162(m) did not exceed the \$1 million limit per officer. We periodically review the potential consequences of Section 162(m) and may structure the performance-based portion of our executive compensation to qualify for an exemption from Section 162(m). However, we reserve

the right to use our judgment to authorize compensation payments that do not comply with the exemptions in Section 162(m) when we believe that such payments are appropriate and in the best interests of our stockholders, after taking into account changing business conditions or the officer's performance.

Section 409A. Under Section 409A of the Internal Revenue Code, if a named executive officer is entitled to non-qualified deferred compensation benefits that are subject to Section 409A, and such benefits do not comply with Section 409A, the officer would be subject to adverse tax treatment, including accelerated income recognition (in the first year that benefits are no longer subject to a substantial risk of forfeiture) and a 20% penalty tax pursuant to Section 409A. With respect to equity and cash compensation, we generally seek to structure such awards so that they do not constitute deferred compensation under Section 409A, thereby avoiding penalties and taxes on such compensation applicable to deferred compensation.

COMPENSATION COMMITTEE REPORT

The Compensation Committee has reviewed and discussed the Compensation Discussion and Analysis contained in this proxy statement with Company management. Based on the Compensation Committee's review of, and the discussions with management with respect to, the Compensation Discussion and Analysis, the Compensation Committee recommended to the board of directors that the Compensation Discussion and Analysis be included in this proxy statement and incorporated by reference in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011 filed with the Securities and Exchange Commission.

COMPENSATION COMMITTEE

Warner Dalhouse, Chairman
Richard W. Roedel
Michael W. Wise

The foregoing compensation committee report is not soliciting material, shall not be deemed incorporated by reference into any filing by us under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof, and shall not otherwise be deemed filed under these acts, except to the extent we specifically incorporate by reference into such filings.

Summary Compensation Table

The following table sets forth the summary information concerning compensation earned during the last three completed fiscal years by all persons who served as our principal executive officer during 2011 and our two next most highly compensated executive officers during 2011 who were serving as executive officers as of December 31, 2011. We refer to these persons as our named executive officers elsewhere in this proxy statement. The following table includes all compensation earned by the named executive officers for the respective periods, regardless of whether such amounts were actually paid during the period.

Name and Principal Position	Year	Salary (\$)	Bonus (\$)	Stock Awards (\$)	Option Awards (\$)	Non-Equity Incentive Plan Compensation (\$)	All Other Compensation (\$)	Total (\$)
My E. Chung <i>President and Chief Executive Officer</i>	2011	209,198(1)	50,000(2)		648,000(4)	70,737(3)	11,315(5)(6)	989,250
Dale E. Messick <i>Chief Financial Officer and former Interim President and Chief Operating Officer</i>	2011	208,958		35,000(7)		75,227(3)	4,950(5)	324,135
	2010	195,000	35,000(7)			30,872(8)	2,345(5)	263,217
	2009	185,000			116,548(9)		4,277(5)	305,825
Scott A. Graeff, <i>Chief Commercialization Officer and Treasurer and former Interim Chief Financial Officer</i>	2011	204,125		35,000(7)		73,486(3)	4,753(5)	317,364
	2010	191,000	35,000(7)			29,677(8)	4,548(5)	260,225
	2009	185,000			24,621(9)		4,270(5)	213,891
Mark Froggatt, Ph.D., <i>Chief Technology Officer</i>	2011	204,125				73,707(3)	4,568(5)	282,400
	2010	178,500				29,677(8)	12,858(5)(10)	221,035
	2009	160,000			167,844(9)		3,874(5)	331,718

