CULTURE AND COMPENSATION RISKS

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MINI-ROUNDTABLE

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PANEL EXPERTS

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Lane T. Ringlee is a managing partner at Pay Governance. Mr Ringlee advises clients on the design and implementation of executive compensation programmes, as well as incentive plans and rewards strategies. He also has extensive experience in managing compensation assignments for major corporations. Some of these engagements include: developing and implementing total compensation strategies, advising boards and senior management on the design and structure of executive and board compensation programmes, and selecting performance criteria and calibrating performance levels for incentive plans.

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Patrick Haggerty is a partner at Pay Governance. Mr Haggerty has over 20 years of experience working with companies on a wide range of executive compensation issues. Clients for whom Mr Haggerty serves as the board or management adviser include major US companies in the healthcare, financial services, medical devices and pharmaceutical industries. His experience extends to working with public and private companies as well as assisting companies with transactions such as acquisitions, spin-offs and IPOs.
RC: Could you provide an overview of recent developments and trends in
the executive compensation arena? Are shareholders overall satisfied with
executive pay?

Haggerty: Recent developments in executive compensation are being driven by the US Securities
and Exchange Commission (SEC) and its four new and pending rules. First,
the CEO Pay Ratio rule will require companies to disclose the ratio of median
pay of all employees to the annual total compensation of the CEO. Second, the
Pay for Performance disclosure rule will require a new table and narrative
description of the relationship between compensation ‘actually paid’ and total
shareholder returns. Third, the Clawback Policy rule requires companies to develop,
disclose and implement a compensation clawback policy. And finally, the Hedging Policy rule
requires disclosure about whether employees are permitted to hedge or offset any decrease in the
market value of equity held. The vast majority of shareholders are satisfied with executive pay given
that approximately 75 percent of companies receive over 90 percent support for say-on pay proposals.
Less than 3 percent of companies actually fail to receive majority support for say-on-pay.

RC: How important is it to foster an ethical culture from top to bottom,
reflected in pay and incentive structures?

Haggerty: Most can agree that any initiative to foster an ethical culture must be supported and led
from top to bottom. Executives must set the example and tone, and take responsibility to promote an
ethical environment. While very few companies have specific pay or incentive structures that are directly
linked to ethical behaviour, the following policies and designs are established to support an ethical culture.
Most companies have an ethics policy that applies to all employees. These policies typically provide a
framework to employees to assess ethical decisions. Violations of these policies are generally subject
to disciplinary action, including termination. Some
companies include ethics as a review item in performance appraisals. Stock ownership and equity retention policies are viewed as tools to promote ethical behaviour as individuals have a long-term economic reason to avoid taking actions that might lead to illegal actions or violations. Clawback policies also promote ethical behaviour since incentive awards can be recouped if illegal actions or violations result in an accounting restatement due to a material error to financial reporting.

**RC: In your opinion, how important is it for a company to link its compensation packages to performance outcomes? How do companies ensure pay-for-performance alignment given the current regulatory environment? What are the inherent risks of such an approach?**

**Haggerty:** Given the SEC’s newly proposed pay for performance disclosure rules, it is very important that management and compensation committees develop incentive programmes that can be effectively measured and communicated to shareholders. Many companies align pay and performance through one or more of the following incentive designs. First, annual incentive designs that reward for achieving financial metrics linked to strategic business goals. Second, while we continue to see the use of stock options decrease, many view stock option programmes as the best incentive to drive stock price growth. Third, long-term performance programmes that reward for outperforming a peer group or index based on relative total shareholder returns, over three years, typically. And finally, long-term performance programmes that reward for achieving financial metrics linked to strategic business goals measured, again, over three years, typically. In connection with these
programmes, compensation committees can use positive or negative discretion to help align pay and performance. Each approach has the potential risk for misalignment, which is why some companies use all four approaches to balance the risk with the expectation that over time results will show alignment of pay and performance.

RC: What strategies should companies employ to help them get to grips with the nuances of compensation and risk culture? How can compensation and control models help?

