



# PENSION & BENEFITS

**DAILY**

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## Compensation Risk—Regulatory Requirements and Practical Applications

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### Summary of Various Requirements

#### Introduction

The near collapse of financial markets and the global financial crises in 2009 focused the public, media, Washington, and individual investors, among others, on outsized Wall Street compensation packages related to excessive risk-taking. Over the course of 18 months, dozens of bills floated around Congress intended to address this issue. In the end, legislation was enacted through the Emergency Economic Stabilization Act of 2008 (EESA),<sup>1</sup> as amended by the American Recovery and Reinvestment Act of 2009 (ARRA),<sup>2</sup> as well as through amendments to the Security Exchange Commission's (SEC) disclosure rules. Banking regulators jumped on the bandwagon with the Federal Reserve Board and the FDIC proposing to regulate risk-taking by organizations within their purview. Finally, RiskMetrics Group changed its policies and voting guidelines to consider compensation-related risk.

This article summarizes each of these significant mandates, and suggests an approach for companies in conducting compensation-related risk assessments.

<sup>1</sup> Pub. L. No. 110-343.

<sup>2</sup> Pub. L. No. 111-5, § 7001.

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#### Troubled Asset Relief Program (TARP) Restrictions

Compensation-related risk first came under the microscope for those companies that received TARP assistance under the ESSA and ARRA (TARP Recipients). The statute prohibits TARP Recipients from providing compensation that encourages unnecessary or excessive risk that threatens the value of the company. Regulations issued under the statute require that TARP Recipients maintain independent compensation committees to evaluate *all* risks inherent in *all* employee compensation plans—defined broadly as any plan or arrangement involving more than one employee pursuant to which cash or other benefits may be paid.<sup>3</sup>

Specifically, compensation committees must:

- discuss, evaluate and review *every six months* with the TARP Recipient's senior risk officers the compensation plans for senior executive officers (SEOs—generally the proxy officers) to ensure that the plans do not encourage SEOs to take unnecessary and excessive risks that threaten the value of the TARP Recipient;
- discuss, evaluate and review *every six months* with the senior risk officers all employee compensation plans in light of the risks posed to the TARP Recipient by such plans and how to limit such risks;
- discuss, evaluate and review *every six months* all employee compensation plans to ensure that these plans do not encourage the manipulation of reported

<sup>3</sup> See <http://www.treas.gov/press/releases/reports/ec%20ifr%20fr%20web%206.9.09tg164.pdf>.

earnings of the TARP recipient to enhance the compensation of any of the TARP recipient's employees;

- provide a narrative description *once per year* of (1) how the CEO compensation plans do not encourage the CEO to take unnecessary and excessive risks that threaten the value of the TARP Recipient, (2) the risks posed by employee compensation plans and how those risks are controlled, and (3) how the TARP Recipient has ensured that its employee compensation plans do not encourage the manipulation of reported earnings to enhance the compensation of any of its employees; and

- certify the completion of the reviews described above in the Compensation Committee Report. The guidance provides a sample certification that can be used to satisfy this requirement.

In order to conduct the first two reviews the committee must discuss and evaluate with senior risk officers any short-term or long-term risks that could threaten the value of the TARP recipient. The committee must also identify the features in the CEO compensation plans that could lead the CEOs to take these risks, as well as any features in the employee compensation plans that pose risks to the TARP recipient, including any features in either of the plans that would encourage behavior focused on short-term results rather than long-term value creation.

The committee is required to limit these features and amend plans to ensure that the CEOs are not encouraged to take risks that are unnecessary or excessive and that the TARP recipient is not unnecessarily exposed to risks.

Significantly, the required evaluation extends to all of the TARP recipient's employee compensation plans, not just plans covering CEOs. As a result, many TARP recipients (particularly the larger ones) were required to extensively review hundreds of plans—many of which had not previously been reviewed by the committee.

