

Executive Compensation:

Balancing Risk, Performance and Pay

By
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With new executive compensation rules in the SEC pipeline, business leaders and board members need to assess how tougher federal regulations will affect their current policies.

The recent turmoil in the financial markets has raised questions about the effect compensation programs are having on executives and nonexecutives when it comes to undertaking risky business behaviors. If compensation programs are not structured appropriately, decision-making can be compromised by a desire to increase personal rewards — at the expense of the company and its shareholders.

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

- Compensation risk assessment is mandatory for Troubled Asset Relief Program (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 proposals; 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.

The SEC believes investors would benefit from an expanded discussion and analysis of how the company rewards its employees, to the extent it creates risk to the company. If the SEC proposal is passed, companies will need to conduct a risk profile assessment of their overall compensation programs. This risk assessment would be disclosed in the Compensation Discussion and Analysis (CD&A) section of the annual proxy report sent to the SEC.

The proposed rules would require a company to discuss and analyze 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.

While the proposals are being finalized, each organization needs to perform an evaluation of its compen-



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sation 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 design the executive compensation program that is right for them.

What is Risk?

The many definitions of risk vary by specific application and situational context. Some types of risk in a business setting are:

Reputation risk: The view of a company by shareholders, customers and the media. This type of risk is the most dangerous as it can affect even very profitable and well-managed companies. A hit to reputation may result in decreased revenues and difficulty in raising capital, among other factors.

Business sustainability risk: This risk is related to the underlying economics of the business. Changes in the economy can cause profits to be reduced and raise a risk to the busi-

ness. That could lead to bankruptcy or a forced sale or merger.

Compensation-related risk: The risk that executives may act in ways to increase personal rewards at the expense of company and shareholders. That's the focus of this article.

Finding Balance

Incentive compensation comprises the bulk of executive pay packages at publicly traded companies. Boards of directors and senior management are continually searching for the right performance measures to balance rewards with financial, individual and operational performance. It's a complex task, and the stakes have been increasing each year.

In 2007, the SEC began requiring companies to disclose performance measures and goals related to executive pay programs. On July 1 of this year, the SEC voted unanimously to publish proposals that would require what it considers "better" disclosure of certain compensation- and corporate governance-related matters, and

would establish rules related to the obligations of TARP recipients to implement “say on pay.” With all of the controversy, hearings, proposals and new regulations, companies have been struggling to provide balance in their compensation programs.

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

- 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;
- Changing the LTI mix away from restricted stock or units to a more performance-based award program; and
- Revising the pay-for-performance curves for both short- and long-term incentive plans by reducing maximum payout levels.

Assessing Balance

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 proposed SEC disclosure rules, 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

| 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 |

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 immediate steps needed to ensure long-term performance.

- **Total Compensation versus the Market:** If total compensation is too low, risk is inability to hire or retain high performers. If compensation is too high, wasting company resources.

- **Performance/payout Curve:** Performance levels must be high enough so performance warrants a payout, but not so high that it de-motivates 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 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.

Since no performance is required to earn the award, it could decrease individual efforts and focus on key initiatives that promote high performance, which 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 long-term value creation 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,

Recent Study of S&P Proxy Statements

There have been substantial changes reported by companies in their 2009 proxy statements following an unprecedented drop in stock prices. A study published in August by James F. Reda & Associates LLC, *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. Forward-looking statements were reviewed with regard to changes in 2009.

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

Incentive compensation makes up the bulk of executive pay packages at publicly traded companies. Boards of directors and senior management are continually searching for the right performance measures to balance rewards with both financial and operational performance. It’s a complex task, and the stakes have been raised.

Generally, the results show 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. The findings show a 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. In addition, the study shows more reliance on restricted stock and restricted stock units, which is not performance-based as it vests simply with the passage of time.

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.

Identifying Compensation-Related Risk

There are various types of risk that need to be addressed. Here are some that companies should avoid:

■ **Setting the wrong goals**, which may substantially impair the compa-

ny and not create value;

- **Paying too much compensation that is not closely connected to performance** (e.g., restricted stock, guaranteed 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, combined 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.

Companies will 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 proposed 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

- compensation policies and programs: 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 proposed rule would only be required if the materiality threshold is triggered.

Applying SEC Disclosure Rules to The 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.

It is recommended that companies begin to prepare for the new disclosure rules that will require an assessment of risk as it relates to executive compensation. This assessment, although now only an SEC proposal, is expected to be applicable as early as the 2010 proxy season. A risk assessment will result in recommendations and steps to reduce risk, better align pay with performance and provide a fair executive compensation program design.

Well-designed compensation policies may enhance a company's business interests by encouraging innovation and appropriate levels of risk taking.

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James F. Reda

James F. Reda, Founder/Managing Director of James F. Reda & Associates, LLC, has served for over 23 years as an advisor to the top management and boards of major corporations in the U.S. and abroad in matters of executive compensation, performance, organization, and corporate governance.

Jim plays an integral role in the field of executive compensation and the definition of the role of the compensation committee. As a widely-quoted, recognized authority on corporate governance, he also is typically retained by compensation committees as an outside independent advisor on matters of executive compensation, particularly those of the Chief Executive Officer. Jim testified before Congress in December 2007 on the issues relating to executive compensation.

Prior to forming his own firm in 2003, Jim worked at three major executive compensation consulting firms. He began his executive compensation consulting career in 1987 for a small executive compensation firm where he worked for 9 years.

Jim Reda is one of only two consultants to be on both the 2003 NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee and the 2009 Conference Board Task Force on Executive Compensation. He has also testified in front of the House Committee on Oversight and Government Reform regarding the issue of the independence of compensation advisors. Additionally, our firm has sponsored the Conference Board Executive Compensation Conference (2004 to 2008) and Directors' Institute (2008 to present) for the past five years. We intend on continuing our relationship with the Conference Board.

Jim has published two books on executive compensation entitled, *Pay to Win: How America's Successful Companies Pay Their Executives* (Harcourt 2000), and the *Compensation Committee Handbook* currently in its third edition (John Wiley 2008).

Jim earned a B.S. in Industrial Engineering at Columbia University, and a S.M. in Management, Massachusetts Institute of Technology, Sloan School of Management.

Who We Are

James R. Reda & Associates is an independent compensation and corporate governance consulting firm with offices in New York and Atlanta. We work with clients to develop pay structures, manage their talent, and improve their economic performance. Our principal consultants have over 75 years of combined experience with compensation consulting, and designing, implementing and communicating performance-oriented compensation programs.