Cleary Gottlieb

Alert Memo

NEW YORK DECEMBER 17, 2009

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Compensation and Risk: Compensation Committee Actions Under New SEC Rules

The SEC has amended its disclosure rules to require, among other matters, a discussion about a company's compensation policies and practices for all employees if they create risks that are "reasonably likely" to have a material adverse effect on the company.[1] Prior SEC guidance, to which the SEC referred in adopting the amendments, indicates that the "reasonably likely" threshold is higher than "possible" but lower than "more likely than not."

We are skeptical that any compensation committee knowingly approves compensation programs and arrangements that place the company at material risk, and insofar as the standard imports a "risk factor"-type threshold, we question whether it will elicit meaningful disclosure. That said, a conclusion that the disclosure trigger is not met necessarily rests on an assessment of the balance of risk and reward implied by the company's compensation program design and incentive targets, taken as a whole. As with many SEC rules in the post-SOX era, process will be key. Because the compensation committee plays a central role in that process, we suggest below practical considerations relevant to its deliberations. We also note that most compensation committees do not now routinely review compensation arrangements for rank and file employees. A predicate for analyzing the disclosure question will therefore be an inventory and review of the operation of compensation programs for all employees, which should be undertaken immediately in light of the effective date of the rules.[2]

[1] The new rules become effective on February 28, 2010. Please refer to our companion client alert memorandum, dated the date hereof, for a description of all of the SEC's compensation and governance rulemaking actions at its open meeting on December 16, 2009. Although the new compensation risk disclosure does not appear in the Compensation Discussion and Analysis (CD&A), under existing rules the CD&A should address risk considerations if they are a material aspect of the company's compensation policies or decisions relating to its named executive officers. We expect that companies will likely address in the CD&A how risk is taken into account when setting executive compensation, even if they conclude that no disclosure is required under the new rules.

[2] For most companies, this review is not likely to yield significant concerns that would trigger disclosure, and therefore should not result in a wholesale expansion of the compensation committee's responsibilities. Rather, for such companies, we would expect that the executive compensation program would continue to be the principal focus of the committee's deliberations, with periodic review of compensation programs for other

Compensation committees have four principal responsibilities that intersect with risk.

- ***Determining compensation program design***

    - Diversity of compensation opportunities and metrics is the most effective tool to cabin risk implied by a company's compensation program. A balanced mix of short- and long-term elements ties compensation to the company's performance, while reflecting the perspective that near-term actions are important in and of themselves, but can also have material long-term consequences. A combination of incentives to reward different aspects of the company's performance also avoids a myopic focus on a single aspect of performance at the expense of other considerations that concern and impact business risk.

    - Long-term compensation elements (*e.g.*, plans with multi-year targets or performance vesting conditions) should generally have a horizon tied to the company's business planning cycle to ensure that the committee and management are driven by a common perspective about the company's prospects and challenges within the context of a board-vetted business plan.

    - The committee should consider whether the compensation program includes other features that mitigate the risk of management misconduct or inappropriately risky behavior. These include clawbacks and long-term stock ownership requirements. These features of compensation programs have become common in recent years. They should be re-examined periodically and in connection with material changes in business circumstances or compensation plan design. Are the clawback triggers calibrated to the company's circumstances and business – rather than being a photocopy of another company's policy or someone else's idea of best practice? Are they clear in their operation, while preserving the committee's ability to exercise its business judgment in determining whether to seek compensation recoupment? Given the level of equity incentives granted or to be granted, should stock ownership guidelines be revised to include a "hold through retirement" provision?

    - The committee should consider whether the categories of employees covered by specific compensation programs are appropriate in light of overall pay elements and job responsibility and function. For example, if

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employees (or groups of employees) when material changes in those programs are implemented or when business circumstances materially change.

authority to make decisions that may have material risk consequences for the business extends to a relatively broad group of employees, it may be appropriate to incorporate diverse company-wide performance criteria with respect to a similarly broad group of employees, as compared to relatively narrow business unit performance criteria, in order to mitigate the incentive of employees to take inappropriate business unit risks.