- (1) Mr. Chung's annual salary was \$305,000, and this amount represents his pro-rated amount for 2011.
- (2) Represents a starting bonus of \$50,000 upon Mr. Chung's hire.
- (3) Represents amounts paid to the officer under our 2011 senior management incentive plan upon the achievement of specified business objectives. Mr. Chung's bonus was pro-rated for 2011.
- (4) Amounts represent the aggregate grant date fair value of grants made in the indicated year, as calculated in accordance with ASC Topic 718 and as further described in Note 8 of the Notes to our Consolidated Financial Statements included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.
- (5) Represents or includes Company 401(k) plan matching contributions and policy premiums paid for life insurance for the benefit of the officer.
- (6) All Other Compensation for Mr. Chung for 2011 includes \$9,574 paid to Mr. Chung for his relocation.
- (7) In March 2011, we awarded discretionary bonuses in the amount of \$70,000 to each of Mr. Messick and Mr. Graeff with respect to their respective service to us in 2010 during a management transition. One-half of the bonus, or \$35,000, was paid in cash and, in accordance with SEC rules, is reported in the Bonus column for 2010 in the table above. The remaining \$35,000 was paid in the form of shares of our common stock. Each of Mr. Messick and Mr. Graeff received 19,444 shares, which is equal to \$35,000 divided by \$1.80 per share, the closing price of our common stock as reported on the NASDAQ Capital Market on March 1, 2011, the date of grant. In accordance with SEC rules, this amount is reported in the Stock Awards column for 2011 in the table above.
- (8) Represents amounts paid to the officer under our 2010 senior management incentive plan upon the achievement of specified business objectives.
- (9) Amounts represent the aggregate grant date fair value of grants made in the indicated year, as calculated in accordance with ASC Topic 718 and as further described in Note 8 of the Notes to our Consolidated Financial Statements included in our Annual Report on Form 10-K for

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the fiscal year ended December 31, 2010.

(10) All Other Compensation for Dr. Froggatt for 2010 also includes \$8,700 paid to reimburse him for personal expenses incurred in connection with a business trip, as well as an associated gross-up for income tax effect.

Grants of Plan-Based Awards for 2011

The following table provides information with regard to potential cash bonuses for 2011 payable under our senior management incentive plan and equity awards made in 2011.

Name	Grant Date	Estimated Possible Payouts Under Non-Equity Incentive Plan Awards(1)			All Other Stock Awards: Number of Shares of Stock or Units (#)	All Other Option Awards: Number of Securities Underlying Options (#)	Exercise or Base Price of Option Awards \$/sh	Grant Date Fair Value of Stock and Option Awards (\$)
		Threshold \$	Target \$	Maximum \$				
My E. Chung	4/25/11	982	98,245	147,368		300,000	2.16	648,000
Dale E. Messick	3/1/11	1,045	104,479	156,719	19,444			35,000
Scott A. Graeff	3/1/11	1,020	102,063	153,094	19,444			35,000
Mark E. Froggatt,		765	102,063	153,094				

- (1) In the table above, the Threshold column represents the smallest total bonus that would have been paid for 2011 to each named executive officer if we had achieved the threshold net loss level for 2011 of \$2.4 million but had not achieved any of the individual qualitative objectives and had only achieved the minimum achievement level for the lowest weighted of the corporate performance metrics specified in the 2011 senior management incentive plan, which would have been equal to 25% of 2%, or equal to 0.5% of each officer's target bonus amount. The Target column represents the amount that would have been paid to each named executive officer if, for the year, the 100% performance level for each performance measure component had been attained. The Maximum column represents the largest total bonus that could have been paid to each named executive officer if, for the year, each of the corporate performance measure components were achieved at the maximum level, resulting in a 150% payout for that measure, and each of the individual qualitative objectives had met at the 100% level. The actual bonus amount earned by each named executive officer in 2011 is shown in the Summary Compensation Table above. As Mr. Chung's employment with us did not begin until April 2011, his amounts have been prorated.

Outstanding Equity Awards at December 31, 2011

The following table shows all outstanding unexercised stock options and unvested stock awards held by our named executive officers as of December 31, 2011.

Name	Option Awards				Stock Awards	
	Number of Securities Underlying Unexercised Options (#)		Option Exercise Price (\$)	Option Expiration Date	Number of Shares that have not vested (#)	Market Value of Shares that have not vested (\$)
	Exercisable	Unexercisable				
My E. Chung		300,000(1)	2.16	4/25/21		
Dale E. Messick	150,000		5.47	8/29/16		
	75,000		3.42	12/20/16		
	56,600	43,400(2)	1.70	2/24/19		
					14,583	25,229
Scott A. Graeff	56,524		0.35	5/20/15		
	22,610		0.35	6/3/15		
	56,524		0.35	7/1/15		
	90,437		0.35	8/1/15		
	84,785		1.77	2/8/16		
	9,644	356(3)	3.69	2/27/17		
	25,810	24,190(4)	0.82	5/12/19		
					14,583	25,229
Mark Froggatt, Ph.D	20,762		0.35	11/1/13		
	56,524		1.77	11/11/15		
	28,262		1.77	2/8/16		
	1,500		3.67	1/25/17		
	14,466	534(3)	3.69	2/27/17		
	61,125	13,875(5)	5.73	11/13/17		
	70,750	54,250(2)	1.70	2/24/19		
	23,229	21,771(4)	0.82	5/12/19		

