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Getting the Most Out of Your Company's Compensation Risk Assessment

INTRODUCTION

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In February 2010, the SEC issued new rules requiring company proxies to include a narrative disclosure of compensation policies and practices as they relate to risk management. Under these regulations, companies must address compensation for all employees, including non-executive officers, if those policies and practices create risks that are reasonably likely to have a material adverse effect on the company. The rules were intended to provide an early warning about compensation programs, processes, or practices that might have unintended consequences and influence employee behavior in a way that could put the company at risk.

Unfortunately, reality has not always lived up to expectations. Companies have struggled to establish an effective process for assessing compensation risk, at times reverting to an exercise akin to checking boxes on a scorecard as opposed to substantively discussing situations in which compensation might materially exacerbate business risks. Such cursory reviews often focus solely on the elements of compensation design rather than holistically evaluating supporting processes and practices and other cultural drivers of behavior that may adversely affect key business risks.

Few organizations may have compensation-driven risks that are likely to rise to a "material adverse" level, yet there is good reason to take the process seriously. Otherwise, the Board may find itself surprised when the compensation program inadvertently supports or encourages behaviors that are not in the best interests of long-term shareholders.

WHAT'S THE BIG IDEA?

While a check-the-box review of the risk factors associated with a company's compensation program elements may satisfy the SEC's requirements, it will not fully reveal the company's compensation-related enterprise risks.

EXECUTIVES desiring a "value-add" compensation risk assessment can employ a multi-faceted approach that marries a company-wide assessment of business risks with a thorough review of compensation programs, processes and practices.

Engaged **DIRECTORS** can then employ four critical questions to ensure their company's compensation risk assessments are compliant, thoughtful and comprehensive.

To fulfill the spirit of the SEC rules, we advocate seeking a broader understanding of a company's risks and how its compensation programs, processes and practices could exacerbate them. To do so, we provide a roadmap for building a better compensation risk assessment process: one that flows from a company's business risk assessment to holistically evaluate both the compensation hardware — program design — and the software — the supporting processes and practices, such as goal setting, performance evaluation and the use of discretion. Engaging in a multi-dimensional process will foster a more comprehensive and thought-provoking conversation about how compensation can have a materially adverse effect on business risk.

Further, a risk assessment will only be as comprehensive as the breadth and diversity of perspectives that underlie it. We therefore recommend establishing cross-functional teams — representing line managers, human resources, audit, finance, risk, and legal — to participate in the assessment of business and compensation risks.

Building a Better Compensation Risk Assessment — A Roadmap

Mandated risk assessments and compensation reviews engage boards around the topic of compensation risk. However, pay is one of many factors that drive business decisions and, therefore, the mitigation or exacerbation of enterprise risks. A risk assessment focused solely on compensation design will have limited effectiveness in assessing how business risks are actively managed and mitigated on a daily basis.

As shown in Exhibit 1, effective risk assessment starts with understanding the company's potential for risk in a variety of areas, for example: financial, operational, regulatory and reputational. Companies should use this step to detect potential weaknesses in the business, culture or monitoring processes that might lead to excessive risk.

Exhibit 1. **A Holistic Approach to Assessing Risk**

REVIEW
ENTERPRISE RISKS

Identify enterprise risks that would have a material reverse effect on the company. It is important to consider all enterprise risks, including (but not limited to):

- Financial
- Operational
- Regulatory/compliance
- Reputational

IDENTIFY
THE RELEVANT RISKS

Determine which of those enterprise risks could potentially be exacerbated by the compensation program.

ASSESS
COMPENSATION PROGRAMS

Review compensation program "hardware" and "software" to determine if the compensation program is likely to exacerbate a given enterprise risk.

- Ensure that there are appropriate risk mitigating design elements
- Understand the degree to which cultural factors influence risk taking activity
- Ensure that there are sufficient internal controls to discourage and mitigate excessive risk taking

The next step is to determine which, if any, enterprise risks could be exacerbated by the compensation program. As shown in Exhibit 2, any of these categories of risk hold that potential. Also shown are potential risk-mitigating activities.

