Is Your Board's Compensation Risk Assessment Doing Enough

A Compensation Committee Series Webinar

Presented by NACD and Pearl Meyer

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Presenters

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Housekeeping

- Submit a question and receive your answer directly from the presenters, either during today's webinar or as a follow-up. You will also be opted-in to receive future executive compensation thought leadership from Pearl Meyer.
- Presentation slides are available today at www.pearlmeyer.com/risk-assessment.
- The replay will be available early next week at www.nacdonline.org/webinars and www.pearlmeyer.com/risk-assessment.

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Agenda

The most recent NACD Governance Outlook notes that outside of overseeing strategy development and execution, the most important area for board improvement, as reported by directors, is the oversight of risk management. While managing risk takes many forms, the compensation committee's annual compensation risk assessment exercise can provide a framework for deeper board conversations about potential risks in corporate goals, governance, and leadership plans and practices.

In this webinar with Pearl Meyer and the NACD, we will share details on conducting a more in-depth compensation risk assessment than is typical—including executive talent management and development—and how such details work together to provide insight to pockets of risk that may not have been apparent.

Learning Objectives:

- Uncover potential risks or unintended consequences associated with executive compensation plan design
- How and why to integrate a leadership risk analysis into the annual compensation risk assessment
- Identify opportunities for the board to mitigate risk

Background

- The SEC mandates that public companies conduct a compensation risk assessment on an annual basis to ensure that compensation plans do not create material adverse risk for the company.
- If no material risks are present, no disclosure is required; however, most companies disclose in the annual proxy statement that an assessment was performed, and no material risks were found.
- Companies have broad latitude in conducting these assessments and often rely on their independent compensation consultant for guidance and third-party validation.

The Fox Guarding the Hen House

How do we ensure objectivity when companies are self-assessing compensation risks or when consultants are validating plans they helped design?

- ✓ **Strengthen Oversight:** Empower compensation committee members to critically evaluate both the findings and the process behind the annual compensation risk assessment.
- ✓ **Transparency:** Use clear, documented criteria for assessments, openly disclosed to ensure accountability.
- ✓ **Stakeholder Input:** Include broader stakeholder feedback to diversify perspectives and reduce bias.
- ✓ **Audit Reviews:** Consider periodic external audits to add an extra layer of objectivity.

Polling Question #1

Q: Who drives your company's annual compensation risk review?

1. Management/HR team
2. Independent Compensation Consultant
3. 50/50 Collaboration between Management and Comp Consultant
4. Other Third Party

Assessing Compensation Risk

Checklist Approach

- **Rote Assessment:** Uses a predefined list to check for the presence of problematic features (e.g., uncapped incentive plans, lack of specific compensation governance features).
- **Isolated Evaluation:** Assesses each element separately, without necessarily considering the overall context.
- **Lack of Nuance:** May not account for mitigating factors or governance structures.

Spectrum Approach

- ✓ **Holistic Evaluation:** Considers the overall compensation program, not just isolated elements.
- ✓ **Contextual Analysis:** Weighs individual risks against mitigating factors and governance structures.
- ✓ **Balanced View:** Recognizes that some moderate risk elements can exist without causing material adverse risk overall.
- **Example:** A combined chairman and CEO role may pose some degree of risk, but independent board oversight and a strong lead director can serve as mitigating factors.

Spectrum Approach

- Taking the "Spectrum Approach" may still involve evaluating individual compensation elements in isolation and categorizing them as low, moderate, or high risk.
- The distinction versus the "checklist approach" is that a single element being scored as high risk in isolation does not necessarily mean the entire compensation program is flawed. Mitigating factors can serve to balance out higher-risk elements.

Low Risk	Moderate Risk	High Risk
The specific item or provision exists (e.g., stock ownership guidelines or caps on incentives) or is structured in such a way as to not (or only minimally) cause or contribute to risk taking behaviors or actions.	Certain features may lack controls, limits, or risk-balancing mechanisms and thus have the potential to cause or contribute to risk-taking behaviors and actions; for example, annual incentives tied solely to one metric may increase the propensity for risk-taking.	The item or practice (or lack thereof) may directly and materially increase the likelihood of taking risks that could potentially have an adverse impact on the company. Such items may lack robust controls or risk-balancing mechanisms; for example, large, uncapped incentives without structured controls.
Recommended Action:	**Recommended Action:**	**Recommended Action:**
None	Consider in overall context, including non-compensation factors; continue to monitor	Review and ameliorate

Case Study: Chemours

- A recent investigation at Chemours, stemming from an anonymous ethics hotline report, revealed top executives manipulated cash flows at year-end to meet annual and long-term incentive plan targets.
- Executives were alleged to have delayed year-end payments to vendors while accelerating collection of receivables to meet free cash flow targets tied to incentive compensation.
- **Compensation Risk Considerations:** Incentive designs that pay significantly more than zero at threshold can increase compensation risk. Even when the payout at threshold is zero, a higher level of "audit" review may be warranted when results are at or just above threshold or if cash flow results are well above/inconsistent with other metrics.