- (1) Represents an option granted on April 25, 2011, the date on which Mr. Chung's employment commenced. This option vests with respect to 40% of these shares on the two-year anniversary of the grant date, with the remaining 60% vesting in 36 equal monthly installments thereafter.
- (2) Represents shares underlying an option granted on February 24, 2009. This option vests with respect to 40% of these shares on the two-year anniversary of the grant date, with the remaining 60% vesting in 36 equal monthly installments thereafter.
- (3) Represents the portion of an option granted on February 27, 2007 that remained unvested and unexercisable as of December 31, 2011. These unvested shares vested in two equal monthly installments through February 27, 2012.
- (4) Represents shares underlying an option granted on May 12, 2009. This option vests with respect to 40% of these shares on the two-year anniversary of the grant date, with the remaining 60% vesting in 36 equal monthly installments thereafter.
- (5) Represents the portion of an option granted on November 13, 2007 that remained unvested and unexercisable as of December 31, 2011. These unvested shares will vest in 11 remaining equal monthly installments through November 13, 2012.

Option Exercises and Stock Vested During 2011

The table below sets forth information concerning the exercise of stock options and vesting for restricted stock for each named executive officer during 2011.

Name	Option Awards		Stock Awards	
	Number of Shares Acquired on Exercise (#)	Value Realized on Exercise (\$)	Number of Shares Acquired on Vesting (#)	Value Realized on Vesting (\$)
My E. Chung				
Dale E. Messick			4,860	8,068
Scott A. Graeff			4,860	8,068
Mark Froggatt				

Employment Agreements and Potential Payments upon Termination or Change-In-Control

We currently have employment agreements with each of our named executive officers as described below.

Employment Agreement with My E. Chung

In connection with his appointment as President and CEO, we entered into an employment agreement with Mr. Chung in April 2011. Pursuant to the employment agreement, Mr. Chung received a starting bonus of \$50,000. In March 2012, we entered into an amended and restated employment agreement with Mr. Chung. This employment agreement has an initial term through March 31, 2013 and automatically renews for additional one-year periods unless terminated by either party on 90 days prior notice.

Under the terms of the employment agreement, Mr. Chung is eligible to participate in our senior management incentive plan for an annual discretionary cash bonus of at least 50% of his then current base salary, subject to the achievement of individual and corporate performance criteria to be determined by our board of directors or our compensation committee and set forth in the incentive plan.

The employment agreement provides that, in the event that his employment is terminated by us without cause or by him for good reason (each as defined in the employment agreement), subject to his entering into and not revoking a release in a form acceptable to the Company, he will be entitled to receive:

a severance payment equal to 1 times the sum of his then current annual salary plus annual target bonus or 150% of such sum if the termination occurs within 12 months following a change in control transaction (as defined in the employment agreement);

if he timely elects and remains eligible for continued coverage under COBRA, an amount equal to the health insurance premiums that we were paying on his behalf and on behalf of his covered dependents prior to the date of termination for a period of 12 months, or 18 months if the termination occurs within 12 months following a change in control transaction;

acceleration of vesting of unvested stock options equal to the number of shares that would have vested if employment had continued for 12 months following the termination (or, if the termination occurred following a change in control transaction, all outstanding unvested stock options held by Mr. Chung will vest); and

a cash payment for any unvested company matching contributions in his account under the Company's 401(k) plan and for any accrued but unpaid vacation.

Mr. Chung's employment agreement also provides for a retention payment equal to one-half of the sum of his then current annual salary plus annual target bonus, if our board of directors engages an investment bank or similar firm for purposes that include exploring a change in control transaction, but no such transaction is

consummated within 24 months thereafter. This retention payment would be payable in shares of our common stock, if necessary to avoid a credit default.