## Securities and Exchange Commission – Revised Proxy Disclosure Rules

At the end of 2009, the SEC made significant amendments to existing executive compensation disclosure rules applicable to publicly filed companies<sup>4</sup>. One of the most important of these changes involved disclosure requirements related to analysis of compensation-related risk. Under the new rule (applicable to companies filing in 2010), companies are required to provide a discussion about situations in which *any employee* compensation program is “*reasonably likely to have a material adverse effect on the company*.” Under the former rules, proxy discussion was generally limited to compensation programs and policies for Named Executive Officers (NEOs).

If policies exist to mitigate or balance risk, the company may conclude that its compensation practices do not meet the “reasonably likely” threshold, and the risk need not be reported if it does not have an *adverse effect*.

Materiality for purposes of this rule is facts and circumstances driven. But guidance is provided in the form of samples of the types of policies and situations that could trigger such disclosure, including:

- a business unit of the company that carries a significant portion of the company's risk profile;

- a business unit of the company with a significantly different compensation structure from the rest of the company;

- some business units of the company that are significantly more profitable than others;

- business units in which compensation accounts for a significant percentage of revenues; or

- programs that vary significantly from the company's overall risk and reward structure, such as payment of bonuses related to objectives for which the revenue and associated risk to the company will extend over a significantly longer period.

If the materiality threshold is met, the rules provide examples of information that may need to be provided, including:

- the general design philosophy of compensation policies for employees whose behavior would be most affected;

- any risk assessment or incentive considerations used in structuring, awarding, and delivering compensation;

- policies that address short-term and long-term compensation risks, such as clawbacks or holding periods;

- how compensation policies are adjusted to address changes in the company's risk profile;

- any material adjustments made to compensation policies or practices due to changes in the company's risk profile; and

- the extent to which the company monitors its compensation policies and practices to determine whether its risk management objectives are being met with respect to motivating its employees.

The rules technically require that this disclosure be provided outside of the Compensation Discussion and Analysis (CD&A) in new Item 402(s), presumably because the discussion applies equally to NEO and non-NEO plans. However, many early filers seemed to have placed a discussion of risk (and the process used to evaluate risk) within the CD&A, finding that it was integral to a discussion of decision-making in the year at issue. Smaller companies (those with a public float of less than \$75 million) are exempt from the risk disclosure requirements, on the ground that such organizations are less likely to have pay compensation policies and practices that pose substantial risks.

The rules clarify that a company does not need to formally state in the proxy that its compensation policies and practices are not reasonably likely to have a material adverse effect on the company, if that is the case. Nonetheless, companies should go through the process to ensure they have conducted an appropriate risk assessment. Moreover, at a recent conference, the SEC Division of Corporation Finance staff indicated that if a company's proxy statement is selected for review by the SEC, the company will be asked to explain the process used to determine that no material risk exists in incentive plans, if no such disclosure is provided in the proxy.

## The Federal Reserve Board Proposal

Expanding its traditional role in ensuring financial companies' safety and soundness, the Federal Reserve proposed guidance that would impose an unprecedented level of influence over risk-taking and the compensation practices of banking organizations within its

<sup>4</sup> See <http://sec.gov/rules/final/2009/33-9089.pdf>

jurisdiction<sup>5</sup>. In contrast to the TARP restrictions and amended SEC rules, the Federal Reserve Proposal is more granular in that it provides specific examples, situations and corrective actions for plans that are determined to promote excessive risk.

The guidance sets forth three principles for designing and implementing incentive compensation arrangements (ICAs) for banking organizations:

**Principle #1: Balanced Risk-Taking Incentives**

The Reserve states that ICAs should balance risk and financial results so that covered individuals are not motivated to take excessive risks, based on the following principles:

- *Full Range of Risk*: All risks associated with an employee's activities should be considered, including but not limited to credit, market, liquidity, operational, legal, compliance, and reputational risks. Even low probability risks should be considered if they would have highly adverse effects.

- *Time Horizon of Risk*: This refers to the time horizon over which those risks may be realized in assessing whether ICAs are balanced. The guidance suggests that short-term financial criteria are inherently flawed.

- *Fixing Unbalanced Arrangements*: The guidance provides tips for balancing arrangements, to be used individually or in combination as appropriate to the situation:

- adjusting awards based on risk;
- deferring payouts (with adjustment for losses during deferral period, or clawbacks);
- extending performance periods; and
- flattening the incentive payout curve for higher levels of performance.