Chemours Case Study Implications

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Compensation risk is not confined to annual reviews. To prevent similar issues, compensation committees should engage in continuous risk monitoring throughout the year.

Key Points:

- **Ongoing Vigilance:** Regularly review and update compensation practices to identify and mitigate emerging risks.
- **Proactive Probing:** Committees make a habit of actively questioning and evaluating incentive plans, and not necessarily solely during annual assessments.
- **Learning from Incidents:** Use real-world examples to refine and enhance compensation strategies.
- **Consulting Partnership:** Collaborate with a consulting partner who keeps the committee informed about emerging issues and best practices in compensation risk management.

Depth of Review

- While the SEC requires companies to disclose any material adverse risks in their compensation plans, the primary focus of compensation consultants and committees is often solely on *executive* compensation programs.

Wells Fargo Example

- The Wells Fargo scandal is a prime example where an incentive plan for branch-level employees created significant material adverse risk for the company.
- Aggressive sales targets and incentives for non-executive employees led to fraudulent account openings, resulting in substantial financial and reputational damage, highlighting the need for the need for comprehensive oversight and risk management across *all levels* of compensation plans.

Polling Question #2

Q: To what extent does your company ensure that incentive plans for non-executive employees are included in the annual compensation risk assessment?

1. Our compensation risk assessment primarily focuses on executive compensation plans; we do not regularly review non-executive incentive plans.
2. We "kick the tires" on our non-executive plans from time to time, but it generally isn't a major focus of our annual compensation risk assessment.
3. We rely on our HR team's knowledge of non-executive compensation plans to confirm that broad-based compensation plans are free of problematic practices.
4. Our annual assessment includes in-depth reviews of all incentive plans, including those for non-executive employees.

The Expanded Remit of the Compensation Committee

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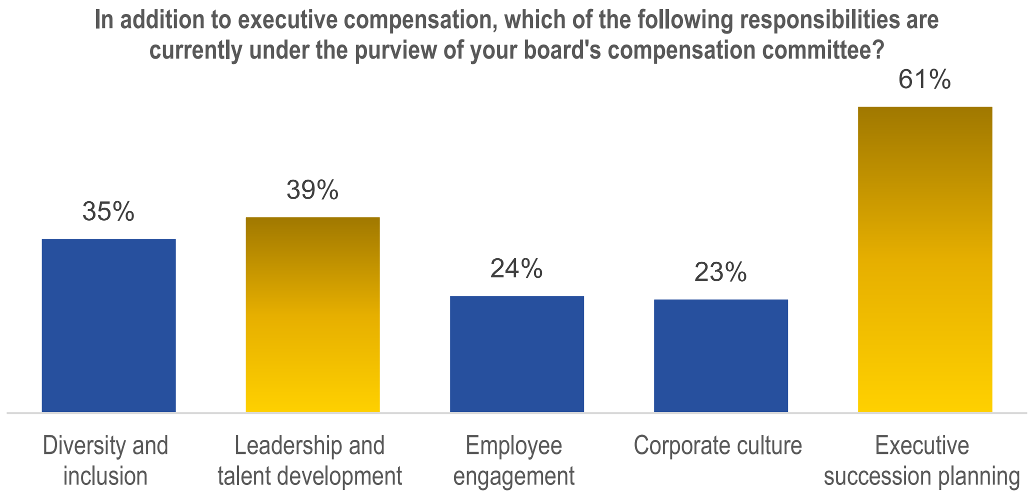
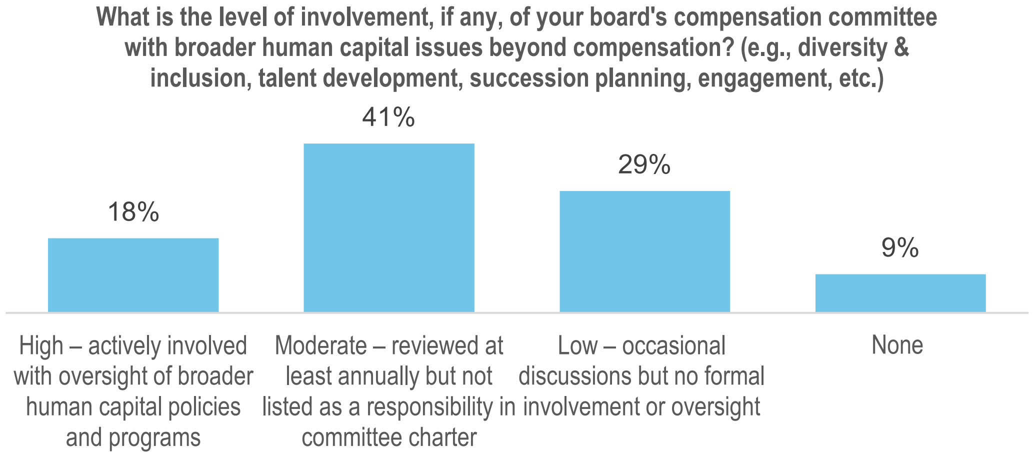
- In recent years, the compensation committee's remit has expanded to include monitoring and overseeing other human capital management ("HCM") areas, including ESG, DE&I, talent management/leadership development, and succession planning.
- A recent Pearl Meyer survey* found that 61% of publicly traded companies consider executive succession planning to be part of their compensation committee's purview, with a majority reporting moderate- to high-levels of involvement in these broader HCM issues.
- **Key Question:** To what extent should succession planning be reviewed as part of the annual compensation risk assessment?

