

Compensation Risk Disclosure – What Are Companies Doing?

A Study of S&P 500 Companies

Introduction

The topic of risk has taken center stage this year - executives are more aware of it, directors are more cautious because of it, and regulators are trying to monitor it. While the focus on risk is in large part a reaction to the financial crisis, new SEC regulations require all companies to discuss the role of risk in their compensation programs.

The new regulations require companies to disclose if the risks arising from compensation policies and practices are reasonably likely to have a material adverse effect on the company. In addition, recent SEC guidance suggests that companies should discuss their risk assessment process, providing information about the Board's process and role in risk oversight.

To see how companies have responded to the new SEC rules, Semler Brossy monitored the risk related disclosure practices of S&P 500 companies (see Appendix A for methodological details). We captured data in three areas:

- **Process:** Has the company described its process for enterprise risk management, particularly as it relates to risks in the compensation program?
- **Mitigators:** Has the company outlined features of the compensation program that mitigate risks?
- **Affirmative Statement:** Has the company made an explicit or implicit affirmative statement that their compensation programs are not reasonably likely to have a material adverse effect on the company?

Key Findings

Types of Disclosure

We did not identify any companies that disclosed their programs create risks that are reasonably likely to have a material adverse impact on the company. However, almost 90% of companies included some discussion in their most recent proxy of how the compensation program addresses risk. The most prevalent type of disclosure was the process for evaluating risk. See Figure 1.

- 80% of companies included a discussion of the process for evaluating risk in their compensation programs.
- A majority of companies disclosed risk-mitigating elements of their compensation program (56%) and/or an affirmative statement about the riskiness of their compensation program (64%).

Prevalence of Disclosure by Type

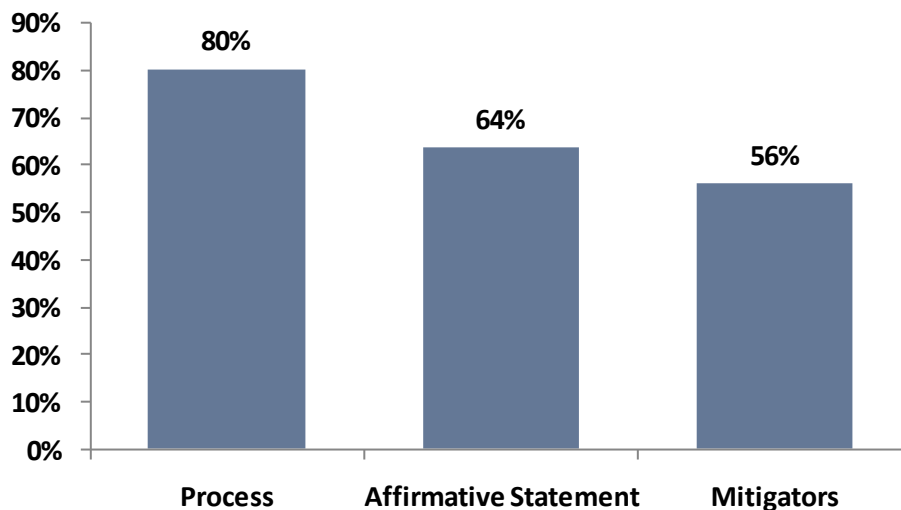


Figure 1: Prevalence of Disclosure by Type.

Process

Process-related disclosures were most commonly made in the Corporate Governance section of the proxy. We observed a trend of higher prevalence of process-related disclosures among companies with later filing dates. We believe this is due to guidance from the SEC indicating that it expects companies to discuss their process for evaluating risk in their compensation programs. The most comprehensive process-related disclosures included a discussion of the following:

- The Board's role in risk management (particularly as it pertains to compensation-risk)
- An overview of the programs and elements reviewed as part of the company's risk assessment
- An overview of the parties involved in conducting the company's risk assessment and evaluating the subsequent findings
- Compensation program changes and/or pay decisions influenced by the risk assessment findings

Risk Mitigators

Companies most often disclosed risk-mitigating elements of their compensation program and an affirmative statement about the riskiness of their compensation program within the Compensation Discussion & Analysis (CD&A). However, we did observe a slight trend toward disclosures outside of the CD&A among companies that issued proxy during the latter half of our study.

