Cooley

Comp Talks

Risk Assessment & Risk Mitigation

Dan Laddin, Compensation Advisory Partners

Thomas Welk, Cooley

Moderated by Amy Wood, Cooley

What is a risk assessment, why do we do it and how do we do it?

Cooley

What is the risk assessment rule?

- Item 402(s) of Regulation S-K requires public companies disclose the relationship of the company's compensation policies and practices to risk management, but only if those compensation policies and practices *create risks* that are *reasonably likely* to have a *material adverse effect* on the company
  - Not part of CD&A
  - No requirement to (but many companies do) include an affirmative statement that risks are not reasonably likely to have an material adverse effect
  - Applies to plans or practices for NEOs and non-NEOs alike
  - In effect, this rule ensures that companies monitor and review such risks annually
  - Goal is not to eliminate risk-taking incentives, but rather to acknowledge how it impacts the company (a well-designed compensation program should encourage employees to take prudent and considered risks, while discouraging excessive risk-taking behavior)

What are the goals of the risk assessment?

- Compliance with legal requirement
- Oversight, with special emphasis on highest risk businesses and positions
- Refocus on incorporating risk analysis into plan design
- Reviewing compensation risk as part of holistic risk assessment (e.g., are certain risk factors exacerbated by compensation program?)

How can enterprise risk be exacerbated by a compensation program?

cap Compensation Advisory Partners
Cooley

- **Financial Risk**: Manipulation of timing of income and expenses to “manage” earnings and achieve plan objectives
  - Mitigate by strong internal controls, account reconciliations, audits
- **Operational Risk**: Objectives and processes for meeting objectives are not communicated properly
  - Mitigate through “town hall” meetings and structured communication
- **Regulatory/Compliance Risk**: Insider trading facilitated by inappropriate level of internal controls
  - Mitigate through established policies and black out periods
- **Reputational Risk**: Lowered quality standards to meet plan objectives.
  - Mitigate through quality assurance process

Big picture: what is the process?

cap Compensation Advisory Partners
Cooley

- No universal process for evaluating risk – process will vary depending on company size, maturity, industry and compensation philosophy
- Take inventory of compensation policies and practices, and incentive plan documents
- Conduct quantitative and qualitative review of all company incentive plans
- Consider plan design risk areas and enterprise risk areas

Beyond the process

- Keeping records of the process
- Preserving the attorney-client privilege
- Minimizing litigation risk

Specifically, how are compensation plans and processes reviewed?

Compensation Advisory Partners
cap
Cooley

- Is the **fixed component** of compensation large enough to meet essential financial commitments of the employee?
- Is there a **combination of top-line and bottom-line** performance metrics, including multi-year results?
- Do incentives appropriately balance compensation through use of **multiple time periods**: short, mid- and long-term?
- Is there a **mix of cash and equity (**or equivalent) that encourages alignment between the employee and the institution?
- How are incentive pools developed? Is the size of the executive bonus pool **linked to corporate results**?
- Are the incentive pools **capped or uncapped**?

Specifically, how are compensation plans and processes reviewed?

Compensation Advisory Partners
cap
Cooley

- Do incentive leverage scales encourage improvement without requiring "**home runs**" or focusing on **cliff-based rewards**?
- Are the metrics appropriate given the **type/line of business**?
- Does the review of corporate performance focus on **more than just current year** results?
- Do incentive timeframes **match income recognition**?
- Do long-term incentives use **different performance metrics** than short-term incentives, or different time horizons if consistent?
- Are long-term incentives subject to the impact of **future business decisions and "tail" risk**?
- Are there **holding periods post-vest** or required **ownership** levels of equity (or equivalent) awards?
- Can previously awarded incentive compensation (to current or former executives) be **recouped** if financials are subsequently determined to be incorrect or the employee is determined to have engaged in misconduct?

What about incentive plan governance?

cap Compensation Advisory Partners
Cooley

- Who designs plans? Who approves plans and how are they tracked? Who validates performance and payments?
- Are operational controls in place to prevent participants from manipulating results?
- What is the level of oversight by finance, risk management, human resources, senior management?
  - Risk management, finance and HR should have a strong, independent role in developing compensation, tracking and validating compensation plans for business areas
  - Are staff engaged in financial and risk control independent, with appropriate authority, and compensated in a manner that is independent of individual business areas they oversee?
- Does the board actively oversee, monitor and review compensation systems?

How is risk balanced?