- The committee should consider the role of its discretionary judgment in determining the amount of performance-based compensation to be paid, as contrasted with strict adherence to objective performance-based formulas. Focus on the requirements of Section 162(m) of the Internal Revenue Code of 1986 has generally oriented committees towards a more formulaic approach to compensation decisions. While such an approach arguably should result in a closer correlation of pay to performance, persuasive arguments can be made that the exercise of committee discretion can be consistent with a pay-for-performance program while at the same time mitigating inappropriate business risks that might otherwise arise from certain performance-based compensation programs. In many circumstances, there are approaches to Section 162(m) compliance that permit committees significant discretion to adjust payouts, upwards or downwards relative to objective formulas, to reflect subjective evaluations of performance.[3]

- The committee should invite its compensation consultant and other advisors to provide perspectives about whether and how well the company's compensation program operates to balance risk and reward and whether other design features are appropriate in light of the company's particular circumstances and peer group practices.

- ***Setting the performance matrix for incentive plans***

  - The committee may approve, depending on the company's plans, threshold, target and maximum levels of performance and payout "curves" under incentive plans. Determining these plan design features is critical in translating strategic goals into incentives that are calibrated to promote the right kind, and the right amount, of risk-taking by executives.

[3] The ability of a committee to use "negative discretion" – that is, to adjust payouts downwards from a formulaic result – is explicitly permitted by the regulations under Section 162(m). The ability of a committee to exercise discretion to make upward adjustments of amounts determined by an objective formula depends on a plan design in which the objective formula that determines the initial payout amount fits within other, objectively determined and shareholder approved, formulaic payout limits. Such plan designs are not uncommon.

Given the significance and complexity of this responsibility, we discuss setting the performance matrix in more detail below.

- ***Certifying performance against targets and determining final awards***

    - The committee approves final awards based on actual performance against targets and may need to refine outcomes so that they fit with the overall program design and prior committee decisions about appropriate risk incentives. It is common practice when setting compensation to adjust financial results to avoid distorting operating fundamentals or penalizing management for the consequences of planned actions (*e.g.*, impairment charges associated with planned asset dispositions). Committees also regularly exercise discretion to adjust final awards if the results of strictly formulaic metrics would be either too low or too high. Plan provisions that authorize this discretion – particularly the committee's power to impose caps on awards – mitigate the risk that executives undertake risky action to obtain outsized awards. Equally important are guidelines for administering provisions of plans that call for adjustment of awards to reflect extraordinary items and changes in accounting methodology.[4]

- ***Understanding risks implied by the compensation program in the context of other risk-mitigating controls and procedures***

    - The committee must reflect on risk implied by the company's compensation program through the lens of other risk-mitigating controls and procedures. These include the board's own risk oversight mechanisms, whether in the form of "enterprise risk management" initiatives, an annual strategic review or the work of the board's other key standing committees, such as the audit committee or, if they exist, the risk, compliance or finance committees. Also relevant are the operation and effectiveness of the company's internal control over financial reporting, financial policies (*e.g.*, those addressing leverage, capital allocation and use of derivatives), controls around areas of subjective judgment within the financial statements and dedicated management functions directed at risk. To the extent that this information is not available to the committee either directly or through the work of the full board, it should consider other means to assure an appropriate ongoing understanding of these risk mitigants, such as through overlapping

[4] As discussed above, authorizing the committee to exercise such discretion raises issues under Section 162(m), as do provisions for making such adjustments. Those issues must be addressed properly, but they do not necessarily preclude the exercise of discretion or appropriate adjustments.

membership or other formal interaction among the committees that bear responsibility for elements of risk oversight, or by those committees and the full board. (While we have listed this item at the end of the list of core committee responsibilities, planning to carry it out may be the first item that the committee wants to consider, so that the overall "risk lens" is in place on an early and ongoing basis.)

Setting the performance matrix is perhaps the most concrete point of contact between the company's business plan and the operation of the compensation program. Compensation committees should be mindful of the following considerations and potential "red flags" when establishing performance goals:

- ***The performance matrix should be integrated with the business planning process.*** To be effective in evaluating the proposed performance matrix of an incentive compensation plan and the behavior the matrix could be expected to drive, the compensation committee must have a clear understanding of the company's business plan, prospects and challenges. Most performance matrices should be a logical outgrowth of a "bottom up" business planning process to assure that they reflect what is reasonably achievable under different sets of assumptions about the business. "Top down" directives divorced from operating realities may effectively incent employees to take material risks inconsistent with the company's risk profile in order to be compensated at reasonable levels. Performance criteria that do not ordinarily flow from a bottom up business planning process, such as total shareholder return targets, should be appropriately balanced within the overall compensation program.