When discussing the risk-mitigating elements of their compensation programs, companies generally identified eight to ten compensation-risk mitigators (with several companies identifying fifteen or more). Common compensation-risk mitigators identified by the study companies include:

- Appropriate mix of “short- vs. long-term” pay and “fixed vs. variable” pay
- Use of multiple, complementary performance metrics (including non-financial, qualitative metrics) to balance incentives
- Alignment of short- and long-term performance metrics
- Capped payout levels for incentive-based compensation
- Share ownership and/or retention guidelines
- Recoupment (i.e., “clawback”) policies
- Ability for the board to exercise discretion

Affirmative Statements

Over half of the companies making an affirmative statement on the riskiness of their program, made an explicit affirmative statement (i.e., an affirmative statement was structured using the SEC’s language, “the company’s compensation programs do not create risks that are reasonably likely to have a material adverse effect on the company”). See Figure 2.

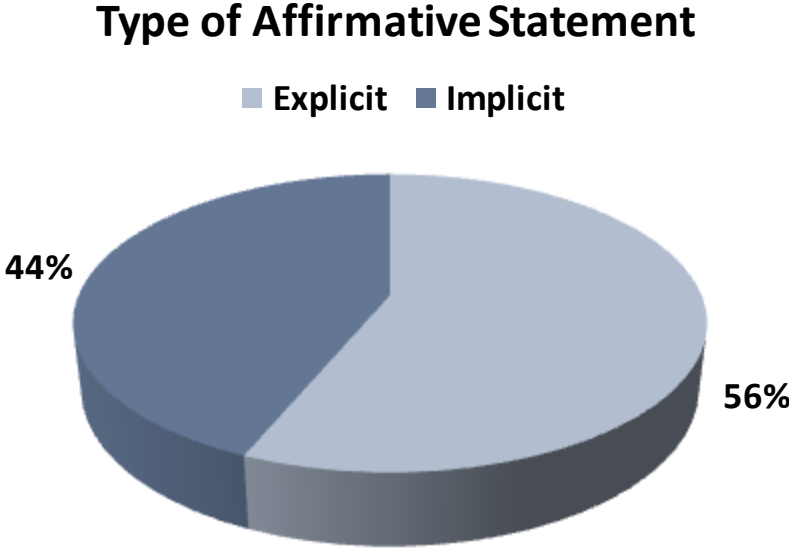


Figure 2: Type of Affirmative Statement on Pay Riskiness (Explicit vs. Implicit).

Also we observed a trend in more recent disclosures that companies were more likely to make an explicit, affirmative statement. We believe this is also due to the SEC’s guidance that companies discuss their risk assessment process, regardless of whether the company identifies any relevant risk.

Disclosure Practices

The most prevalent practice observed was to provide a comprehensive disclosure on risk. See Figure 3.

- 41% of companies provided a discussion covering all three disclosure types: process for evaluating compensation risk, pay elements that mitigate risk and an affirmative statement on pay riskiness. See Appendix B for an example of a comprehensive disclosure.
- The second most prevalent practice was to include a disclosure on the process for evaluating compensation risk, either in isolation, or in combination with an affirmative statement on pay riskiness.
- We do also note that 11% of companies provided no disclosure on compensation risk.