Aspects of Compensation Design	Balanced Approach		Balance Achieved
Performance Metrics	Growth Returns	Profitability Shareholder Experience	Compensation program does not inappropriately emphasize performance along one metric
Target Setting	Internal Perspective	External Perspective	Objectives are meaningful and appropriate Pay outcomes make sense
Measurement Approach	Absolute Performance	Relative Performance	Enables executive team to unite behind shared absolute goals <u>and</u> performance recognizes external conditions impacting industry
Vehicle Selection	Cash Annual	Equity Long-Term	Individual pay mix balances an executive's (group's) impact on company results, link to shareholder experience and risk / reward profile
Time Horizon	Short-term (1 year) Intermediate (2 to 4 years) Long-term (> 5 years)		Less emphasis on short-term goal attainment

SEC *examples* of scenarios that could potentially trigger disclosure

- A business unit carries a significant portion of the company’s risk profile
- A business unit is significantly more profitable than others within the company
- A business unit with compensation structured significantly different than other units within the company
- A business unit where the compensation expense is a significant percentage of the unit’s revenues
- A business unit with a compensation practice that varies significantly from the overall risk and reward structure of the company

What are examples of other red flags?

- Aggressive business strategy or plan (e.g., unreasonable sales quotas)
- Unrealistic revenue growth and/or earnings targets
- Growth based on acquisitions
- Increase in customer dissatisfaction
- Incentives focusing on stock price volatility (e.g., payouts only where excessive stock price goals are achieved)
- Sudden “over-performance” in historically under-performing area

How is risk mitigated?

What mitigates risk?

Compensation Advisory Partners
cap
Cooley

- **Program design features**:
  - **Graded**, rather than lump sum, vesting
  - Ability to use **discretion**
  - Use of **complementary financial metrics**
  - **Balance** of financial and non-financial performance measures
  - Balance of absolute and **relative performance** measurement
  - Maximum **payout caps**
  - **Interpolation** between performance goals
  - **Modeling** for extreme cases
  - **Performance threshold** overlay

- **Devices that complement program design**:
  - Stock ownership guidelines
  - Stock holding requirements
  - Clawback policies/provisions

What does Glass Lewis think?

- Re **stock ownership guidelines**: no stated policy, but generally listed as either a positive (if have guidelines) or negative (if no guidelines) compensation program feature in say-on-pay analysis
- Re **holding periods** (from equity plan policy): stock grants should be subject to minimum vesting and/or holding periods sufficient to ensure sustainable performance and promote retention
- Re **clawback policies** (from say-on-pay policy): "prudent for boards to adopt detailed and stringent bonus recoupment policies to prevent executives from retaining performance-based awards that were not truly earned"
  - Awards should be subject to recoupment as a result of financial restatement, noncompliance with applicable rules, negligence and other forms of misconduct
  - Should allow for the recovery of awards for all senior executives
  - Should be subject to only limited discretion "to ensure the integrity of such policies"

What does ISS think?

- ISS **QualityScore** is intended to assess risk in the areas of board structure, compensation programs, shareholder rights, and audit & risk oversight
- Over 100 factors generally and approximately 33 compensation factors, including:
  - Existence of **clawback policy** (company's ability to recoup performance-based awards (including any cash-based incentive awards, at a minimum) in the event of fraud, restatement of results, errors/omissions)
  - CEO stock **ownership guidelines** (< 3x base salary raises the level of governance risk concern)
  - **Holding periods** for restricted shares/holding periods for stock options (meaningful = 50% or more of net shares (after paying tax liabilities) held or 25% of gross shares)

What does ISS think?

Compensation Advisory Partners cap Cooley

- May recommend withhold/against compensation committee members and/or say-on-pay proposals and/or equity plans in cases where pay elements that may promote excessive risk-taking are identified
- ISS will also take into consideration factors that may mitigate the impact of potentially “risky” incentives, such as rigorous clawback provisions and robust stock ownership/holding guidelines
- Equity plan “scorecard”:
  - Clawback policy – full points if company has a policy that would authorize recovery of gains from all or most equity awards in the event of certain financial restatements
  - Holding period – credit if shares received from grants under the plan required to be held for a specified period following their vesting/exercise (at least 36 months or until end of employment = full points; less than 36 months or until share ownership guidelines met = 1⁄2 of full points; no holding period/silent = no points)

Stock ownership guidelines

Cooley

What are stock ownership guidelines?