In addition to the severance and retention payments described above, in the event a change in control occurs due to a sale of the Company's assets or a merger of the Company or an acquisition of the Company via tender offer, the employment agreement also provides that Mr. Chung will receive a payment equal to the sum of his annual salary plus annual target bonus. If this change in control occurs within one year after he has received a retention payment (as described above), however, then this change in control payment shall be subject to partial reduction.

In addition, the employment agreement continues to provide for a temporary housing allowance to Mr. Chung for a period up to 24 months.

Employment Agreement with Dale E. Messick

We previously entered into an employment agreement with Dale E. Messick to serve as our Chief Financial Officer. In March 2012, we entered into an amended and restated employment agreement with Mr. Messick. This employment agreement has an initial term through March 31, 2013 and automatically renews for additional one-year periods unless terminated by either party on 90 days prior notice.

Under the terms of the employment agreement, Mr. Messick is eligible to participate in our senior management incentive plan for an annual discretionary cash bonus of at least 50% of his then current base salary, subject to the achievement of individual and corporate performance criteria to be determined by our board of directors or our compensation committee and set forth in the incentive plan.

The employment agreement provides that, in the event that his employment is terminated by us without cause or by him for good reason (each as defined in the employment agreement), subject to his entering into and not revoking a release in a form acceptable to the Company, he will be entitled to receive:

a severance payment equal to 9/12 times the sum of his then current annual salary plus annual target bonus or 1 times such sum if the termination occurs within 12 months following a change in control transaction (as defined in the employment agreement);

if he timely elects and remains eligible for continued coverage under COBRA, an amount equal to the health insurance premiums that we were paying on his behalf and on behalf of his covered dependents prior to the date of termination for a period of 9 months, or 12 months if the termination occurs within 12 months following a change in control transaction;

acceleration of vesting of unvested stock options equal to the number of shares that would have vested if employment had continued for 12 months following the termination (or, if the termination occurred following a change in control transaction, all outstanding unvested stock options held by Mr. Messick will vest); and

a cash payment for any unvested company matching contributions in his account under the Company's 401(k) plan and for any accrued but unpaid vacation.

Mr. Messick's employment agreement also provides for a retention payment equal to one-half the sum of his then current annual salary plus annual target bonus if our board of directors engages an investment bank or similar firm for purposes that include exploring a change in control transaction, but no such transaction is consummated within 24 months thereafter. This retention payment would be payable in shares of our common stock, if necessary to avoid a credit default.

In addition to the severance and retention payments described above, in the event a change in control occurs due to a sale of the Company's assets or a merger of the Company or an acquisition of the Company via tender

offer, the employment agreement also provides that Mr. Messick will receive a payment equal to the sum of his annual salary plus annual target bonus. If this change in control occurs within one year after he has received a retention payment (as described above), however, then this change in control payment shall be subject to partial reduction.

Employment Agreement with Scott A. Graeff

On July 14, 2006, we entered into an employment agreement with Scott A. Graeff as our Chief Financial Officer. This agreement was subsequently amended and restated, effective as of January 1, 2007, to reflect a change to Mr. Graeff's base compensation and a previous change to Mr. Graeff's title to Chief Commercialization Officer. In March 2012, we entered into an amended and restated employment agreement with Mr. Graeff. This employment agreement has an initial term through March 31, 2013 and automatically renews for additional one-year periods unless terminated by either party on 90 days prior notice.

Under the terms of the employment agreement, Mr. Graeff is eligible to participate in our senior management incentive plan for an annual discretionary cash bonus of at least 50% of his then current base salary, subject to the achievement of individual and corporate performance criteria to be determined by our board of directors or our compensation committee and set forth in the incentive plan.

The employment agreement provides that, in the event that his employment is terminated by us without cause or by him for good reason (each as defined in the employment agreement), subject to his entering into and not revoking a release in a form acceptable to the Company, he will be entitled to receive:

a severance payment equal to 9/12 times the sum of his then current annual salary plus annual target bonus or 1 times such sum if the termination occurs within 12 months following a change in control transaction (as defined in the employment agreement);

if he timely elects and remains eligible for continued coverage under COBRA, an amount equal to the health insurance premiums that we were paying on his behalf and on behalf of his covered dependents prior to the date of termination for a period of 9 months, or 12 months if the termination occurs within 12 months following a change in control transaction;

acceleration of vesting of unvested stock options equal to the number of shares that would have vested if employment had continued for 12 months following the termination (or, if the termination occurred following a change in control transaction, all outstanding unvested stock options held by him will vest); and

a cash payment for any unvested company matching contributions in his account under the Company's 401(k) plan and for any accrued but unpaid vacation.