- *Quantitative Measures*: If available, use quantitative measures of risk and risk outcomes to assess the balance of ICAs. The use of scenario analysis (i.e., evaluation of payments on a forward-looking basis based on a range of performance levels, risk outcomes, and levels of risks taken) is encouraged to help assess whether certain ICA features are likely to achieve balance over time.

- *Risk Motivating Factors*: Eliminate ICA design features that might encourage undue risk taking behavior, including:

- where incentive compensation is a large portion of total compensation;
- where substantially all of a covered individual's potential incentive compensation is paid even when risk, or risk outcomes, are materially worse than expected; and
- where a covered employee's incentive compensation payments are closely tied to business generated by the employee (versus basing payments on measures such as firm-wide profit that are only distantly linked).

- *Tailored Programs*: *Balancing risk is not a one-size-fits-all process*. ICAs should be tailored to different employees—including the substantial differences between senior executives and other employees—and different banking organizations.

- *Golden Parachute Arrangements*: Providing windfalls upon termination of employment or change-in-control may encourage undue risk-taking by essentially providing a safety net against risky outcomes. Such arrangements should be carefully reviewed.

- *Communication*: Banking organizations should effectively communicate to employees the ways in which ICAs and payments will be reduced as risks increase. The sophistication of the communication should be tailored to the respective audience.

**Principle #2: Effective Controls and Risk Management**

The Reserve's proposal also states that banking organizations should have appropriate controls governing the processes for designing, implementing, and monitoring ICAs.

- *Policies and Controls*: Policies and procedures should:

- identify and describe the role(s) of the personnel, business units, and control units authorized to be involved in the design, implementation, and monitoring of ICAs;

- identify the source of significant risk-related inputs into these processes and establish appropriate controls over their development and approval;

- identify the individual(s) and department(s) whose approval is necessary for the establishment of new ICAs or modification of existing arrangements; and

- create and maintain sufficient documentation for an audit of the organization's processes for establishing, modifying, and monitoring ICAs.

- *Frequent Reviews, Reporting and Adjustments by Appropriate Personnel*: Regular internal reviews should be conducted by audit, compliance, human resources, or other personnel, as appropriate. The results should be reported to management and/or the board, and ICAs should be monitored and revised as needed.

- *Substance of Review*: A risk assessment process of ICAs should include, but not be limited to:

- reviewing the types of risks associated with the activities of employees covered by an ICA;

- approving the risk measures used in risk adjustments and performance measures, as well as measures of risk outcomes used in deferred payout arrangements; and

- analyzing risk-taking and risk outcomes relative to incentive compensation payments.

- *Adequate and Independent Resources*: The guidelines provide that adequate resources will be needed to implement this principle. Compensation for risk management and control functions should be sufficient to attract and retain qualified employees and avoid a conflict of interest.

**Principle #3: Strong Corporate Governance**

Finally, the Reserve's proposal states that strong and effective corporate governance is needed to ensure sound compensation practices.

- *Board Involvement*: The board, compensation committee, or other committee with primary responsibility over compensation should be actively involved in developing and approving ICAs for senior executives and all covered individuals. Those responsibilities include:

- monitoring performance and regularly reviewing the design and function of ICAs;

- at least annually, reviewing an assessment by management (with appropriate input from risk management personnel) of the effectiveness of the design and operation of the ICAs in promoting appropriate risk-taking;

<sup>5</sup> See <http://edocket.access.gpo.gov/2009/pdf/E9-25766.pdf>.

- examining reviews of ICAs and risk-related payments on a forward- and backward-looking basis, using scenario analysis as appropriate; and

- staying abreast of significant marketplace changes in compensation plan mechanisms and incentives.

- **Board Composition and Resources:** The board should have a separate compensation committee that consists solely or predominately of independent directors. Where feasible, at least one member of the committee should have expertise and experience in risk management and compensation practices in the financial services industry that is appropriate to the nature, scope, and complexity of the organization. The board should also maintain authority to select, compensate, and use outside counsel, independent consultants, or other experts with expertise in incentive compensation and risk management.

