

EXECUTIVE PAY AND RISK: WILL NEW SEC RULES AFFECT THE ABILITY TO ATTRACT AND RETAIN TALENT?

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“There are some things you learn best in calm, and some in storm.”—Willa Cather

With new rules on conducting an annual compensation risk assessment for publicly-traded companies approved by the SEC on December 16, 2009, each organization needs to perform an evaluation of its compensation program, paying special attention to the risk it is assuming with the policies and procedures currently in place. Further determination should be made as to the changes that companies can make to de-

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sign executive compensation programs that make sense.

The stormy economy is certainly testing our business executives. Top performers will pull their companies through the recession, maintaining the respect and trust of their employees, stock holders, and the public. Poor performers will feel a much brighter spotlight than ever before. When times are good, it's easier to overlook poor performance in leadership. When times are not so good, we turn to our leaders to provide answers. Recently, the answers from some of our largest companies have not exactly given us with that warm and fuzzy feeling we have been longing for.

Since congress has been asking many of the questions these days, the spotlight gets pretty hot. Those companies receiving assistance from the TARP (Trouble Asset Relief Program) have shed light onto many areas of the business practices of these companies. One of the most high-profile questions Congress has asked is

the affect that compensation programs are having on executives and nonexecutives when it comes to undertaking risky business behaviors. Are employees engaging in activity that presents a high level of risk for the company in order to increase personal gain?

This overarching concern has led to the following legislative and regulatory activity:

- Compensation risk assessment is mandatory for TARP recipients—those companies that are receiving government assistance;
- Annual compensation risk assessment for all publicly-traded companies is included in the recent U.S. Securities Exchange Commission rules; and
- United States Treasury Secretary Timothy Geithner has referred to compensation risk assessment in two of the five principles outlined for executive compensation/governance reform.

In short, the SEC believes investors would benefit from an expanded discussion and analysis of how the company rewards its employees. The extent of this discussion should include disclosure of compensation policies and practices that create risks and could potentially have a material adverse impact. Companies should conduct a risk profile assessment of their overall compensation programs, and include this assessment in the Compensation Discussion and Analysis (CD&A) section of the annual proxy report sent to the SEC.

HOW ARE COMPANIES RESPONDING?

Whenever the subject of change rears its head with regard to executive compensation, anxiety about retaining top talent soon follows. Staying competitive in recruiting and avoiding the “brain drain” has caused some companies to bend and stretch themselves into knots. So, at this point in the game, how do companies unwind? What are companies doing to appease the SEC and their executives at the same time?

While we do not know how companies will respond to any new rules, we conducted a study to track trends that have emerged since the Compensation Discussion and Analysis (CD&A) section was added as a requirement of annual SEC proxy reports in 2007. Our study, published in August 2009 and entitled “Executive Compensation Trends for 2009: Balancing Risk, Performance and Pay,” reviewed 200 of the largest companies (by market capitalization) that comprise the S&P 500 Stock Index.

Surprisingly, 70 percent of companies reported changes to their 2009 executive compensation programs. These range from “minor changes” relating to salaries to “major changes” relating to short and long-term incentive programs. We also reviewed changes to severance, retirement and perquisites programs. In our study, we reviewed each proxy statement for a description of prospective changes for 2009 in response to the economic downturn and increased shareholder scrutiny.

In general, incentive plans have changed as follows:

- A shift away from long-term incentives to include more focus on short-term incentive plans;
- Short-term incentive plan performance measures shifted to profit and cash flow from capital efficiency;
- Long-term incentive plan performance measures shifted to capital efficiency, cash flow and total shareholder return; and
- Companies are increasing their emphasis on time-vested restricted stock and restricted stock units.

Specifically, a substantial majority (70 percent) of companies that filed proxy statements disclosed changes to their executive compensation programs effective in 2009 that will impact pay levels reported in next year’s proxy. Our findings show:

- (i) Greater focus on short-term cash flow results which is counter to the direction suggested by the U.S. Treasury, academics and other expert advisers

regarding ways to mitigate risk, which is to encourage a long-term perspective by subjecting more compensation to stock price risk; and

- (ii) More reliance on restricted stock and restricted stock units which is not performance-based as it vests simply with the passage of time.