Prevalence of Disclosure by Practice

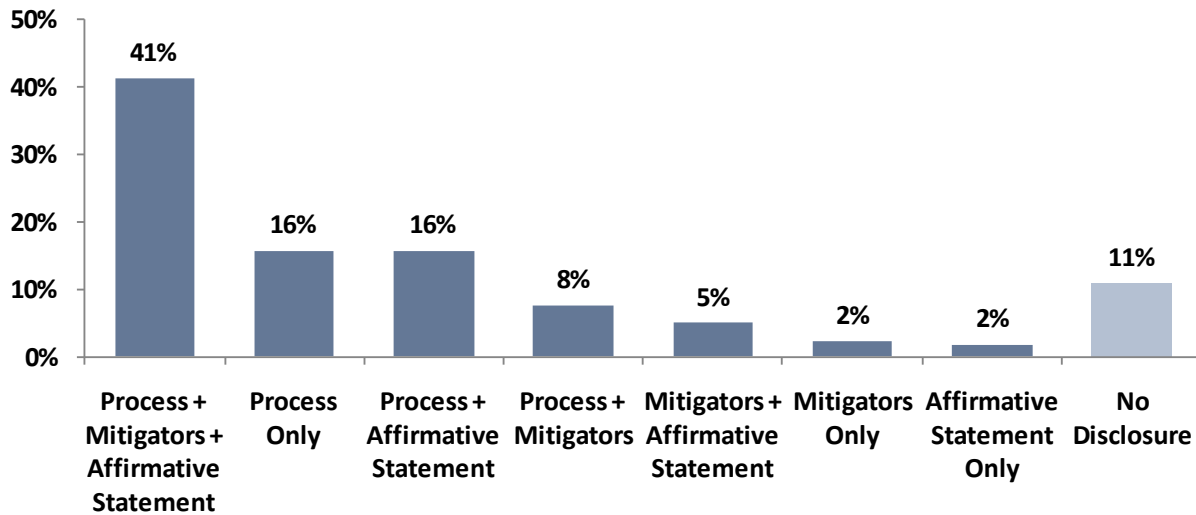


Figure 3: Prevalence of Disclosure by Practice.

Conclusion

Evaluating the affect that compensation programs may have on the riskiness of their enterprise could be a value-adding endeavor for some companies. However, we believe that risk disclosure likely will be an administrative disclosure requirement rather than having any material impact on how companies conduct their day to day business. Like other recent regulatory changes, the addition of risk disclosure demonstrates that legislating thoughtfulness only works to the extent that companies want to seize the opportunity.

Our experience to date suggests that the process will be driven by a team of employees from the company's internal audit, legal, and HR functions. Board level review should include both Audit and Compensation Committee members to ensure a thorough review of the compensation program, financial implications, and internal controls and processes.

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Appendix A: Methodology

This study represents 223 S&P 500 companies filing definitive proxies between March 1, 2010 and April 1, 2010 (excluding past or current CPP/TARP/TALF participants for whom disclosure may have been influenced or governed by CPP/TARP/TALF regulations).

As part of the study, we identified compensation-risk disclosures in the following three issue areas:

- **Process:** Has the company described its process for enterprise risk management, particularly as it relates to risks in the compensation program (and how it evaluates those risks)?
- **Mitigators:** Has the company outlined features of the compensation program that it believes mitigate risks?
- **Affirmative Statements:** Has the company made an affirmative statement that the company's compensation programs are not reasonably likely to have a material adverse effect on the company?

With respect to affirmative statement disclosures, we have further identified whether such statements explicitly or implicitly follow the SEC's language. Explicit statements discuss compensation risk using portions or all of the SEC's language and implicit statements discuss compensation risk without using the SEC's language. Examples of each type of statement are provided below:

- **Explicit:** "The Committee believes that the Company's compensation programs do not create risks that are reasonably likely to have a material adverse effect on the Company."
- **Implicit:** "The Committee believes that the Company's balanced approach to performance measurement and pay delivery works to avoid misaligned incentives for individuals to undertake excessive or inappropriate risk."

Further, we identified the location of compensation-risk disclosures in the following three sections of the definitive proxy:

- **Corporate Governance:** Disclosures occurring within the Corporate Governance section that covers the various responsibilities of the Board and its Committees.
- **Compensation Discussion & Analysis (CD&A):** Disclosures occurring within the CD&A section.
- **Other:** Disclosures occurring after the CD&A (i.e., supplementary disclosure sections following the CD&A, including the Summary Compensation Table and/or other related compensation tables).

Appendix B: Sample Disclosure

Ford Motor Co. (F); DEF 14A filed on April 1, 2010

“Board’s Role in Risk Management

The Board of Directors of the Company has overall responsibility for the oversight of risk management at Ford. Day to day risk management is the responsibility of management, which has implemented Enterprise Risk Management processes to identify, manage and monitor risks that face the Company.