Mr. Graeff's employment agreement also provides for a retention payment equal to one-half the sum of his then current annual salary plus annual target bonus if our board of directors engages an investment bank or similar firm for purposes that include exploring a change in control transaction, but no such transaction is consummated within 24 months thereafter. This retention payment would be payable in shares of our common stock, if necessary to avoid a credit default.

In addition to the severance and retention payments described above, in the event a change in control occurs due to a sale of the Company's assets or a merger of the Company or an acquisition of the Company via tender offer, the employment agreement also provides that Mr. Graeff will receive a payment equal to the sum of his annual salary plus annual target bonus. If this change in control occurs within one year after he has received a retention payment (as described above), however, then this change in control payment shall be subject to partial reduction.

Employment Agreement with Mark Froggatt

On July 16, 2009, we entered into an employment agreement with Mark Froggatt, Ph.D, as our Chief Technology Officer. In March 2012, we entered into an amended and restated employment agreement with Dr. Froggatt. This employment agreement has an initial term through March 31, 2013 and automatically renews for additional one-year periods unless terminated by either party on 90 days prior notice.

Under the terms of the employment agreement, Dr. Froggatt is eligible to participate in our senior management incentive plan for an annual discretionary cash bonus of at least 50% of his then current base salary, subject to the achievement of individual and corporate performance criteria to be determined by our board of directors or our compensation committee and set forth in the incentive plan.

The employment agreement provides that, in the event that his employment is terminated by us without cause or by him for good reason (each as defined in the employment agreement), subject to his entering into and not revoking a release in a form acceptable to the Company, he will be entitled to receive:

a severance payment equal to 9/12 times the sum of his then current annual salary plus annual target bonus or 1 times such sum if the termination occurs within 12 months following a change in control transaction (as defined in the employment agreement);

if he timely elects and remains eligible for continued coverage under COBRA, an amount equal to the health insurance premiums that we were paying on his behalf and on behalf of his covered dependents prior to the date of termination for a period of 9 months, or 12 months if the termination occurs within 12 months following a change in control transaction;

acceleration of vesting of unvested stock options equal to the number of shares that would have vested if employment had continued for 12 months following the termination (or, if the termination occurred following a change in control transaction, all outstanding unvested stock options held by him will vest); and

a cash payment for any unvested company matching contributions in his account under the Company's 401(k) plan and for any accrued but unpaid vacation.

Dr. Froggatt's employment agreement also provides for a retention payment equal to one-half of the sum of his then current annual salary plus annual target bonus if our board of directors engages an investment bank or similar firm for purposes that include exploring a change in control transaction, but no such transaction is consummated within 24 months thereafter. This retention payment would be payable in shares of our common stock, if necessary to avoid a credit default.

In addition to the severance and retention payments described above, in the event a change in control occurs due to a sale of the Company's assets or a merger of the Company or an acquisition of the Company via tender offer, the employment agreement also provides that Dr. Froggatt will receive a payment equal to the sum of his annual salary plus annual target bonus. If this change in control occurs within one year after he has received a retention payment (as described above), however, then this change in control payment shall be subject to partial reduction.

Termination of Employment Not Within 12 Months Following a Change in Control

Under the terms of the current employment agreements with Messrs. Chung, Messick, Graeff and Froggatt and based on their respective current (2012) salaries, assuming (i) the employment of each of the executive officers had been terminated as of December 31, 2011, (ii) the termination was by us without cause or by the executive for good reason and (iii) the termination was not within 12 months following a change in control transaction, each named executive officer would receive the benefits set forth in the table below.

Name	Cash Severance (\$)	Healthcare Benefits (\$)	Intrinsic Value of Accelerated Stock Options (\$)(1)	Total Potential Payments (\$)(2)
My E. Chung	472,500	10,555		483,055
Dale E. Messick	247,500	8,266	958	256,724
Scott A. Graeff	236,475		13,309	249,784
Mark Froggatt	243,338	11,413	8,484	263,235

- (1) The intrinsic value of accelerated stock options is the difference between the \$1.73 closing trading price of our common stock on December 30, 2011, the last trading day of the year, and the exercise price, multiplied by the number of unvested options that would have vested upon termination.
- (2) Does not include any cash payment for unvested matching 401(k) contributions.

