CORPORATE WAVELENGTH

The Corporate Governance, Risk, and Compliance Web Series

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Compensation Practices and Policies How Do They Impact Risk?

September 24, 2009

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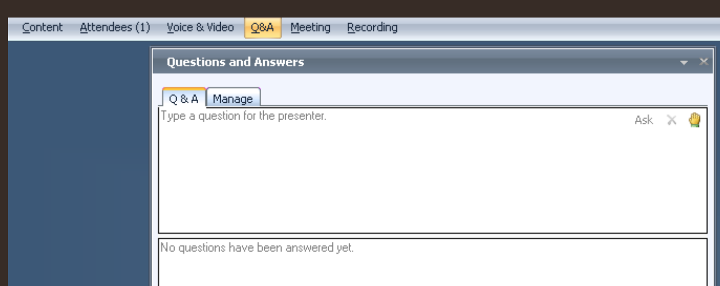

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Today's Speakers

Mark Plichta

- Partner in Foley's Transactional & Securities Practice
- Practices in the areas of mergers and acquisitions, securities law, and general corporate business law
- Regularly counsels private and publicly held companies on executive compensation, corporate governance and securities law compliance
- Certified public accountant

Today's Speakers

Jay Rothman

- Chair of the firm's national Transactional & Securities Practice
- Focuses his practice in the areas of mergers and acquisitions, securities law, takeover defense, and general corporate and business law
- Author and speaker on topics including executive compensation, corporate governance, mergers and acquisitions and securities law

Today's Moderator

Brendan Sheehan
Executive Editor, *Corporate Secretary*

- Editorial mission: To provide innovative and insightful analysis for corporate secretaries, general counsel and compliance officers
- *Corporate Secretary* is the leading source of information on matters relating to the SEC, Sarbanes-Oxley, D&O insurance, shareholder communications, proxy solicitation and voting, director education and compensation, listing requirements and entity management

Overview

- Background
- Summary of relevant legislation and regulation
- Implications for directors
- Recommended process for addressing risk and compensation

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Background

- Financial meltdown
- Role of risky compensation packages?
  - No empirical studies
  - Frequently cited practices

What is Risk?

- Financial risk definitions:
  - Degree of uncertainty or variability of return on an asset or investment
  - The standard deviation of the return on total investment
  - The quantifiable likelihood of loss or less-than-expected returns
- Beta: The relation of a return on an investment with the return on the financial market as a whole
- Concentration
- Compare “short-term focus” – sometimes grouped together

Regulation of Risk in Executive Compensation (Overview)

- Troubled Asset Relief Program (TARP)
- SEC guidance under current rules
- SEC proposed rules
- Federal Reserve proposal
- Other proposals
- Voluntary actions

TARP

- Only applies to participating "financial institutions"
- Requires limits on compensation that exclude incentives for senior executive officers to take "unnecessary and excessive risks that threaten the value of the financial institution" during the period of the government's investment
- Other requirements (clawback, prohibition on golden parachute payments, limitation on bonuses and other compensation, ban on plans that encourage earnings manipulation, independent compensation committee, $500,000 §162(m) tax deduction cap, certification requirement, luxury expenditures, "Say on Pay" and retroactive review of prior payments)

Informal SEC Guidance Under Current Rules

October 21, 2008 speech by then-director of the SEC Division of Corporation Finance John White suggested that risk assessments of the type required under TARP might also be appropriate for other companies:

"[A]sk yourself this question: Would it be prudent for compensation committees, when establishing targets and creating incentives, not only to discuss how hard or how easy it is to meet the incentives, but also to consider the particular risks an executive might be incentivized to take to meet the target — with risk, in this case, being viewed in the context of the enterprise as a whole? …[T]o the extent that such considerations are or become a material part of a company's compensation policies or decisions, a company would be required to discuss them as part of its [Compensation Discussion and Analysis (CD&A)]."

SEC Proposed Rules

- Would require the CD&A to address compensation policies and practices as they relate to risk management practices and risk-taking incentives.
  - Discussion would be required about compensation policies and practices for employees generally — not, as in the rest of the CD&A, for only the named executive officers — to the extent that risks arising from such policies and practices may have a material effect on the company.
- In preparing this discussion, companies would need to consider the level of risk that employees might be encouraged to take to meet their incentive-compensation targets or conditions.

SEC Proposed Rules (Continued)

- Compensation policies and practices that might warrant discussion:
  - Compensation policies at business units:
    - that carry a significant portion of the company's risk profile
    - with compensation structured significantly differently from other units
    - that are significantly more profitable than other business units
    - where compensation expense is a significant percentage of the unit's revenues

SEC Proposed Rules (Continued)

- Compensation policies that vary significantly from the overall risk and reward structure of the company (such as policies under which bonuses are awarded upon accomplishment of a task for which income and risk to the company extend over a significantly longer period of time) also might warrant discussion
- Examples of the types of issues that may need to be addressed for the employees or units discussed:
  - The general design philosophy of the company's compensation policies for employees whose behavior would be most impacted by the incentives established by the policies, as such policies relate to or affect risk taking by employees on behalf of the company, and how they are implemented
  - The company's risk assessment or incentive considerations, if any, in structuring compensation policies or in awarding and paying compensation

SEC Proposed Rules (Continued)

- Additional examples:
  - How the company's compensation policies relate to the realization of risks resulting from the actions of employees in both the short term and the long term such as through policies requiring clawbacks or imposing holding periods
  - The company's policies regarding adjustments to its compensation policies to address changes in its risk profile
  - Material adjustments the company has made to its compensation policies or practices as a result of changes in risk profile
  - The extent to which the company monitors its compensation policies to determine whether its risk management objectives are being met in providing incentives for its employees
- SEC rules already require companies to discuss in CD&A, to the extent material, exposure to downside performance risk and cost-benefit analysis with respect to the compensation of named executive officers.