* Source: *Pearl Meyer On Point Survey: Looking Ahead to Executive Pay Practices in 2024*





Polling Question #3

Q: To what extent does your current compensation risk assessment process consider issues of succession planning or leadership/talent development?

1. Not at all: Our risk assessment focuses solely on "traditional" compensation risks.
2. Minimally: We occasionally discuss succession planning and leadership development, but it is not systematically integrated into our risk assessments.
3. Moderately: Succession planning and talent development are regular components of our risk assessment, though not the primary focus.
4. Extensively: These issues are central to our risk assessment process, ensuring alignment with long-term strategic goals.

The Supply and Demand Dynamics of CEO Succession

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Demand is High and Predominantly Expected

Roughly 10% of global companies experience CEO turnover; average of 181 per year [2]

86% of CEO transitions were planned; 7% health related and 7% were under pressure[1]

Supply is Largely Internally Sourced First-Timers

88% of appointed CEOs are first-timers (5-year running avg.) [2]

78% of CEO appointments were internal between 2018-2022.[1]

Implications for Boards Onboarding New CEOs

Hedge the risk. Ineffective CEO transitions in the S&P 500 cost roughly $1 trillion a year[3]

Get to know your insider candidates

Understand the experience of first-time CEOs

1 *Spencer Stuart, 2022 CEO Transitions*
2 *Russell Reynolds Global CEO turnover index 2023*
3 *Harvard Business Review 2023: The High Cost of Poor Succession Planning*

Additional Statistics on CEO Succession

Average CEO Tenure is Declining

S&P 500 at 8.9 years, continued to decline from its 2021 peak of 11.2 years and 10.2 years in 2022.

Average Age of Departing CEOs is Rising

In the S&P 500, the average age dipped to 53.8 in 2022 and bounced back up to 56.4 in 2023 continuing a longer-term trend of rising CEO age. This is not surprising in a more uncertain period when leaders who have lived through more economic cycles are leaned on more heavily. (Spencer Stuart, Jan 2024)

Failure Rates for New CEOs similar for Outsiders and Insiders.

The failure rate for externally hired CEOs in the S&P 500 varies based on company performance. In better-performing companies, the rate is approximately 11.3%, while in lower-performing companies, it's around 20.2% (UChicago, 2023)

Varying % of CEOs Staying on Boards

In the S&P 500, in 2022, 48% of outgoing CEOs stayed on as board chair after their departure in 2022, down from 63% in 2021, but higher than 38% in 2020. (Spencer Stuart, 2022 and 2021)

% of CEOs on Boards Slightly Declining

The percentage of directors who are active or former CEOs has decreased since 2018. The recorded decline was from 42 percent in 2018 to 41 percent in 2023 in the S&P 500, and from 37 to 34 percent in the Russell 3000. (Conference Board, 2023)