- A policy adopted by a company that encourages or requires its executives to own a certain amount of equity in the company
- Reasons to consider:
  - Align executives’ interests with shareholders’ interests
  - Mitigate risk-taking
  - Influence behavior
  - Institutional shareholders & proxy advisory firms like them
- Reasons to avoid:
  - May cause executives to be too risk averse
  - May result in higher executive compensation (to aid in meeting guidelines)
  - Moving target
  - May encourage early termination

Design considerations

- Guideline as multiple of salary or other amount?
- Multiples vary by position
- Dollar value or fixed shares? Spot price or average stock price?
- Accumulation Period
- Which shares count? Outstanding equity awards? Shares held by family/trusts/related entities?
- Holding requirement
- Moving target or “once met, always met” (what if individual gets significant base salary increase or there is a significant stock drop?)
- Address noncompliance?
- What are the measurement dates?
- Who is responsible for monitoring?

Holding Requirements

Holding requirements: overview

- A binding equity award provision that prevents executives from selling a certain portion of shares either for a set period of time or until ownership guidelines are achieved
  - Often it is a portion of the post-tax gain on equity awards, but can be accomplished through a delayed issuance of stock underlying stock unit awards.
- Reasons to consider:
  - Gets ownership to desired levels
  - Mitigate risk taking
  - Creates a “reserve” of retrievable stock in the event the company needs to clawback income from an executive
  - Possible valuation discounts on financials and SCT (lack of marketability of the award deserves a discount)
  - Institutional shareholders & proxy advisory firms like them
- Reasons to avoid:
  - Complicated
  - Could be unattractive to prospective employees
  - Could encourage early termination

Design considerations

Compensation Advisory Partners

cap

Cooley

- Who should be subject to post-vest holding periods?
- What types of equity compensation? Restricted and performance awards, ESPP shares and stock options
- Consider need to sell to cover taxes (e.g. RSUs are subject to income tax when shares are issued but FICA taxes still due at vest)

Clawback policies

Cooley

SOX 304

- Trigger: issuer required to prepare an accounting restatement caused by “misconduct”
- Result:
  - CEO and CFO “shall” reimburse company
  - Any bonus or other incentive-based compensation
  - Any profits from the sale of issuer’s securities
  - Received during the year following the issuance of the misstated financial statements
- Enforcement: SEC

Dodd-Frank 954 (+ Proposed Rule 10D-1)

cap Compensation Advisory Partners
Cooley

- Trigger: issuer required to prepare an accounting restatement; no misconduct required
- Result:
  - Clawback of "excess" portion of "incentive-based compensation" (pre-tax amount)
  - Measure based/derived on information in financial statements or stock price
  - Does not apply to strategic measures (e.g., merger) or operational measures (e.g., increased market share)
  - From each "executive officer" (i.e., Section 16) who performed services during the performance period
  - During lookback period (three fiscal years preceding restatement)
- Enforcement: Issuer (with discretion to not enforce if doing so would be impracticable (i.e., cost of recovery would exceed amount, or violation of applicable laws))
- Disclosure: Proposed Reg S-K Item 402(w) would require disclosure of accounting restatement that results in clawback

Financial CHOICE Act of 2017

- Modifies the DFA no-fault clawback for erroneously awarded compensation to apply only where the “executive officer had control or authority over the financial reporting that resulted in the accounting restatement”
- House passed in June 2017
- Has gone nowhere in Senate

SOX versus Dodd-Frank Act clawback policy requirements

cap Compensation Advisory Partners

Cooley

	SOX 304	Dodd-Frank 954
Persons Impacted	CEO & CFO	Current and former executive officers
Misconduct required?	Yes (issuer misconduct without regard to individual conduct)	No
Arrangements subject to clawback	Compensation earned and profits realized from sale of issuer securities during 12-month period following first non-compliant filing	Incentive compensation (including stock options) during the 3-year period preceding the restatement
Amount at risk	Entire Amount	Pre-tax excess
Recovery period	12-month period following first public issuance or filing of financial document with SEC	3-year period preceding date on which the issuer is required to prepare the accounting restatement
Enforcement	SEC	Issuer

Clawback policy design considerations

Compensation Advisory Partners

cap

Cooley

- Who should be covered?
- What compensation should be covered?
- What events should trigger recovery?
- For what period of time is compensation subject to recovery?
- How should the policy be enforced?
- Should the board have discretion is seeking recovery?

Dan Laddin

daniel.laddin@capartners.com

Thomas Welk

twelk@cooley.com

Amy Wood

awood@cooley.com

Cooley

Comp Talks
Webcast Series

Our monthly program addresses hot topics in executive pay and equity compensation.

Cooley

Join Us

Keep up with current compensation trends and balance the legal, tax and disclosure requirements and best practices with your practical business needs.

Explore past topics. Find upcoming talks.

cooley.com/comp-talks