ADJUSTING FOR THE NEW SEC RULES

The SEC rules will apply to the 2010 proxy season. Companies need to begin to prepare for the new disclosure rules that will require an assessment of risk as it relates to executive compensation.

The new rules will require a company to disclose, in the CD&A section of the annual SEC proxy, its broader compensation policies and overall actual compensation practices for employees in general, including nonexecutive officers, if risks arising from those compensation policies or practices may have a material effect on the company. Simply put, the new rules will require that companies identify and disclose any risk that may be introduced by its compensation policies and practices.

It may be difficult for board members or compensation committees to be able to readily spot risk in their plans. There are various types of risk that may be hiding in your plans. Here are a few risky behaviors to avoid:

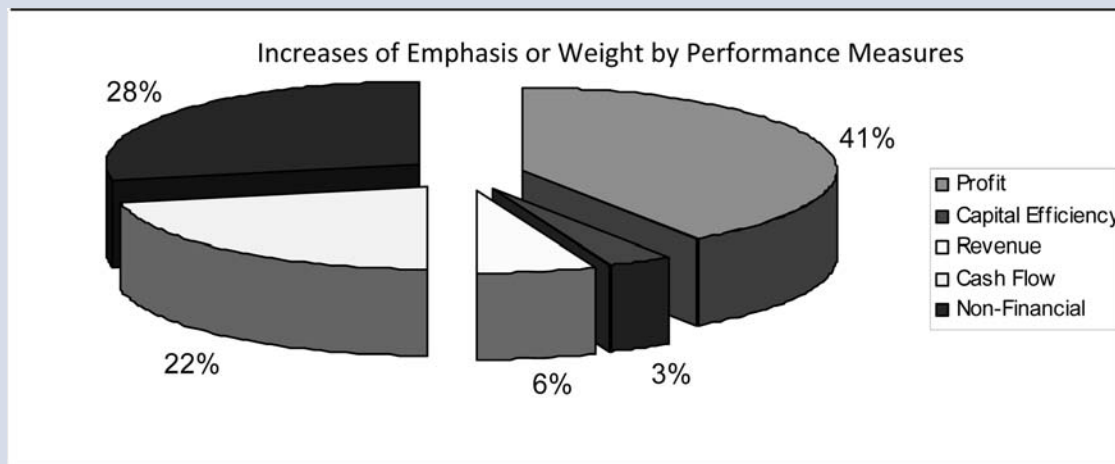
- Setting the wrong goals, which may substantially impair the company and not create value;
- Paying too much compensation that is not closely connected to performance (e.g., restricted stock, guaranteed

EXHIBIT 1

Changes in LTI Performance Measures

Changes in LTI Performance Measures			
Performance Criteria Type	Changes to Weight or Emphasis		
	No of Reported increases	No of Reported Decreases	Net Changes
Capital Efficiency: Return on equity, relative return on equity, return on invested capital, economic value added	5	0	5
Cash Flow: Free cash flow, operating cash flow	2	0	2
Total Shareholder Return: Stock price appreciation plus dividends (relative and absolute)	6	4	2
Profit: EPS, relative EPS growth, net income, corporate income, operating income, operating profit, OIBDA	5	5	0
Other: relative measure based on total direct premiums written, absolute measure based on vested net premiums earned	1	1	0
TOTAL	19	10	9

Changes to Short-Term Incentive Measures



or retention bonuses, large severance payouts with or without a change-in-control, large pension entitlements, generous perquisites);

- Providing too much of total compensation in the form of incentive compensation, com-

bined with too little in salary, may encourage risky behavior with either corporate strategy or financial accounting;

- Creating windfall compensation such as a large severance payout or extremely large bonus;

■ Overpaying executives in a systematic way over a period of time, which depletes the financial viability of the company; and

- Paying cash bonuses for short-term performance that turns out to be specious and

ultimately causes stock price to drop over time.