Exhibit 2. **Enterprise Risks Exacerbated by Compensation Program**

ENTERPRISE RISKS	ILLUSTRATIVE RISK FACTORS POTENTIALLY EXACERBATED BY COMPENSATION PROGRAM	ILLUSTRATIVE RISK MITIGATING ACTIVITY
FINANCIAL	Manipulation of accounting and timing of income or expenses to "manage" earnings to achieve plan objectives	• Strong control environment • Account reconciliations • Segregation of duties • Internal and external audits
OPERATIONAL	Plan objectives and processes for meeting those objectives are not properly or appropriately communicated	• Senior leadership town hall meetings to discuss strategy • Regular HR communications
REGULATORY/ COMPLIANCE	Insider trading facilitated by inappropriate level of internal disclosure or timing of disclosure	• Established policies regarding insider trading • Blackout periods applied to key executives
REPUTATIONAL	In order to meet plan objectives, quality standards are significantly lowered	• Quality assurance processes

With a full understanding of the risks and how the compensation program potentially might contribute to them, a company is ready to analyze all elements of the compensation hardware and software, including the internal controls and company culture that influence compensation decision-making.

An effective compensation review involves both a holistic look at the compensation program and an appraisal of all incentive plans to identify potential risks and associated risk mitigators.

Holistic Program Review. This review encompasses compensation program design elements like pay mix and pay positioning, severance/change-in-control provisions, and others. The review should focus on identifying any key risk factors inherent in each design element and the degree to which those risk factors are mitigated by other aspects of the program. For example, significant leverage in the relationship between performance and pay can be mitigated by a cap on the maximum payout.

Incentive Plan Inventory and Review. In its ruling, the SEC provided the following (non-exclusive) list of places within a company to look for compensation policies and practices that could potentially create material risks to the company, but that might not be discovered in a review of the NEO programs only. Those places include:

- At a business unit of a company that carries a significant portion of the company's risk profile
- At a business unit with compensation structured significantly differently than other units within the company
- At a business unit that is significantly more profitable than others within the company

- At a business unit where the compensation expense is a significant percentage of the unit's revenues
- Where programs vary significantly from the overall risk and reward structure 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

Accordingly, the incentive plan inventory and review encompasses all incentive plans throughout the organization, with an emphasis on incentive plans for those individuals or groups that could potentially have a material impact on company financial results. As shown in Exhibit 3, it should identify any key risk factors inherent in the plan and the degree to which those risk factors are mitigated by certain other design elements.

Exhibit 3. **Areas of Focus in a Comprehensive Compensation Risk Assessment**

HOLISTIC PROGRAM REVIEW FOCUS AREAS	INCENTIVE PLAN REVIEW FOCUS AREAS
What (if any) are the key risk factors in the following program areas? • Pay mix and pay positioning • Equity incentives • Performance management • Severance/Change-in-Control • Stock Ownership	*What (if any) are the key risk factors in the following incentive plan design areas?* • Performance metrics • Approach to setting goals • Relationship of performance to pay (i.e., leverage)
RISK MITIGATING COMPENSATION DESIGN ELEMENTS	
• Ability to exercise discretion • Use of complementary financial performance metrics • Balance of financial and non-financial performance metrics • Balance of short- and long-term performance measurement • Stock ownership guidelines and/or stock retention requirements	• Balance of absolute and relative performance measurement • Goal setting that balances affordability and value sharing • Maximum payout caps • Deferral and/or clawback mechanisms • Form of payout (e.g., cash vs. stock)

As noted above, a review of compensation design alone may not fully produce thoughtful and creative discourse on the manner in which the company's processes, practices and culture may influence and affect risk. The result can be unaddressed risks like cultural influences and internal controls that create a potentially hazardous path forward. Risks that may be missed include:

- Conflicting objectives within the organization that discourage collaboration and drive inappropriate or inefficient behaviors

- Quality assurance processes insufficient to ensure that quality standards are not sacrificed in order to achieve incentive plan goals
- Risk review/approval processes that lack sufficient teeth or an organizational structure that compromises the risk review process (e.g., decisions about compensation for risk personnel made by the dealmakers those personnel are meant to oversee)
- A culture that encourages meeting the numbers at all costs or not bringing bad news, with the consequence that risks are either not appropriately elevated or not elevated in a timely manner

Therefore, better compensation risk assessments also ask key questions such as the following:

- Does the company's culture emphasize the importance of internal controls and strong corporate governance?
- Do those internal controls and the company's governance structure effectively support compensation practices in a manner that ensures sound and appropriate business decisions/risks?
- What enterprise level risks might manifest in the event that the company's internal controls or governance structure breaks down?

In Summary

Companies that have not completed a sufficiently well-rounded assessment may be open to exposure if they disclose that their compensation programs do not incur undue risk and cannot back up that claim. By establishing a multi-faceted compensation risk assessment that incorporates an evaluation of the business and compensation elements, processes and practices, companies can initiate a more comprehensive discourse on the topic of compensation risk and extract more value from the exercise. A holistic analysis ensures the most obvious red-flags are addressed and the company's environment and the controls encourage the intended outcomes.

Four Critical Questions Boards Should Ask About Risk Assessment

Directors play an important role in the risk assessment process by ensuring that compensation risk assessments are compliant, thoughtful and comprehensive. Their due diligence allows the company to state with confidence in the proxy that the compensation programs are not reasonably likely to have a material adverse effect on the company.

In reviewing the compensation risk assessment, Directors should consider the following four questions:

1 | Was the compensation risk assessment sufficient to satisfy SEC requirements?

Absent the potential for reputational harm, directors have a fiduciary responsibility to ensure their company's compensation risk assessments are compliant with SEC requirements. If a compensation-related, material adverse risk were to manifest and Directors were shown to have failed to act in good faith to ensure shareholders of regulatory compliance, those directors could be exposed to legal action.

2 | What are the uncontrollable and unforeseeable risks that are inherent in the company's operations? Do the company's compensation designs, processes and/or culture sufficiently mitigate those risks?

An important aspect of risk management for businesses subject to uncontrollable and unforeseeable risks — for example, catastrophic weather events — is to anticipate and appropriately prepare for such "tail risks." Within the context of the compensation risk assessment, Directors should explore the degree to which the company's culture and incentive programs might encourage short-term earnings (for personal gain) over the company's long-term ability to absorb and sustain such catastrophic events.

3 | Does the Board understand the company's culture well enough to know where the compensation programs may encourage "bad actors"?

We encourage Boards to step back from the structural design of the company's compensation programs, evaluate the company's material risk factors, and ask how the company's culture might exacerbate or manifest those risks as well as compensation-related risks. Properly designed pay programs should support and reflect targeted business outcomes. So, while we note the importance of risk mitigators in compensation programs, we recognize that pay is one of many factors that drive business decisions and, therefore, the mitigation or exacerbation of enterprise risks. By examining the company's cultural influences and their impact on compensation risk, Directors will gain a better sense for how business risks are actively managed and mitigated on a daily basis.

4 | What is the right amount of risk-taking for the organization (or parts of the organization)? Do the compensation programs encourage the right amount of risk-taking for those populations?

Businesses inherently require that employees thoughtfully engage in an appropriate level of risk taking activities. Compensation programs that are poorly designed and lack appropriate risk mitigators or companies with insufficient internal controls may foster a "heads, I win; tails, you lose" environment in which employees too actively take risks as a means to drive up short-term compensation. Conversely, when compensation programs are designed to be hypersensitive to negative risk outcomes, they may encourage employees to be too risk-averse, to the detriment of long-term opportunity.

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