- **Disclosure:** Appropriate information concerning ICAs and related risk management, control, and governance processes should be provided to allow shareholders to restrain the potential for excess risk. The Federal Reserve intends to work with the SEC to improve banking organizations' compensation-related disclosures.

- **Tailored Governance Programs:** Once again, the Federal Reserve recognizes that a one-size-fits-all approach with respect to corporate governance is not appropriate. For example, large complex banking organizations (LCBOs) with many risk-taking employees engaged in diverse activities require a formalized, robust, and systemic approach to developing and overseeing their compensation practices. In contrast, smaller regional and community banking organizations should tailor their approaches to their size, complexity, activities, and the prevalence and scope of their own ICAs.

#### Supervisory Initiatives

The Federal Reserve also took two supervisory initiatives to “spur and monitor progress toward safe and sound incentive compensation arrangements, identify emerging best practices, and advance the state of practice more generally in the industry.” The first consists of a “horizontal review” of ICAs at 28 LCBOs. The LCBOs are required to provide the Federal Reserve with documentation of: (i) the structure of their organization's current ICAs, (ii) their existing processes to oversee these arrangements, and (iii) the organization's future plans to improve risk sensitivity. The Federal Reserve will work closely with each organization to link planned compensation structures with principles of safety and soundness that can be implemented expeditiously. If the LCBO fails to submit or develop effective plans, the Federal Reserve may take enforcement or supervisory action such as limiting incentive awards.

The second initiative consists of a review of community and regional banking organizations. The ICAs of these organizations will be examined as part of the regular supervisory reviews for over 6,000 community and regional banking organizations. The reviews will be conducted in connection with the review of each organization's risk management, internal controls and corporate governance processes, and tailored to reflect the scope and complexity of the bank's activities and scope of ICAs. While the process will be less extensive and formalized than for the LCBOs, the Federal Reserve will take supervisory action against the organization to address deficiencies.

## FDIC Proposal

The FDIC also has an outstanding proposal to amend the FDIC's system for risk-based deposit insurance assessment of all insured banks to account for risks imposed by employee compensation programs.<sup>6</sup> In other words, insurance rates will now be based in part on compensation-related risk as defined by the FDIC. The FDIC methodology under consideration would likely establish a standard for employee compensation programs. It includes a series of criteria that would allow the FDIC (and the insured depository institution) to determine whether that standard has been met. The Proposal contemplates a list of potential criteria that would create a “safe harbor” giving financial institutions greater certainty that their employee compensation programs will satisfy the FDIC's goals and that the insured depository institution will not be subject to an increased risk-based assessment rate.

The contemplated criteria that are outlined in the Proposal include the following:

- A significant portion of compensation for senior management and employees whose work presents significant risk to the institution and who receive a significant portion of compensation based on achieving performance goals should be made in the form of restricted, nondiscounted company stock that vests over a number of years.

- Company stock awards should vest over several years and be subject to a clawback so that gains realized on payment of awards can be recouped in the event earlier risks lead to losses.

- A board committee comprised of independent directors, with input from independent compensation advisors, should administer the compensation program.

## RiskMetrics Group

Proxy advisory firm RiskMetrics Group (RMG) also issued important updates to its voting policy in 2010 that included greater emphasis on the issue of compensation-related risk. Depending on a company's shareholder base, an RMG voting recommendation can have a meaningful impact on the outcome of items submitted to a shareholder vote.

Under the policy update, RMG will analyze the following specific practices on a case-by-case basis as to whether they encourage excessive risk-taking:

- guaranteed bonuses,
- a single performance metric used for short- and long-term plans,
- lucrative severance packages,
- high pay opportunities relative to industry peers,
- disproportionately high supplemental pensions,
- mega annual equity grants that provide unlimited upside but no downside risk.

On the other end of the spectrum, RMG will consider the existence of rigorous clawback provisions and robust stock ownership/holding guidelines as potentially mitigating factors.