Overall, companies need to consider the level of risk that employees might be encouraged to take to meet their incentive compensation elements. The disclosure of a company's overall compensation policies in certain circumstances may help investors identify whether the company has established a system of incentives that can lead to excessive or inappropriate risk-taking by employees.

DISCLOSING COMPENSATION-RELATED RISK UNDER SEC RULES

Under the SEC's new rules, the situations that would require disclosure will vary depending on the particular company and its compensation programs. Situations that may require discussion and analysis of the company's compensation policies and practices include, among others:

- A business unit of the company that carries a significant portion of the company's risk profile;
- Business units that are significantly more profitable than others within the company;
- Business units where the compensation expense is a significant percentage of the unit's revenues; or
- Business units with a vastly different overall risk and reward structure from other units of the company, such as when bonuses are awarded upon accomplishment of a task while the income and risk to the company from the task extend over a significantly longer period of time.

This is a partial list of situations where compensation programs may have the potential to materially increase risk to the company. Furthermore, even if a program does have the potential to subject the company to more risk, disclosure under the new rule would only be required if the materiality threshold is triggered.

APPLYING SEC DISCLOSURE RULES TO A PARTICULAR COMPANY

The application of a particular example must be tailored to the facts and circumstances of a particular company. A company must assess the importance to investors of the information that is identified by the example in light of the particular situation of the company. Examples of risk-related issues that companies may need to address regarding the compensation policies or practices include (the level of detail required will necessarily depend on the particular facts of a company and within various business units of a company):

- The general design philosophy of the company's compensation policies for employees whose behavior would be most affected by the incentives established by the policies, as such policies relate to or affect risk taking by those employees on behalf of the company, and the manner of its implementation;
- The company's risk assessment or incentive considerations, if any, in structuring its compensation policies or in awarding and paying compensation;
- How the company's compensation policies relate to the realization of risks resulting from the actions of employees in

both the short term and the long term, such as through policies requiring clawbacks or imposing holding periods;

- The company's policies regarding adjustments to its compensation policies to address changes in its risk profile;
- Material adjustments the company has made to its compensation policies or practices as a result of changes in its risk profile; and
- The extent to which the company monitors its compensation policies to determine whether its risk management objectives are being met with respect to incentivizing its employees.

TECHNIQUES TO REDUCE RISK

For changes that collectively will better align corporate risk, corporate performance and executive pay, companies can consider:

- a) Rebalancing their short- and long-term incentive (STI, LTI) target opportunity levels, which may result in a reduction of STI levels, or a combination of reduced STI levels and a slight increase in LTI levels;
- b) Changing the LTI mix away from restricted stock or units to a more performance-based award program; and
- c) Revising the pay-for-performance curves for both short- and long-term incentive plans by reducing maximum payout levels.

FINDING THE ANSWER FOR YOUR COMPANY

Before any changes should be made to compensation programs,

companies should first evaluate their programs to find the right formula for their organization. The goals of a compensation program should be to align the interests of executives with shareholders, provide pay that is appropriately aligned with performance, and ensure that program goals do not encourage unnecessary risk.

To comply with the new SEC disclosure rules on risk assessment, companies will need to assess the following:

- Overall compensation program design, including the relationship between fixed and variable compensation and the balance of short- and long-term programs;
- Individual program design, such as short- and long-term incentives and severance or change-in-control (CIC) provisions;
- Administrative provisions such as ownership guidelines and clawbacks.

Once the programs are reviewed, a competitive assessment relative to the market can and should be conducted.

- Fixed versus Variable Compensation: A high percentage of variable compensation is positive from a pay-for-performance standpoint but could incentivize executives to take undue risks.
- Short-term versus Long-term Compensation: Too much emphasis on short-term goals may undermine long-term perspective. On the other hand, too long of a performance period can cause executives to lose sight of im-

mediate steps needed to ensure long-term performance.