Ringlee: In terms of strategies, companies first need to realise that incentive compensation is but one component of a system that needs a comprehensive view. With that perspective, companies must consider compensated-related risk philosophy/tolerance, oversight/control approaches, performance definitions and measurement horizons. Most of the nuance is not with compensation per se, but with measurement of performance, including: time horizon for measurement, comprehensiveness of the scorecard, use of qualitative performance and alignment with role profiles. To help support and control the performance and risk management culture, companies can use broader scorecards of performance, longer measurement periods, qualitative performance and compensation at risk models.

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RC: What advice would you give companies in terms of balancing the realities of a corporate risk-taking culture with the compensation incentives available? What types of compensation programmes assist with retaining talent and creating competitive incentives?

Ringlee: Cash compensation has been the driving force in the past with a strong tilt toward cash incentives that are earned and paid for relatively short-term, narrowly-defined success that is oft-measured without consideration for risk. Greater balance is achieved among the sometimes
competing goals of risk-taking, risk management, effective performance measurement and talent retention through a more holistic approach: greater emphasis on competitive fixed compensation for security and retention, broad measurement of performance including risk considerations, balance of cash and longer-term compensation through cash deferrals or restricted stock units, and look-back approaches to performance measurement. The overuse of incentive compensation paid in short-term cash bonuses should transition to a greater balance among the vehicles available to institutions: salary, annual incentives and long-term equity-based awards.

RC: In your opinion, to what extent was excessive risk-taking responsible for the financial crash? What role, if any, did pre-existing compensatory mindsets play in the meltdown?

Ringlee: Excessive risk-taking was a contributor to the financial downturn, but likely not the sole cause. But, when combined with a mixture of an imperfect mortgage origination model, failure to clearly understand the risk profile of investments, absence effective internal oversight and monitoring, a low interest rate environment and a clear tilt toward quantity of earnings versus quality, the mixture proved to be toxic. The changes we have seen since the crash in compensation models – more holistic measurement of performance, inclusion of risk measurement, deferrals of payouts, with potential reductions if performance deteriorates, and longer-term measurement of performance, that more effectively spans the true measurement period rather than financial reporting periods – show the compensation mindset has shifted. A more effective balance has been achieved, particularly at senior management levels where a greater emphasis on multi-year performance measurement and qualitative evaluation of performance – not just quantity of performance.

RC: How would you characterise the impact and continuing influence of Sarbanes-Oxley and Dodd-Frank Acts when it comes to executive compensation? What compensation programme design changes have been made due to these regulations? And what has been the impact of say-on-pay and proxy advisers?

Lerner: The impact of Sarbanes-Oxley and Dodd-Frank are quite different. Since Sarbanes-Oxley requires a certification of the financial results, it prompted an increase in the control functions related to calculations of financial results and related compensation payments. Other than clawback requirements, Sarbanes-Oxley has had a limited effect on compensation design. Many
sections of Dodd-Frank are still pending, so the full impact cannot be judged yet. Say-on-pay is the most significant and established part of the Dodd-Frank regulation thus far. We believe say-on-pay has increased the influence of proxy advisers because every shareholder needs to make a voting decision on the executive pay programmes and many institutional investors consider the views of the proxy advisers before voting. The biggest changes we’ve seen since say-on-pay are the removal of tax gross-up features, more conservative change-of-control and termination awards, an increase in performance-based equity awards, and a homogenisation of pay programmes.

RC: How do you expect the culture around compensation to unfold over the coming years? Are companies likely to learn the lessons of the past and introduce a sustainable, risk-aware culture that rewards tangible performance?

Lerner: While compensation programmes can help reinforce a company culture, there are other management actions that influence culture – it isn’t just about compensation. At the executive levels, financial services firms have emphasised the long-term via deferred compensation, delivering pay in restricted stock, and expecting key employees to hold a significant portion of their equity during their employment. This type of longer-term emphasis is needed for revenue-producing jobs below the senior executive level. This is a very challenging area for organisations since the markets are increasingly short-term focused and yet the culture and compensation needs to be considering both annual results and long-term consequences. We have seen, and do expect to see more, long-term incentive awards tied to future three-to-five year performance rather than looking back at previous year results. That is probably the biggest change we expect to see unfold. RC