Payments in Connection With a Change in Control; Termination of Employment Within 12 Months Following a Change in Control

Under the terms of the current employment agreements with Messrs. Chung, Messick, Graeff and Froggatt and based on their respective current (2012) salaries, the table below sets forth the benefits each named executive officer would receive in connection with a change in control, as well as such additional benefits that would be payable upon each executive officer's termination, assuming such termination (i) occurred on December 31, 2011 and within 12 months following the change in control transaction and (ii) was by us without cause or by the executive for good reason.

Name	Payments Upon Change in Control	Additional Payments in Connection with Termination of Employment within 12 months following Change in Control			Total Potential Payments (\$)(3)
	Cash Change in Control Payment (\$)(1)	Cash Severance (\$)	Healthcare Benefits (\$)	Intrinsic Value of Accelerated Stock Options (\$)(2)	
My E. Chung	472,500	708,750	15,833		1,197,083
Dale E. Messick	330,000	330,000	11,022	958	671,980
Scott A. Graeff	315,300	315,300		13,309	643,909
Mark Froggatt	324,450	324,450	15,217	8,484	672,601

- (1) If the change in control occurs within one year after the executive officer receives a retention payment, as described in each executive officer's employment agreement, the change in control payment listed would be subject to partial reduction. See Employment Agreements and Potential Payments upon Termination or Change in Control for a discussion of the retention payments.
- (2) The intrinsic value of accelerated stock options is the difference between the \$1.73 closing trading price of our common stock on December 30, 2011, the last trading day of the year, and the exercise price, multiplied by the number of unvested options that would have vested upon termination.
- (3) Does not include any cash payment for unvested matching 401(k) contributions.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth certain information with respect to beneficial ownership of our common stock, as of March 31, 2012, by:

each person known by us to be a beneficial owner of 5% or more of the outstanding shares of our common stock;

each of our directors and the board of directors nominees for director;

each of the executive officers named in the Summary Compensation Table, to whom we refer as our named executive officers; and

all of our currently serving executive officers and directors as a group.

Beneficial ownership is determined in accordance with the rules of the SEC. Except as indicated by the footnotes below, we believe, based on the information furnished to us, that the persons and entities named in the table below have sole voting and investment power with respect to all shares of the common stock that they beneficially own, subject to applicable community property laws. In computing the number of shares beneficially owned by a person and the percentage ownership of that person, shares of common stock subject to options, restricted stock units, warrants or other exercisable or convertible securities held by that person that are currently exercisable or convertible or exercisable or convertible within 60 days of March 31, 2012 are deemed outstanding, but are not deemed outstanding for purposes of computing the percentage ownership of any other person. Unless otherwise indicated, these shares do not include any stock, options or restricted stock units awarded after March 31, 2012. A total of 13,888,454 shares of our common stock were outstanding as of March 31, 2012.

Unless otherwise indicated, the address of each beneficial owner listed in the table below is c/o Luna Innovations Incorporated, 1 Riverside Circle, Suite 400, Roanoke, Virginia 24016.

Name and Address of Beneficial Owner	Number of Shares Beneficially Owned	Percent of Class
Kent A. Murphy, Ph.D (1)	2,797,998	20.1%
Carilion Clinic (2) c/o Carilion Roanoke Memorial Hospital First Floor Roanoke, Virginia 24033 Hansen Medical, Inc. (3) 800 East Middlefield Road Mountain View, CA 94043	3,769,563	24.5%
My E. Chung (4)	1,357,189	9.9%
Dale E. Messick (5)	8,632	*
Scott A. Graeff (6)	334,117	2.4%
Mark E. Froggatt, Ph.D. (7)	392,119	2.8%
John B. Williamson, III (8)	299,645	2.1%
Warner Dalhouse (9)	129,546	*
Jonathan M. Cool (10)	131,208	*
Edward G. Murphy, M.D. (11)	131,576	*
Richard W. Roedel (12)	27,811	*
Michael W. Wise (13)	478,884	3.3%
Neil D. Wilkin, Jr.	573,564	4.1%
All current directors and executive officers as a group (12 persons) (14)	7,500	*
	5,358,804	34.8%

