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A Compensation Committee Framework For Conducting Executive Compensation Risk Assessments

Many commentators on the current financial crisis gripping Wall Street and the U.S. banking community blame financial incentives for encouraging executives to take excessive risks that got their companies in trouble. In response, the Treasury Department's TARP Capital Purchase Program imposes four executive compensation curbs on those financial companies that participate in the program. One of these is that the compensation committee of the board conduct an independent assessment with the firm's senior risk officers to identify any features in the company's executive compensation program that could encourage top executives to take "unnecessary and excessive risks that could threaten the value of the financial institution."

Beyond the financial institutions participating in TARP, it is possible that the practice of conducting executive compensation risk assessments should and will migrate into other large companies' governance practices.

This advisory letter provides a suggested framework and process for conducting an executive compensation risk assessment.

Overview

The executive compensation risk assessment process should proceed in three distinct phases: *first*, having the senior risk officer (or other persons acting in similar capacity) identify for the committee the risks that the company faces that could threaten its value; *second*, identifying the features of the executive compensation program that could induce the senior executive officers to take those risks; and *third*, taking any necessary actions to change the features of the program to reduce the incentive to take such risks, thereby mitigating moral hazard in incentive design and administration.*

Framework

1. Compensation committee develops a framework and process for conducting the executive compensation risk assessment, with input and guidance from its independent advisor, management and legal counsel

* See our companion piece, "Moral Hazard and Executive Compensation," October 7, 2008

SRO Risk Assessment and Report

2. Senior Risk Officer (SRO), or executive(s) acting in a similar capacity, conducts a risk assessment of the company's executive compensation program on behalf of the committee. In preparation for doing so, he or she:
 - is briefed by the top HR executive and the committee's independent advisor on the philosophy and design of the executive compensation program and the performance metrics and payout curves that drive incentive payouts;
 - becomes familiar with how individual executive's performance is evaluated by the CEO and by the compensation committee for purposes of allocating rewards and promotions; and
 - also becomes familiar with the factors and process used by the board in evaluating the CEO's performance.
3. The SRO identifies for the committee the short and long-term risks faced by the company that could harm its value and threaten its existence as a successful enterprise
4. In addition, the SRO, perhaps in conjunction with the committee's independent advisor, identifies the features of the company's executive compensation program or its administration that could induce the senior executive officers to take those risks
 - See Exhibit for examples of compensation design or administrative features that *could* induce excessive risk taking
5. Compensation committee meets with SRO to hear his/her report and evaluation

Compensation Committee Response

6. Compensation committee then decides upon the design or administrative changes needed, if any, to the program to reduce the incentive to take those risks that threaten to harm the company.
 - Recommendations for these changes should come from the committee's independent advisor, the HR head, and other expert sources

Review

7. Committee informs CEO and general counsel of the findings of its risk assessment and the program changes, if any, it is considering
 - Committee considers management and legal input
8. Compensation committee chair briefs full Board of the results of its risk assessment and proposed program changes, if any
 - Committee considers Board input

Implementation

9. Committee makes final decisions based on the results of the assessment, instructs management as to any changes to be made, and, with input from the company's general counsel, adopts its statement for disclosure in the CD&A, if required, e.g.:

“The compensation committee certifies that it has reviewed with senior risk officers the [senior executive officers’] incentive compensation arrangements and has made reasonable efforts to ensure that such arrangements do not encourage [our senior executive officers] to take unnecessary and excessive risks that threaten the value of [the company].”*

Repetitive Process

10. Those companies subject to TARP regulations are required to repeat the process annually, with the compensation committee being responsible for the process and obligated to sign off in the CD&A so long as the U.S. Treasury holds equity or debt securities in the company (including warrants)
11. Other companies, which undertake an executive compensation risk assessment voluntarily, may only wish to repeat the process biennially or triennially
12. Voluntary companies also may find it appropriate to fold the executive compensation risk assessment into an overall HR risk assessment conducted for the compensation committee by the company's HR staff in cooperation with the committee’s advisors
13. Committee evaluates the results of the compensation risk assessment and adopts changes to improve effectiveness in subsequent evolutions

Long-Term Growth Enhancements

14. As a "dividend" of the risk assessment process, management and the committee may discover and adopt program changes that, in fact, enhance future value creation that might not have occurred had the assessment been conducted

* Paraphrased example provided by U.S. Treasury in TARP Capital Purchase Program interim final rule.

**SAMPLE LISTING OF
EXECUTIVE COMPENSATION DESIGN
OR ADMINISTRATIVE FEATURES THAT COULD
INDUCE EXCESSIVE RISK TAKING**

A. Pay Profiles

- Very low salary and high annual incentive pay mix

B. Performance Metrics

- Exclusive focus on financial performance for bonuses, with no exercise of committee discretion to adjust for "quality" of earnings
- Not adjusting performance for risk at financial institutions
- Use of performance metrics that do not benefit the company over the long-term

C. Performance Goals and Payout Curves

- Annual goals and payouts where future impact of decisions (or restatements) does not result in an adjustment
- Financial goals that are so far above the company's past performance as to require performance outside the acceptable risk profile of the company
- "Direct drive" financial incentives, without ability of committee to exercise judgment
- Steep payout curves, where very high threshold levels of performance are required to achieve a threshold level of incentive payout
- Very high leverage above target to achieve maximum incentive payout

D. Equity Incentives

- Over emphasis on use of stock options in equity incentives
- Mega option grants, perhaps even with premium prices
- Highly leveraged performance-vested RSUs, e.g., 200% payouts or more based on exceeding long-term performance goal
- Relative TSR performance goal, which requires highest-of-peers performance for maximum payout

- LTI paid in cash rather than in stock

E. Stock Ownership Requirements and Trading Policies

- No requirement to hold net gain shares from exercised options or vested equity grants
 - Ability to "flip" mega-option grants at exercise is particularly suspect
- No prohibition against buying company shares on margin or using owned shares as collateral for loans
- Top executives with large stock ownership requirements are not required to hold some shares past retirement or other termination

F. Performance Appraisals Management

- A simplistic evaluation system that favors quantitative achievement without regard for risks undertaken
- A culture that venerates current shareholder-value maximization rather than long-term shareholder-value creation
- Personal success and advancement defined as meeting quantitative goals without due regard to the means of goal achievement