RMG acknowledges that public companies typically do not like to provide negative disclosures (e.g., “We found no material adverse risks caused by compensation”) due to concerns over liability, and the SEC's rules do not generally require such statements. It therefore recognizes that some companies may be silent in their

<sup>6</sup> See <http://www.fdic.gov/news/board/2010jan12anpr.pdf>.

2010 proxies with regard to searches for material adverse effects from pay that found no such risks. While RMG does not have a policy regarding nondisclosure, it advises companies at a minimum to discuss their process and any mitigating features (such as clawbacks or bonus banks) that they have adopted. RMG views this disclosure as an opportunity for communication, not simply compliance, and believes that shareholders will expect a reasonably substantive discussion of how the board determines if incentive pay programs might motivate inappropriate risk-taking and how that risk is being mitigated.<sup>7</sup>

RMG also introduced for the 2010 proxy season a new tool—Governance Risk Indicators (or GRId) for institutional investors to assess the level of governance-related risk at current or prospective portfolio companies in four categories: audit, board, shareholder rights, and compensation.<sup>8</sup> On the compensation side, companies will be receiving scores based on RMG's notions of perceived riskiness of certain compensation designs and programs. Factors such as adequate disclosure of performance measures, dilution, burn rates, minimum vesting periods, holding periods, repricings, stock ownership guidelines, and poor pay practices (as defined by RMG) will be considered in conducting this risk analysis.

## Sample Risk Assessment Process

While the preceding authorities are not entirely consistent in their approaches to permissible levels or programs with respect to compensation risk, it is clear that all public companies subject to SEC filing requirements, as well as any banking organizations within the purview of the Federal Reserve or FDIC, should undergo a risk assessment process. This section provides an illustrative three-step approach for conducting this process.

### Step 1: Establish the Basis

The process should start with identifying who will be responsible for preparing the supporting documentation for the compensation committee to review and approve. Typically, this may include individuals in the human resources, finance, controller, or risk functions. Once ownership of the process is established, the individuals driving the process should establish the frequency and/or timing in which to conduct the assessment. They should also establish a policy going forward to consider risk assessment policy as part of the annual compensation review.

### Step 2: Establish a Framework and List of Critical Questions for Risk Assessment

Companies should create a scorecard that addresses whether there are areas in the compensation program that may encourage inappropriate risk taking. One process analyzes seven key areas in which such a review could focus, with some sample questions following.

**Business Risks:** Consideration should be given to: the company's key business risks; which of these risks pose the highest probability and could most threaten the

company's value; what time horizon should be used in which to measure the risk; and which risks are connected (directly or indirectly) to incentive compensation.

**External Market Questions:** Consideration should be given to how the compensation peer group was selected, and its similarity to the company on key size parameters. Committees should consider how the compensation program design, opportunities, and actual payouts compare to market practices. Companies that maintain plans using an aggressive peer group, or that have heavily leveraged plans compared to an appropriate peer group, may have a higher degree of risk associated with them.

**Pay Mix Questions:** Companies should carefully consider the mix of pay elements and whether too much emphasis is placed on any one component. Relationships between fixed vs. variable, long-term vs. short term and equity vs. cash should be a focus. Companies should ask if the timing for incentive payouts is consistent with the risk horizon. The mix of equity-based incentives should also be analyzed—too much of a focus on either options or time-based awards may be considered risky.

**Leverage Questions:** A study should be done of the full range of upside and downside potential, and payouts, under each incentive plan. Possible red flags include any plan that allows for uncapped upside, guaranteed threshold payouts, or small changes in performance that result in large changes in payouts (i.e., a steep payout curve). All-or-nothing incentive awards or performance metrics are also potentially problematic.

**Performance Metrics Questions:** Companies should ensure that incentive plan metrics align and support its business strategy and sustained performance. Too much weight on any one metric is considered riskier than multiple metrics (although too many performance metrics may dull the incentivizing intent of the plan). There should be a mix of "top line" and "bottom line" metrics and of long- and short-term metrics, noting that the use of the same measures for both long and short term could be problematic. Companies should determine what risks an executive might take to achieve the performance metrics and how that would affect the company.