- Total Compensation versus the Market: If total compensation is too low, the risk is the inability to hire or retain high performers. If compensation is too high, you are wasting company resources.
- Performance/payout Curve: Performance levels must be high enough so that performance warrants a payout, but not so high that it demotivates participants. Payout levels—if payouts are uncapped or maximum amounts are too high—can cause risky behavior. But, amounts must be high enough to offer incentives for participants to work toward goals.
- Performance Metrics: The need to balance the number and type of performance measures used in annual and long-term programs. Too much weight on one measure can cause lack of focus on other measures important to long-term strategy. On the other hand, use of too many different measures can fail to provide focus on important strategies. Qualitative measures are helpful to counterbalance the quantitative performance measures. This allows for the board's and management's judgment in the determination of incentive payments.
- Type of Long-Term Incentive Award: Stock options have all upside potential and little or no downside potential until they are exercised, while restricted stock

is earned without regard to stock price performance.

KEEPING EVERYONE HAPPY

If no performance is required to earn the award, it could decrease individual efforts and focus on key initiatives that promote high performance. High performance should lead to stock price growth. However, restricted stock may be important in attracting and retaining high-potential employees.

Here are suggestions for ways to reduce risk by aligning pay with performance and with shareholders, and by subjecting more compensation to stock price risk:

Increased emphasis on long-term pay. Unlike short-term incentives, long-term pay keeps management focused on the creation of long-term value and protects shareholders from paying compensation based on short-term results, which at times may be specious. Most long-term pay programs are tied to stock price performance. However, companies also need to consider financial and nonfinancial performance measures that balance annual plans and ultimately lead to a sustained increase in stock price performance.

Stock ownership requirements. Requiring significant ownership in the company is a way in which management provides additional “skin in the game” and subjects wealth accumulation to stock price risk.

Hold equity until retirement. Though similar to stock ownership guidelines, this prevents management from “unloading” equity during high periods of growth and reducing its link to shareholders. Executives can further be aligned with shareholders by requiring the equity to be held for one-to-two years following termination

of employment, including retirement, so that employees are still “on-the-hook” for decisions made while they were an employee of the company.

Pay a portion of bonus in stock. This protects companies from making large cash payouts for short-term results that later prove to be unfounded based on future performance that ultimately leads to a decline in stock price and shareholder value.

Clawback policy. Many companies have already instituted a clawback policy to recoup payments based on materially misstated financial statements, primarily stemming from the requirements of The Sarbanes-Oxley Act of 2002.

This additional type of policy goes further in protecting against the generation of “bad business” that first appears to be profitable, but is later reversed when the economy or other factors change and these initial results ultimately

become unprofitable or even detrimental to the company’s health.

Impose caps on bonus payouts and reduce maximum payouts. When companies have unexpected and transitory growth resulting in unusually large bonus payments, these payments should be capped. During the recent financial meltdown, many companies that had enormous growth were unable to sustain that level of growth and were substantially affected by the economic downturn.

Careful use of perquisites and SERPs. Although perquisites represent a relatively small portion of pay, they nevertheless have become a focal point for the ire of shareholders, shareholder activist groups and media. Improper use of perquisites and Supplemental Executive Retirement Plans may result in reputational risk. No gross-ups (payments of full amounts with no deductions) on

compensation or benefits of any type should be made.

Severance/CIC arrangements. There is a need to balance the level of potential severance benefits. Above market payments may encourage executives to pursue a merger or sale that is not in the best interest of shareholders. But if potential payments are considered too low, executives may not entertain any merger or sale offers.

Changing your compensation programs does not mean that you will not be able to retain talented employees and increase stock holder value. Well-designed compensation policies will enhance a company’s business interests by encouraging innovation and appropriate levels of risk taking. Finding the right balance of risk, performance, and pay will protect your company, its investors, and its employees.