SEC Proposed Rules (Continued)

- The proposing release emphasizes that
  - Companies should evaluate whether discussion of these issues is appropriate in light of their importance to investors based on the individual company's circumstances, and
  - The level of detail should vary depending on the particular facts of the company or business unit involved.
- The release sought comment on a number of issues, including whether the discussion should be mandatory only for certain sizes of companies or certain industries and whether discussion of all of the examples of issues should be required.

Federal Reserve Proposal

- Fed review of compensation arrangements believed to encourage excessive risk taking at Fed-regulated banks
- Ability to amend salary and bonus policies
- Scope to extend beyond top executives to include other traders and loan officers

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Other Proposals

- Corporate and Financial Institution Compensation Fairness Act of 2009 passed the House of Representatives on July 31, 2009.
  - Includes a section regulating pay at large financial institutions (more than $1 billion in assets), and in particular their incentive-based pay packages.
  - Would require federal regulators to prohibit "certain compensation" structures at large financial institutions if they could have a "serious adverse effect on financial stability."
  - Also would require federal regulators to adopt rules requiring these institutions to disclose their incentive-based pay plans for executives and employees - and then the regulators would determine if the pay packages are "aligned with sound risk management."
  - Other provisions relate to "Say on Pay" and compensation consultant independence.

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Other Proposals (Continued)

- Shareholder Bill of Rights Act of 2009 was proposed by Sen. Charles Schumer on May 19, 2009
  - For public companies, includes Say-on-Pay, Say on Severance, proxy access.
  - For listed companies, includes annual election of directors (majority voting standard), independent board chair and Risk Committee composed entirely of independent directors.

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Other Proposals (Continued)

- G-20 Finance Ministers' Declaration
  - Calls for global framework on compensation practices, including disclosure of pay for employees who impact risk taking and an emphasis on aligning pay with long-term performance
  - Links board oversight of compensation and risk

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Voluntary Actions

- Conference Board Task Force on Executive Compensation "Guiding Principles"
  - Paying for the "right" things and paying for performance
  - The "right" total compensation
  - Avoid controversial pay practices
  - Credible board oversight of executive compensation
  - Transparent communications and increased dialogue with shareholders
- Policies against multi-year guaranteed contracts

Implications for Directors

- High level challenges/considerations
  - Basic objective – drive business decisions that create balance between risk and return
  - Defining/identifying "risk"
  - Human motivations
  - Quarter-to-quarter market pressures
  - Human capital management

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Implications for Directors (Continued)

- Board expertise/liability concerns
- Expansion of the role of the Compensation Committee deeper into the organization
- Intersection with the role of the Audit Committee
- Unintended consequences

Implications for Directors (Continued)

- Defining appropriate practices
  - No consensus
  - Trade-offs
    - Incentives for performance (What will "pay for performance" mean in this new environment?)
    - Qualitative versus quantitative standards
    - Recruitment/retention
- Differences in the financial services versus other industries
  - In many non-financial organizations, very few persons are likely to be able to materially impact company risk in the ordinary course of business
  - One size does not fit all

Implications for Directors (Continued)

- Consider how certain risks are best addressed
  - E.g., M&A risks may be better addressed by corporate governance policy and practice rather than compensation practice

Implications for Directors (Continued)

- Board/committee should consider and document key factors/practices
  - Longer-term performance periods?
  - Align compensation with the entity's strategic plan
  - Consideration of both upside potential and downside risks
  - Consideration of both absolute and relative metrics (including peer group comparisons when practical)
    - A rising tide lifts all boats

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Implications for Directors (Continued)

- Maintain a competitive compensation structure
- Potential "red flags"
  - Uncapped upside
  - Incentives tied to a short timeframe; incentive to "swing for the fence"
  - Equity awards with limited downside risks
  - Misaligned base salary/incentive compensation mix
- Does the company's financial reporting system capture the information necessary to appropriately measure selected compensation metrics?
- Do the company's internal control and risk management systems adequately mitigate against employees engaging in fraud or inappropriately "gaming" the compensation system?

Implications for Directors (Continued)

- Specific potential trends include:
  - Caps on bonus opportunities
  - Holdbacks ranging from one to three years under annual bonus plans
  - Mandatory deferrals of bonuses/bonus banks
  - Clawbacks (with or without fraud or restatement)
  - Longer performance periods for incentive plans
  - Less reliance on pure metrics; Board/Compensation Committee discretion
  - Share ownership requirements
  - Hold "'til" or "through" retirement policies

Implications for Directors (Continued)

- Other specific potential trends include:
  - No flipping of options
  - Little or no severance for failed performance
  - No accelerated vesting on termination for poor performance
  - Partial payment of bonuses in restricted stock
  - Adjusting performance compensation measures/payouts for risk
  - Simplification of compensation arrangements to "core" elements – cash and equity only
  - Comparison to peer groups
  - "Say on Pay"

Recommended Process

- Identify material internal and external risks in the context of company's business activities and markets of operation (meet with senior risk officer)
- Determine how compensation practices and arrangements influence these risks
- Identify policies that will mitigate or limit these risks but still align compensation to the achievement of the entity's strategic plan

Recommended Process (Continued)

- Meet with senior risk officer (or equivalent officer) to assess risk in executive compensation
- Consult with outside experts
- Document these assessments and disclose in proxy statement (if applicable)

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