**Goal-Setting Process Questions:** It is important to vet whether the process for setting goals and related performance payouts could drive unnecessary risk. Target performance should be compared with historical performance and the companies could consider whether the goals are realistic, or would require excessive risk to achieve based on historical performance. Historical payout ranges for each incentive plan and each metric should be analyzed. The company should also consider timing issues: are annual and long-term incentive goals consistent and aligned, or is there a disconnect? It also is important for risk purposes as well as for optics that companies consider whether the pattern of incentive payouts over time tracks with the company's stock performance.

**Checks and Balances:** The committee should ensure that compensation related risk is balanced. Members should understand the range of potential payouts under the current program and have a formal process for discussing checks and balances in the compensation risk profile. Guaranteed payouts, multi-year hiring guarantees, use of the same metric for both long-term and

<sup>7</sup> See [http://www.riskmetrics.com/policy/2010\\_NewUSDisclosureFAQ](http://www.riskmetrics.com/policy/2010_NewUSDisclosureFAQ).

<sup>8</sup> See [http://www.riskmetrics.com/sites/default/files/GRId\\_Tech\\_Doc.pdf](http://www.riskmetrics.com/sites/default/files/GRId_Tech_Doc.pdf).

short-term plans, excessive termination for poor performance, or supplemental retirement guarantees are all red flags. On the other hand, the existence and efficacy of clawback policies, stock ownership guidelines, and other deferred stock programs may mitigate risky behavior.

### Step 3: Establish How Results Will Be Reviewed, Addressed, and Disclosed

The results of the risk assessment process should be reported to the compensation committee and the full board, and the committee should then consider if the results warrant changes to the compensation program. The committee or board should adopt resolutions or keep minutes documenting that it received the risk assessment report, the report appears to be comprehensive and thoughtful, the committee agrees with the recommendations (with or without modification), and representative disclosure as to the report will be made in the CD&A. While disclosure is not technically required

by the SEC if no material adverse effects are deemed reasonably likely, a review of early filers certainly indicates that most companies are proving some level of disclosure both as to process and results of findings (e.g., see proxy filings of *Eli Lilly*, *Parametric Technology Corporation*, *Verizon Communications Inc.*, and *Intel*).

### Hot Button Design Features

As suggested by the Federal Reserve, the key to a successful compensation philosophy is balancing risks. This is accomplished not by eliminating any factor that increases risk, or simply adopting practices that seem to mitigate risk, but rather by achieving a risk profile tailored and appropriate to the specific business model. The following is a list of common compensation programs (some discussed above) that typically either mitigate risk or drive risk:

Factors That May Mitigate Risk	Factors That May Drive Risk
Balanced mix of short-term and long-term pay	Pay mix focused on short-term performance
Appropriate peer group derived from a standardized process	Aggressive, cherry-picked peer group
Target pay set at median or below	Target pay set at 75th percentile or higher without corresponding performance requirements
Robust measure selection and goal-setting	Accounting-driven measures/definitions and/or top-line measures only
Different measures for short- and long-term performance	Overlapping short- and long-term measures
Smooth incentive curve payouts	Steep incentive curve payouts
Bonus banking, emphasis on deferral mechanisms and/or minimum stock ownership requirements	Immediate payouts with no holding/deferral requirements
Caps or maximums on the upside; no guarantees on downside	Unlimited upside; guaranteed payouts
Enforceable clawback/recoupment policy	No clawback/recoupment policy
Balanced equity grant mix	No mix of equity incentives
Competitive CIC protection	Above-market CIC
Limited SERP payouts	Above-market or unjustified SERP payouts or enhancements
Independent advisers	No advisers or nonindependent advisers

### Conclusion

Boards of directors and/or compensation committees are now charged with ensuring that undue risk is not promoted in the design of employee incentive plans. As they consider this issue, they should be mindful that

risk is not inherently bad—rather, it is essential to meaningful corporate growth and genuine innovation. The most important lesson from these multiple sources of regulatory guidance is that a robust design and review process, such as the one discussed herein, is key to maintaining the right level of risk.