In Practice

The Red Flags of Executive Compensation

Enterprise Risk Management (ERM) has become a major focus of boards of directors.

By Patrick R. Dailey

Executive compensation has earned its place as one of the more crucial areas of enterprise risk due to some alleged abuses that occurred over the last decade. Compensation committees feel the heat as investors dig through CD&As and investigative media spotlight executive compensation as a corporate ill.

Regulators have arrived on the scene to remedy past ills and restore shareholder trust. Their remedies are both constructive and punitive. One constructive remedy proposed is the requirement that public companies conduct executive compensation risk-assessment and mitigation procedures. Gauging by the regulation lumbering through the federal legislature, it looks certain that compensation risk-assessment will become a required, annual task for every compensation committee.

Anticipating statutory regulation, prudent compensation committees should now begin to thoroughly identify potential material risks arising from compensation plans and practices and then mitigate those risks. An exhaustive list of executive-compensation red flags is a starting point for compensation committees and their advisors to complete executive-compensation risk assessments and mitigate potential material risks to the financial and operational viability and reputation of the company.

Risk management must not be interpreted as risk avoidance. Yet today, there is pressure and inducement toward risk aversion in the philosophy and practice of executive compensation. These influences are a genuine threat to a company's success. A company's compensation program provides the essential linkage among strategy, implementation, short-term results and long-term sustained performance. Compensation programs must remain competitive tools and companies must be able to tailor compensation plans to their unique cultures and risk profiles. There must be innovation in compensation-plan design; there must be outliers; and executives must be motivated and properly rewarded for the risks they navigate each day.

Compensation committees cannot succumb to pressures–often coming from federal regulators and even shareholder advisory groups--to boil down compensation plans to government-service inspired standardized-pay schedules and performance targets that fail to excite and challenge leaders toward high achievement.

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Risk Elements and the Executive Compensation Considerations	
Affordability • Executive compensation plans are unaffordable • Payout guarantees are present in plans and employment agreements • Total direct compensation targeted at/above 75% of peer group • Scenario payout projections and tally sheets are not available to compensation committee. Impact analysis not available • CEO compensation package significantly exceeds other NEOs	**Board Practices** • Use of incentive compensation elements for independent directors • Director policy does not require equity ownership • Directors do not own company stock • Directors do business other than board service with the company • Equity repricing or exchange can occur without shareholder approval

Risk Elements and the Executive Compensation Considerations

Compensation Committee Practices
- Committee members are not independent
- Directors attend less than 75% of committee meetings
- Lack of expertise in executive compensation, risk and compliance
- Committee lacks access and control over independent advisors
- Advisory services are shared with management
- Members do not participate in continuing education

Compensation Philosophy
- Very low base vs. high annual-incentive pay mix
- Over-leveraged performance-based (variable) compensation elements
  - 90% of Total Direct opportunity
- Absence of external comparative metrics in performance goal-setting and evaluation (S&P 500, Shareholder Return, etc)
  Performance targets
  Performance evaluation
- Non-alignment of long-term incentive plans and vesting/payout with strategic time horizon
  Vesting schedules
  Payout holdbacks (hold until retirement, equity release policy)
- Adoption of minimum, target and maximum payout philosophy
- Long-term incentives paid in cash vs. settled with stock
- Neglect in requiring plan participants to acknowledge code of conduct and regulator compliance accountabilities
- No analysis and understanding of shareholder voting

Peer Group Composition
- Aspirational growth is principal design criterion
- Company is a peer group outlier
- Repeated re-casting of peer group
- Neglect of peer group composition

Board Discretion
- Incentive payouts/special awards determined without board discretion

Employment Agreements
- "Evergreen" executive-employment agreements
- "Sun-setting" of transitional recruitment matters does not occur
- No-fault severance benefits are guaranteed in employment agreements
- Multi-year recruiting inducements without performance-based criteria

Business Factors
A business unit of a company…
- Accounts for a significant proportion of the company's overall profitability
- Has compensation expense which is a significantly larger proportion of revenues than other units
- Has strategic time horizons that are significantly different (shorter/longer) than the company's overall time horizon
- Operates a significantly different compensation program than other units of the company

Base Pay
- Loss of qualification for IRS 162(m) tax exclusion
- Company is a chronic outlier within peer group
- Salaries pegged at high or excessive levels (above peer median; > 75%; >90%)

Annual Incentive Plan and Bonuses
- Degree of difficulty not addressed in plan design and target setting
- Payout threshold set at unlikely achievements levels
- Highly geared payout curves beyond threshold targets
- Short-term targets and payouts exceed 33% of TDC
- Annual targets not clearly aligned with strategic or long-term intent
- Reliance on single performance metrics
- Failure in design to balance financial metrics with controllable operational objectives
- Uncapped payout opportunities
- Tax excludability (162m) is not assured
- No reserves or bonus bank for disgorgement (clawbacks)

Equity Compensation
- Excessive reliance upon stock options (SARs) in total direct compensation buildups
- Over-weighted use of time-based vs. performance-based vesting
- Mega-option grants with premium pricing tiers
- Mega performance-based share grants with highly leveraged multipliers for aspirational levels of performance
- Vesting period time-based of restricted stock is less than three years
- Deficient fraud, backdating, misconduct policy and monitoring
- Highly geared TSR targets for equity-grant maximization
- Absence of fixed grant date policy
- Prevention of spring loading or bullet dodging is missing
- No prohibition against executive hedging activity

Executive Benefits
- Benefits and perquisites misaligned with shareholder interests
- "Red flag" perquisites not explained in proxy
- Perquisites outlie other competitors in sector or peer group

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Pension and SERPs
- SERPs fully explained in proxy statement with explanation for restorative vs. enhanced features
- Determination of corporate liabilities created by SERPs
- Policy on additional service crediting provided. Impact on liabilities
- Accelerated vesting of accrued pension benefits in CIC