ABOUT JAMES F. REDA & ASSOCIATES

James F. Reda & Associates is a nationally-recognized independent compensation and corporate governance consulting firm. Headquartered in New York, New York with a satellite office in Atlanta, Georgia, our principal consultants have over 50 years of combined experience in compensation consulting. Our consultants are quoted frequently in leading media publications such as Business Week, Forbes, Fortune, The New York Times, and The Wall Street Journal.

Our firm has extensive experience in the areas of equity awards, compensation committee advisory services, incentive programs of all kinds, and the performance evaluation and goal-setting process. We work with clients from the following industries: financial services, health-care, life-science, technology, retail, and manufacturing. We have substantial experience working with private companies.

James Reda has authored two books on the subject of executive compensation and the role of the compensation committee, entitled *Pay to Win: How America's Successful Companies Pay Their Executives* (Harcourt: 2000) and *The Compensation Committee Handbook* (John Wiley: 2007), which is in its third edition. Mr. Reda served as a commissioner on the national panel "Executive Compensation and the Role of the Compensation Committee," assembled by the National Association of Corporate Directors. Mr. Reda is also a member of a task force created by the pre-eminent trade group, the National Association of Stock Plan Professionals, in order to rationalize executive compensation.

Our Services Include:

- Advising compensation committees on all executive compensation matters
- Providing corporate governance advice with respect to executive and board compensation
- Benchmarking total compensation, including: base salary, short-term incentives, long-term incentives, executive benefits and perquisites
- Assisting with all aspects of short- and long-term incentive plan design, including: tax, accounting, and SEC implications of such arrangements
- Working with companies to determine competitive employment agreement plan designs
- Providing expert witness testimony, opinion, and litigation support
- Evaluating CEO, other senior executives and boards and committees
- Providing assumption analysis and expense calculation for FASB ASC Topic 718 (formerly FAS 123R) purposes
- Designing executive ownership guidelines and capital accumulation programs
- Reviewing special situation incentives associated with IPOs, business units, partnerships, distressed companies, and mergers & acquisitions
- Designing deferred compensation, supplemental executive retirement programs (SERPs) and other executive perquisite and benefit programs
- Designing change-in-control and severance programs

JAMES F. REDA



Consulting Experience

Jim works with both public and private organizations in planning, creating, and implementing incentive programs. Jim also advises companies on incentive strategy, including long- and short-term senior executive employment arrangements, change-in-control metrics, business combinations, shareholder rights, and corporate governance issues. He is a recognized expert in the area of integrating incentive and corporate strategies. Jim has more than 23 years of experience specifically in the area of senior executive compensation.

Work Experience

Prior to recently forming his own firm, Jim worked at three major executive compensation consulting firms. He began his executive compensation consulting career at The Bachelder Group in 1987, where he worked for nine years.

Education

Jim has a B.S. in Industrial Engineering from Columbia University and an S.M. in Management from the Massachusetts Institute of Technology, Sloan School of Management.

Professional Activities

Jim is a member of the American Society of Corporate Secretaries, WorldatWork, The National Association of Stock Plan Professionals, National Association of Corporate Directors, and the New York Society of Security Analysts, for which he serves on the Corporate Governance and Shareholders Rights Committee. He is Chair of the Atlanta Chapter of NACD. He is a commissioner member of the recently published BRC entitled "Executive Compensation and the Role of the Compensation Committee."

Jim has written numerous articles on executive compensation, stock award programs, long-term incentive strategy, merger and acquisition issues, and compensation committees in publications such as *The Corporate Board*, *Directorship*, *Directors & Boards*, *Journal of Deferred Compensation*, *WorldatWork Journal*, *Director's Monthly*, *Journal of Taxation of Employee Benefits*, and *Journal of Compensation & Benefits*. He has published books on executive compensation, including *Pay to Win: How America's Successful Companies Pay Their Executives* (Harcourt: 2000), and *The Compensation Committee Handbook* (John Wiley: 2007), which is in its third edition.