



## Employee Benefits

September 2009

### A Step-by-Step Action Plan For Conducting Executive Compensation Risk Assessments

#### Background

The most important year-end 2009 task for Companies, Boards of Directors, and Compensation Committees may be to begin to establish a process for assessing the risk of the Company's executive and employee compensation programs. The U.S. Securities and Exchange Commission ("SEC") is expected to publish final rules later this Fall (the proposed rules were issued in July), which will apply to proxy statements for fiscal years ending after December 15, 2009, and require that every company:

- Evaluate whether any of its compensation plans or practices, including non-executive officer compensation plans and practices, include risk-taking incentives that may have a material effect on the company, and
- Disclose the results of that evaluation and any steps the company has taken to manage or mitigate those risk-taking incentives.

CHARLOTTE

The failure to conduct a risk assessment process in the thorough and intensive manner required by the rules, which most companies have not historically conducted, could put a company at a disadvantage if and when the SEC rules are finalized. A failure to conduct a risk assessment in compliance with the rules could lead to increased scrutiny (and liability) from the SEC and shareholders, and/or the company's failure to identify or manage a critical incentive for risk-taking.

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This requirement originally appeared in the Emergency Economic Stabilization Act of 2008 (EESA), as amended by the American Recovery and Reinvestment Act of 2009 (ARRA), which contained language requiring affected financial institutions to adopt:

LOS ANGELES

MOSCOW

- Limits on compensation that exclude incentives for senior executive officers to take unnecessary and excessive risks that threaten the value of the company.
- A prohibition on any compensation plan that would encourage manipulation of the company's reported earnings to enhance the compensation of any of its employees.

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The EESA and ARRA provisions only apply to companies receiving funds under the Troubled Asset Relief Program ("TARP"). However, legislation passed by the full House of Representatives would, if approved by the Senate and signed by the President, impose similar requirements on all public companies, even if the SEC does not finalize the rules this year.

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Therefore, all public companies should prepare to conduct a risk assessment this year.

## Objective

Because every company of every size in every industry has a different risk profile, there can be no “one size fits all” program for conducting the required risk assessment. However, we have designed two forms of *Step-by-Step Action Plan for Conducting Executive Compensation Risk Assessments* – one for larger companies and one for smaller companies -- which create a structure (or starting point) for the assessment and set forth many of the steps that would be required of any Company, Board of Directors, or Compensation Committee for the upcoming proxy season.

These Action Plans set forth a series of procedural steps to conduct a thorough and compliant risk assessment. For some companies, this approach may have as many as thirty separate but integrated steps. For smaller companies or industries with fewer risk factors, the Action Plan may be as few as ten steps. Different companies also may choose to change the order of these steps, as suitable. Not every step of either Action Plan will apply to every company.

An Exhibit to the Action Plans describes a number of factors that can help identify executive and employee compensation practices that create incentives for excessive risk-taking. The following are a few simplified examples of executive compensation program features that could provide too much incentive for executives to take risk or otherwise manipulate financial results:

- The Company’s annual (or long-term) bonus plan that provides for a payout equal to 100% of base salary if the Company achieves a specified EPS Target – and no payout if the Company fails to achieve that target.

*Executives are already under enormous pressure to achieve announced or expected EPS figures. This all-or-nothing approach would only exacerbate the problem. Instead, the Company should consider bonus payouts at 90% of base salary for achieving EPS that is barely below the Target and straight-line interpolation downward for other, lesser performance targets.*

- The Company provides equity incentive compensation solely in the form of stock options. Many of the stock options are underwater.

*Executives need to “hit a grand slam home run” in terms of performance in order to see any return on their stock options. Slow, but steady, growth may not be enough. Ideally, the*

*Company would provide part of its equity compensation in restricted stock or RSUs, so that executives will receive some benefit for navigating through difficult financial times.*

- The Company maintains an employee compensation program that provides cash incentive pay based on the number of transactions the employee makes, without a qualitative requirement (e.g., did the transactions create profit for the Company and, if so, at what risk?).

The Action Plans also discuss ways to manage or mitigate these risk factors.

## Overview

The executive compensation risk assessment process should proceed in several distinct phases:

1. Collect and review the Company’s existing policies and programs (including corporate governance guidelines and committee charters) on risk management.
2. Organize of the team and the risk assessment process. Select the involved parties. Create a timeline (including compliance dates) for the process. Create a list of all executive and employee plans to be reviewed.
3. Conduct the risk assessment. Identify for the Compensation Committee the risks that the Company faces that could threaten its value or have a material impact on the Company. Identify the features of the executive and employee compensation programs that could induce executives and employees to take those risks.
4. Analyze the results of the risk assessment and deliberate over how to manage any risks, and/or revise any compensation and incentive programs with materials risks.
5. Implement changes to executive and employee compensation programs to manage incentives for risk-taking (and eliminate inappropriate incentives).
6. Record the results in meeting minutes and report them in the Company’s Proxy Statement (and/or Form 10-K, as required).
7. During the assessment process (or at its conclusion), develop written policies and guiding principles for proposing, establishing and monitoring compensation and incentive plans that can be applied company-wide in the future (which will make future risk assessments easier).

To contact your Winston & Strawn employee benefits attorney, please click [here](#).

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