The oversight responsibility of the Board and its Committees is supported by Company management and the risk management processes that are currently in place. Ford has extensive and effective risk management processes, relating specifically to compliance, reporting, operating and strategic risks. Compliance risk encompasses matters such as legal and regulatory compliance (e.g., Foreign Corrupt Practices Act, environmental, OSHA/safety, etc.). Reporting risk covers Sarbanes-Oxley compliance, disclosure controls and procedures, and accounting compliance. Operating risk addresses the myriad of matters related to the operation of a complex company such as Ford (e.g., quality, supply chain, sales and service, financing and liquidity, product development and engineering, labor, etc.). Strategic risk encompasses somewhat broader and longer-term matters, including, but not limited to, technology development, sustainability, capital allocation, management development, retention and compensation, competitive developments and geopolitical developments.

We believe that key success factors in the risk management at Ford include strong Board and senior management commitment, effective top-down and bottom-up communication (including communication between management and the Board and Committees), and active cross-functional participation among the Business Groups and Functional Skill Teams. More specifically, our Chief Executive Officer, Alan Mulally, has institutionalized a Business Plan Review and Special Attention Review process where, on a weekly basis (and more often where circumstances dictate), the senior leadership of the Company from each of the Business Groups and the Functional Skill Teams, reviews the status of the business, the risks presented to the business, (once again in the areas of compliance, reporting, operating and strategic risks), and develops specific plans to address those risks.

As noted above, the full Board of Directors has overall responsibility for the oversight of risk management at Ford and the Board of Directors itself oversees operating risk management, with reviews at each of its regular Board meetings. The Board of Directors has delegated responsibility for the oversight of specific areas of risk management to certain Committees of the Board, with each Board Committee reporting to the full Board following each Committee meeting. The Audit Committee assists the Board of Directors in overseeing compliance and reporting risk. The Board, the Sustainability Committee, the Compensation Committee and the Finance Committee all play a role in overseeing strategic risk management.

Risk Assessment Regarding Compensation Policies and Practices

We recently conducted an assessment of our compensation policies and practices, including our executive compensation programs, to evaluate the potential risks associated with these policies and practices. We reviewed and discussed the findings of the assessment with the Compensation Committee and concluded that our compensation programs are designed with an appropriate balance of risk and reward in relation to our ONE Ford Plan and do not encourage excessive or unnecessary risk-taking behavior. As a result, we do not believe that risks relating to our compensation policies and practices for our employees are reasonably likely to have a material adverse effect on the Company.

In conducting this review, we considered the following attributes of our programs:

- Mix of base salary, annual bonus opportunities, and long-term equity compensation, with performance-based equity compensation opportunities for officers;
- Balance between annual and longer-term performance opportunities;
- Capped payout levels for both annual bonuses and performance-based stock awards for Named Executives — the Committee has negative discretion over incentive program payouts;
- Alignment of annual and long-term incentives to ensure that the awards encourage consistent behaviors and achievable performance results;
- Inclusion of non-financial metrics, such as quality and market share metrics, and other quantitative and qualitative performance factors in determining actual compensation payouts;
- Use of 10-year stock options and equity awards that vest over time;
- Generally providing senior executives with long-term equity-based compensation on an annual basis. We believe that accumulating equity over a period of time encourages executives to take actions that promote the long-term sustainability of our business; and
- Stock ownership guidelines that are reasonable and align the interests of the executive officers with those of our shareholders. This discourages executive officers from focusing on short-term results without regard for longer-term consequences.

Our Compensation Committee considered compensation risk implications during its deliberations on the design of our 2010 executive compensation programs with the goal of appropriately balancing short-term incentives and long-term performance. In addition to the above, on March 26, 2010, the Committee formally adopted a policy of recoupment of compensation in certain circumstances. The purpose of this policy is to help ensure executives act in the best interests of the Company. The policy requires all Company officers to repay or return cash bonuses and/or equity awards in the event: (i) the Company issues a material restatement of its financial statements and where the restatement was caused by an employee's intentional misconduct; (ii) the employee was found to be in violation of non-compete provisions of any plan or agreement; or (iii) the employee has committed ethical or criminal violations. The Committee will consider all relevant factors and exercise business judgment in determining any appropriate amounts to recoup and has the discretion to determine the timing and form of recoupment. The policy will apply to the Incentive Bonus Plan beginning with the 2010 performance period and equity awards beginning with grants made in 2011."