- * Represents less than 1% of the outstanding shares of common stock.
- (1) Includes 9,999 shares subject to options that are exercisable within 60 days of March 31, 2012.
 - (2) Includes 1,321,514 shares of Series A Convertible Preferred Stock, which are currently convertible into an equivalent number of shares of common stock, as well as 155,941 shares of common stock payable as accrued dividends on the Series A Convertible Preferred Stock that will be issued upon the holder's request, and 43,212 shares subject to stock options that are immediately exercisable or exercisable within 60 days of March 31, 2012. Does not include 366,000 shares of common stock underlying warrants that are not exercisable within 60 days of March 31, 2012. Nancy Agee, Don Lorton and Rob Vaughan share voting and investment power over the shares beneficially owned by Carilion Clinic.
 - (3) Excludes shares issuable upon exercise of a warrant, exercisable until January 12, 2013, that entitles Hansen to purchase additional shares of our common stock, at a purchase price of \$0.01 per share, such that the total number of shares issuable under the warrant, plus the reported shares, is equal to 9.9% of our outstanding common stock.
 - (4) Represents shares subject to options that are immediately exercisable or exercisable within 60 days of March 31, 2012.
 - (5) Includes 292,058 shares subject to options that are immediately exercisable or exercisable within 60 days of March 31, 2012.
 - (6) Includes 352,998 shares subject to options that are immediately exercisable or exercisable within 60 days of March 31, 2012.
 - (7) Represents shares subject to options that are immediately exercisable or exercisable within 60 days of March 31, 2012.
 - (8) Includes 93,198 shares subject to options that are immediately exercisable or exercisable within 60 days of March 31, 2012, and 28,348 shares of common stock issuable pursuant to restricted stock units held under our Non-Employee Director's Deferred Compensation Plan that are payable under circumstances within the control of the holder.
 - (9) Includes 93,198 shares subject to options that are immediately exercisable or exercisable within 60 days of March 31, 2012, and 28,010 shares of common stock issuable pursuant to restricted stock units held under our Non-Employee Director's Deferred Compensation Plan that are payable under circumstances within the control of the holder.
 - (10) Includes 93,198 shares subject to options that are immediately exercisable or exercisable within 60 days of March 31, 2012.
 - (11) Includes 21,270 shares subject to options that are immediately exercisable or exercisable within 60 days of March 31, 2012, and 6,541 shares of common stock issuable pursuant to restricted stock units held under our Non-Employee Director's Deferred Compensation Plan that are payable under circumstances within the control of the holder.
 - (12) Includes 412,897 shares subject to options that are immediately exercisable or exercisable within 60 days of March 31, 2012, and 61,463 shares of common stock issuable pursuant to restricted stock units held under our Non-Employee Director's Deferred Compensation Plan that are payable under circumstances within the control of the holder.
 - (13) Includes 39,600 shares subject to options that are immediately exercisable or exercisable within 60 days of March 31, 2012, and 6,969 shares of common stock issuable pursuant to restricted stock units held under our Non-Employee Director's Deferred Compensation Plan that are payable under circumstances within the control of the holder. Also includes 13,840 shares held by Mr. Wise's family members over which Mr. Wise shares voting and investment power.
 - (14) Includes an aggregate of 131,331 shares of common stock issuable pursuant to restricted stock units issued under our Non-Employee Director's Deferred Compensation Plan that are payable under circumstances within the control of the holders, and an aggregate of 1,755,645 shares of common stock issuable under stock options that are immediately exercisable or exercisable within 60 days of March 31, 2012 (this total includes 53,704 shares issuable under stock options held by Talfourd H. Kemper, Jr., an executive officer of the Company who is not a named executive officer.).

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires that certain of our executive officers and directors, and persons who own more than 10% of a registered class of our equity securities, file reports of ownership and changes in ownership (Forms 3, 4 and 5) with the Securities and Exchange Commission. Such executive officers, directors and greater than 10% holders are required to furnish us with copies of all of these forms that they file. Certain of our executives hold a power of attorney to enable such individuals to file ownership and change in ownership forms on behalf of the reporting persons.

