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Effective Compensation Risk Assessment at the Board Level

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Corporate Boards have always played an important role in the *oversight* of traditional business risks such as fraud, corruption, and employment practices. However, in light of recent events there is growing concern that Boards, primarily through the actions of their Compensation Committees, may have *introduced or encouraged* “excessive risk taking” in the design of executive incentive programs. This is a subtle, but very meaningful, expansion of Boards’ accountability from generally monitoring corporate risk to potentially *causing* the kinds of serious risks that may ultimately threaten the organizations’ long-term viability.

In practice, this means that Compensation Committees and Boards have the added fiduciary responsibility of directly assessing and effectively managing the relationship between compensation programs and risk-taking. In fact, proposed new SEC rules would require that companies disclose “material information concerning how the registrant compensates and incentivizes its employees that may create risk.” However, mere compliance with disclosure mandates will not meet the governance challenge of providing more rigorous oversight of compensation-related risk.

Similar to the lessons of TQM, we believe the key to successfully managing compensation-related risk is not inspecting quality at the *end* of the program design process, but rather *building* quality directly into the process. The following diagram illustrates the fundamental questions, key topics, and critical outcomes of an effective process for directly incorporating risk assessment in the design of incentive-based compensation programs:

	Governance	Design	Disclosure
Fundamental Question	Are our structure and process beyond reproach?	Did we consider risk when evaluating and designing our programs?	Are our disclosures accurate and transparent?
Key Topics	<ul style="list-style-type: none"> • Board Leadership Roles • Classified Board Structure • Plurality/Majority Voting • Roles & Responsibilities • Qualifications & Experience • Independent Advisor 	<ul style="list-style-type: none"> • Peer Group/Positioning Strategy • Pay Mix/Performance Leverage • Incentive Plan Measures & Goals • Deferral/Banking/Clawback • Equity Grant Mix and Features • Stock Holding/Ownership • ClC/Severance Protection 	<ul style="list-style-type: none"> • Tables/Narratives • Executive Summary • Analysis • Performance Targets • Risk Assessment Results
Critical Outcomes	<ul style="list-style-type: none"> • Defensible Leadership Structure • Independent Advisor 	<ul style="list-style-type: none"> • Defensible Benchmarking • Balanced Program Design 	<ul style="list-style-type: none"> • Include Analysis in CD&A • Risk Assessment Results

However, it is also essential to recognize that organizations are in business to take risks and that effective incentive programs encourage and reward appropriate risk-taking. What Boards and Compensation Committees must consider is whether there are sufficient controls in place to ensure that incentives are not overly leveraged, aligned to the wrong performance measures, and/or not tied to the quality and sustainability of the performance results. In other words, risk

assessment should serve as a moderating factor in compensation programs that are driven by strategic alignment, performance linkage, cultural fit, and competitive necessity.

As Boards evaluate and design compensation programs, they should recognize and weigh practices and features that can exacerbate or mitigate risk. Their response should not be to eliminate any factors that might exacerbate risk, or to automatically adopt factors that seem likely to mitigate risk, but rather to achieve a balance of risk that is appropriate for their particular organization. In that regard, following are some common compensation practices that may have a significant impact on the level of risk:

Exacerbate Risk	Mitigate Risk
<ul style="list-style-type: none"> • Aggressive Peer Group • 75th Percentile or Above Pay Positioning Strategy • Short-Term Oriented Pay Mix • Accounting Driven Measures / Definitions • Top Line Oriented Measures Only • Overly Aggressive Goal Setting • Multiple/Overlapping Measures • Changing Slope/Kinked Incentive Curve • Narrow Performance Range/Steep Slope • No Caps or Maximums • Stock Option Only Equity Grant Mix • Above Market CIC Protection 	<ul style="list-style-type: none"> • Defensible Peer Group • 50th Percentile Pay Positioning Strategy • Balanced Pay Mix • Robust Measure Selection and Goal Setting • Fewer/Non-Overlapping Measures • Constant Slope Incentive Curve • Banking/Deferral Mechanisms • Clawback/Recoupment Policy • Balanced Equity Grant Mix • Minimum Stock Ownership Requirements • Temporary Stock Holding Periods • Competitive CIC Protection • Independent Advisor

Among the more challenging aspects of avoiding program designs that promote “excessive risk taking” are the selection of appropriate performance measures and performance goals. In addition to seeking an appropriate link between targeted performance and related payouts, Boards will need to carefully assess the number and mix of measures being used, the interaction between measures, and the setting of threshold performance, maximum performance and payout opportunities. In some instances, this will require greater involvement by the CFO and Audit Committee in the design of compensation incentives.

Effective risk assessment also requires a holistic and dynamic view of pay. Such a perspective provides Directors with an in-depth look at the individual and cumulative impact of all elements of compensation under a wide range of forward-looking performance and/or event scenarios – essentially serving as a “stress test” to identify any material program weaknesses on the upside or downside. Absent such a forward-looking perspective, performance-driven pay programs that seemed reasonable and appropriate when put in place may later be discovered to have driven unintended behaviors and created inappropriate risks.

In summary, Boards’ fiduciary duties now include ensuring that undue risk is not promoted in the design of employee incentive programs. This is effectively accomplished by establishing a defensible governance structure and a robust design process that considers risk as a moderating factor. At a minimum, Boards should re-evaluate their governance structure to ensure independence, incorporate risk assessment into their compensation program review process, and analyze the compensation outcomes of proposed programs under various performance scenarios. Creating such discipline around the governance structure and design process promotes an effective risk/reward relationship and will prepare companies for any potential new SEC disclosure requirements related to their oversight of compensation-related risk.

About Pearl Meyer & Partners

For 20 years, PM&P has served as a trusted independent advisor to Boards and their senior management in the areas of compensation governance, strategy and program design. The firm provides comprehensive solutions to complex compensation challenges through the development of programs that align rewards with business goals to create long-term value for all stakeholders: shareholders, executives and employees. The firm maintains offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, Los Angeles and San Jose.



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