- ***Targets must be "just right" – not too easy and not too hard.*** Setting targets is an art, as well as a skill. If the bar is set too low, an incentive may be perceived as being the equivalent of a guaranteed bonus, undermining the very purpose of incentive compensation. If the bar is set too high, employees may believe they have nothing to lose – and much to gain – from taking high risk actions with potentially significant compensation upside, but also potentially significant downside for the company's results and prospects. Establishing any target calls into question whether the balance it strikes between risk and reward will be efficient – will the company in fact get what it is paying for? As noted above, given the difficulties inherent in setting targets, permitting the committee to exercise subjective discretion where appropriate in determining payouts, rather than requiring strict adherence to objective formulas, may improve the effectiveness of compensation plan design.

- ***A performance curve that is too steep can signal overly risky incentives, but a flat curve may signal insufficient incentives for risk-appropriate behavior.*** Committees should be alert to the slope of performance curves. Plans with steeply sloped curves or threshold "cliffs" are more likely to encourage excessively risky behavior because employees have more at stake for each increment of performance. Conversely, a curve that is too flat may be insufficient to motivate employees to take any risk that might otherwise be appropriate.[5] This is of course a company-specific exercise. The nature of the industry and the business and profile of the company are important factors in determining the appropriateness of the slope of a given performance curve.

- ***Targets should be set at points that support the balance of desired incentives in the plan design.*** For example, a long-term bonus plan could be designed to reward a combination of profits growth and return on assets, so that the incentive to grow profits is balanced and restrained by a performance measure that penalizes undue expenditures for the sake of fast growth. This balance can be undermined, however, if the target levels under each measure are set so that one of them eclipses the other. For example, if payout levels under a bonus plan are based on an equal weighting of two performance criteria, the design suggests that plan participants must pay equal attention to each of the two criteria, thereby mitigating risks that might arise from a focus on only one of the criteria in isolation. However, if achieving maximum performance for one of the criteria is relatively easy because the range of performance for that criterion was set too low, then the intended effect of diversifying management incentives may be undermined and the risk profile of the plan may vary from the committee's original intentions.

- ***The time horizon of the compensation plan is an important contextual factor in judging the appropriateness of targets.*** The longer the performance period, the more difficult it is to judge the appropriateness of a target – there is simply less visibility into potential outcomes. In general, the longer the period covered by a compensation plan, the more appropriate it will be to have a relatively flat performance curve with a larger spread between threshold and maximum levels, smoothing out the effects of unpredictable future events that are outside employees' control. Today's continuing economic uncertainty exacerbates the problem of visibility, and similar issues can be raised during key inflection periods in the company's industry. In those cases, a temporarily shorter horizon for compensation incentives or a mix that may increase shorter-term compensation opportunities may be appropriate because of the particular business context.

[5] Steep payout curves, as well as cliff-type arrangements, may nevertheless be appropriate in particular contexts, in which case it may also be appropriate for the committee to ensure that other external controls are in place to mitigate the risk of inappropriate business decisions. For example, a fixed bonus payable to management upon completion of a divestiture is a common arrangement that provides a binary payout curve – *i.e.*, payment is either earned in full or not at all. In those circumstances, however, oversight by the board in regard to the divestiture may provide the external control that eliminates the risk of management disposing of the business for less than full value in order to achieve the payout.

- ***How results are calculated under a metric is important.*** Committees should be sure to understand the operation of compensation plans and particularly the calculation of each performance measure. For example, if a plan incorporates a stock price metric measured on a single day, it may encourage management to take or to time actions with a view to temporarily boosting the stock price. In this example, the risk of manipulation can be mitigated by a longer measurement period (*e.g.*, a three-month average stock price) that is less susceptible to manipulation.

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While the recent financial crisis may be the immediate catalyst for the new rules, the nexus between compensation and risk has been a growing focus among investor advocates and academics for many years. Whatever the quality of disclosures under the new rules, the merits of a robust compensation committee process that analyzes this relationship are incontrovertible.

Please contact any of the lawyers listed in the Corporate Governance or Employee Benefits section of our website (www.cgsh.com) or any of your other regular contacts at the firm for further information about the matters discussed above.

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