To our knowledge, based solely on our review of these reports or written representations from certain reporting persons that no other reports were required, we believe that during 2011, all filing requirements applicable to our officers, directors, greater than 10% stockholders and other persons subject to Section 16(a) of the Exchange Act were complied with, except that each of Messrs. Williamson, Dalhouse and Cool filed a late Form 4 on April 15, 2011 to report an option grant that had been incorrectly reported on a Form 3 filed by each of those directors on February 3, 2010.

OTHER INFORMATION

Other Matters to be Presented at the Annual Meeting

We do not know of any matters to be presented at our 2012 annual meeting of stockholders other than those described in this proxy statement. If any other matters are properly brought before the annual meeting, proxies will be voted in accordance with the best judgment of the person or persons voting the proxies.

Security Holder Communication with Board Members

Any holder of our common stock may contact the board of directors or a specified individual director by writing to the attention of the board of directors (or a specified individual director) and sending such communication to the attention of our corporate Secretary at our executive offices as identified in this proxy statement. Each communication from a stockholder should include the following information in order to permit us to confirm your status as a security holder and enable us to send a response if deemed appropriate:

the name, mailing address and telephone number of the security holder sending the communication;

the number and type of our securities owned by such security holder; and

if the security holder is not a record owner of our securities, the name of the record owner of our securities beneficially owned by the security holder.

Our corporate Secretary will forward all appropriate communications to the board of directors or individual members of the board of directors as specified in the communication. Our corporate Secretary may, but is not required to, review all correspondence addressed to the board of directors or any individual member of the board of directors. The purpose of this review is to allow the board to avoid having to consider irrelevant or inappropriate communications, such as advertisements, solicitations and hostile communications, or any correspondence more suitably directed to management.

Stockholder Proposals for 2013 Annual Meeting

Our bylaws provide for advance notice procedures to recommend a person for nomination as a director or to propose business to be considered by stockholders at a meeting but not to be included in our proxy materials. For the 2013 annual meeting of stockholders, such nominations or proposals, other than those made by or at the direction of the board of directors, must be submitted in writing and received by our corporate Secretary at our offices no later than January 24, 2013, which is 90 days prior to the anniversary of the expected first mailing date of this proxy statement. If our 2013 annual meeting of stockholders is moved more than 30 days before or after the anniversary date of our 2012 annual meeting of stockholders, then the deadline is the close of business on the tenth day following the day notice of the date of the meeting was mailed or made public, whichever occurs first. Such proposals also need to comply with all applicable requirements of the rules and regulations of the SEC. The chairperson of a stockholder meeting may refuse to acknowledge the introduction of your proposal if it is not made in compliance with the foregoing procedures or the applicable provisions of our bylaws.

In addition, for a stockholder proposal to be considered for inclusion in our proxy statement for the 2013 annual meeting of stockholders, the proposal must be submitted in writing and received by our corporate Secretary at our offices at 1 Riverside Circle, Suite 400, Roanoke, Virginia 24016 no later than December 25, 2012, which is 120 days prior to the anniversary of the expected mailing date of this proxy statement. You are also advised to review our bylaws, which contain additional requirements about advance notice of stockholder proposals and director nominations.

Householding of Annual Meeting Materials

Some banks, brokers and other nominee record holders may participate in the practice of householding proxy statements and their accompanying documents. This means that only one set of our annual meeting

materials is sent to multiple stockholders in your household unless you instruct otherwise. We will promptly deliver a separate copy of these documents without charge to you upon written request to Luna Innovations Incorporated, 1 Riverside Circle, Suite 400, Roanoke, Virginia 24016, Attn: Investor Relations. If you want to receive separate copies of our annual meeting materials in the future, or if you are receiving multiple copies and would like to receive only one copy per household, you should contact your bank, broker or other nominee record holder, or you may contact us at the above address and phone number.

By Order of the Board of Directors

/s/ Talfourd H. Kemper, Jr.
Talfourd H. Kemper, Jr.
Vice President, General Counsel and Secretary

April 24, 2012

A copy of our Annual Report to the Securities and Exchange Commission on Form 10-K for the fiscal year ended December 31, 2011 is available without charge on our website, www.lunainnovations.com, or upon written request to: Corporate Secretary, Luna Innovations Incorporated, 1 Riverside Circle, Suite 400, Roanoke, Virginia 24016.