Polling Question #4

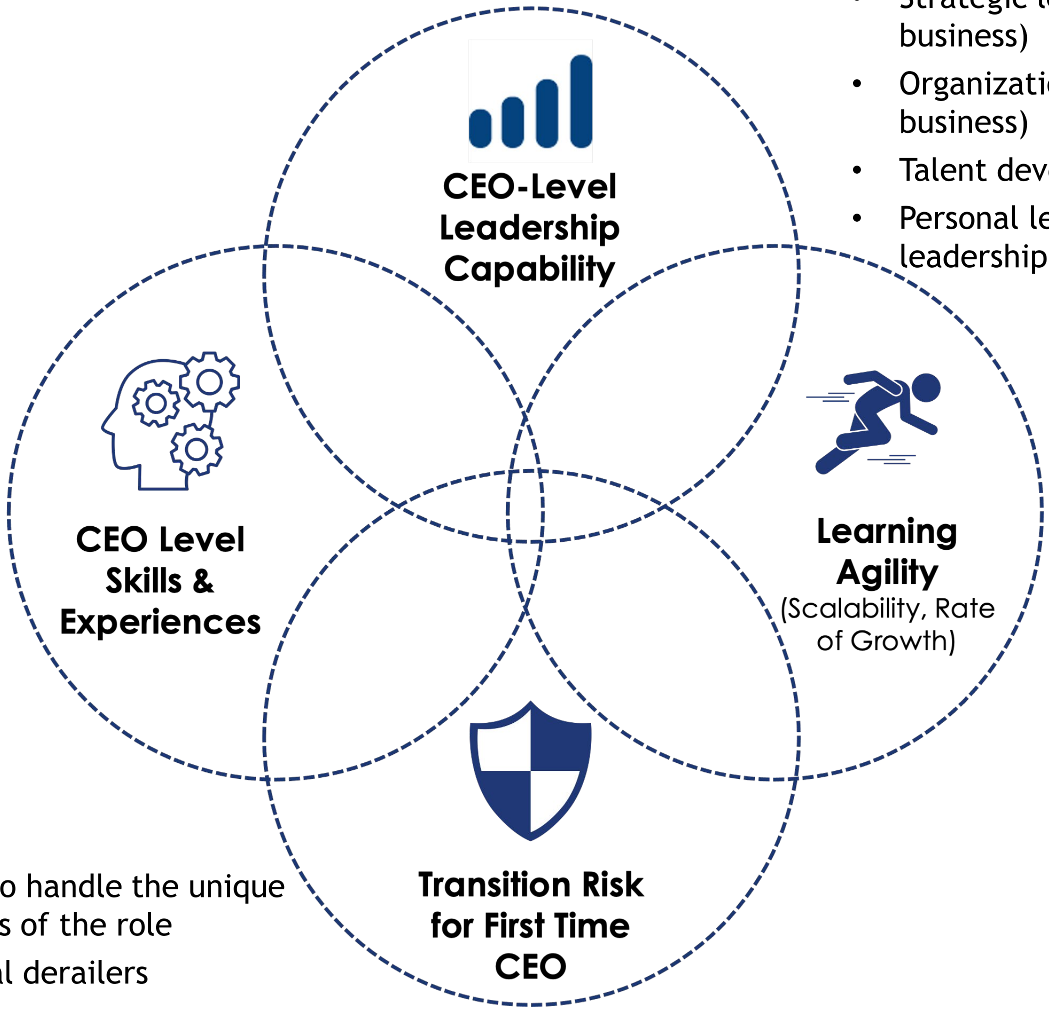
Q: To what extent has your comp committee discussed the risk of failed succession planning?

1. Succession and associated risk is a regular part of our compensation committee meetings
2. It has been a topic of discussion
3. Some, but not regularly
4. Not at all

Skills and Experiences: Assessing Internal Candidate Readiness for the CEO Role

- Strategic leadership (growing the business)
- Organizational capability (building the business)
- Talent development (growing leaders)
- Personal leadership (enterprise leadership)

- Constituent management
- P&L responsibility
- Domain expertise
- Leading change (M&A, transformation, etc.)



- Success in first-time challenging situations
- Adaptability and resourcefulness
- Learning orientation

- Ability to handle the unique demands of the role
- Potential derailers

Closing Thoughts

- **Expand Risk Assessments:** Include broad-based plans, succession planning, and leadership development.
- **Learn from Scandals:** Use cases like Chemours and Wells Fargo to improve strategies.
- **Monitor Continuously:** Conduct risk assessments throughout the year, not just annually.
- **Ensure Comprehensive Oversight:** Review all incentive plans, including non-executive ones.
- **Leverage Expertise:** Partner with consultants for ongoing updates and best practices.

By adopting these strategies, committees can better manage risks and align compensation with long-term goals.

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Q&A

Please submit your questions in the Q&A box below.

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