



# PENSION & BENEFITS



## REPORTER

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This article examines the strength of the assumption that executive compensation was an important cause of the financial crisis. The author discusses how to best manage risk and reward in executive compensation, and suggests that compensation committees are uniquely and best situated in the changing landscape of corporate governance to strike the right balance between reasonable rewards and acceptable risks in executive compensation.

### Managing Performance Risk in Executive Compensation

By PETER W. KENNEDY

#### Introduction

**N**ever far from the headlines,<sup>1</sup> executive compensation became in 2008 the lightning rod for public anger over the financial crisis and the recession it nurtured. Past efforts to influence the level and struc-

ture of executive pay<sup>2</sup> have seemingly culminated, as of this writing, in a House of Representatives passed bill to give investors in public companies the right to have a nonbinding vote on whether or not they approve of executive compensation in the companies whose shares they hold. But taken in the context of the last 20 years, this is really just one more step in the evolution of executive compensation regulation and oversight.

As in past years, the sheer magnitude of executive pay levels has continued to dominate press reports about executive compensation in the last 12 months. New this year though, in what has become a very hot topic for lawmakers, regulators, academics, auditors, consultants, proxy advisers, and others is the notion

<sup>1</sup> Even in the 1980s and then especially in the prosperous decade that followed, large executive paydays have never been far from the headlines with major news organizations regularly featuring in-depth articles and surveys of executive compensation, particularly during the spring proxy season when most companies disclose the compensation of their five highest paid officers to shareholders.

<sup>2</sup> Of note, among other developments over the last 15 years, would be SEC requirements for greater disclosure of executive compensation in 1992, 2006, and most recently in proposed rules issued July 17, 2009; the \$1 million compensation deduction limitation passed into law in 1993 as § 162 (m) of the Internal Revenue Code, the Financial Accounting Standard Board's Statement 123R, issued in 2006 and requiring companies to reflect an estimate of the amortized expense of stock options on their income statements, and the Internal Revenue Code § 409A nonqualified deferred compensation rules issued initially in 2004 with a final effective date of Dec. 31, 2008.

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that the financial crisis was caused at least in part by executive compensation plans that induced executives to take excessive risks. After all, executives, traders, and literally hundreds of employees in each of nine banks getting federal bailout funds (a low of 44 at State Street Bank to a high of 1,626 at J.P. Morgan Chase) received bonuses that exceeded \$1 million for 2008 performance<sup>3</sup> Taken for granted in earlier years as the handsome but typical Wall Street rewards for generating short term profits, these enormous bonuses certainly don't make sense in light of the near collapse of the entire financial system last year. What role did such enormous incentives to produce quarterly and annual profits play in building an over-leveraged financial system in the last decade as more and more debt became securitized in various forms of complex derivatives?<sup>4</sup> Did this pay structure cause the crisis?

**Assumptions About Rewards, Risks and the Regulatory Response.** This article examines the strength of the assumption that executive compensation was an important cause of the financial crisis while making the further assumption that, like it or not, it appears now fairly certain that the banking industry, if not all larger publicly traded companies, will be dealing with new laws, regulations, and guidelines of one kind or another that will put the word 'risk' front and center in the executive (and in many cases, other key employee) pay setting process.<sup>5</sup> For a time at least, we will have to add the word 'risk' to the now familiar phrase "pay for performance" to more formally acknowledge what has long been a watchword for executive compensation plan design, that rewards and incentives be aligned with the long-term interests of the shareholders.

<sup>3</sup> See, most recently, New York Attorney General Andrew Cuomo's report released on July 30, 2009, *No Rhyme or Reason: The 'Heads I Win, Tails you Lose' Bank Bonus Culture*; Stephen Joyce, *Banks Paid Bonuses While Losing Billions And Taking Federal Aid*, *Cuomo Report Says* (146 PBD, 8/3/09; 36 BPR 1799, 8/4/09).

<sup>4</sup> See, for example, the August 2007 article in the *NEW YORK TIMES* by Floyd Norris, a full year before the height of the crisis in September 2008, when Lehman Brothers was allowed to go bankrupt. AIG was rescued, the government took over Fannie Mae and Freddie Mac, and the stock market began its long tumble in earnest with a drop of 344.65 points, or 2.99 percent on Sept. 4, ending the month down about 11 percent at 10,850.66, and on its way to its most recent low of 6,547.05 on March 9, 2009; Floyd Norris, *A New Kind of Bank Run Tests Old Safeguards*, *N.Y. TIMES*, Aug. 10, 2007.

<sup>5</sup> In particular, there are requirements levied by the Treasury Department on financial institutions that received U.S. financial assistance under the Troubled Asset Relief Program (TARP) to conduct semi-annual risk assessments and exclude incentives for senior executive officers to take excessive and unnecessary risks (§ 111(b) of the Emergency Economic Stabilization Act of 2008 (EESA), Pub. L. No. 110-343, as amended by § 7001 of the American Recovery and Reinvestment Act of 2009 (ARRA), Pub. L. No. 111-5; also H.R. 3269, Corporate and Financial Institution Compensation Fairness Act of 2009 (the "Say on Pay" bill), passed by the House of Representatives on July 31, 2009, requires regulators of financial institutions to issue regulations that prohibit any incentive pay arrangements that encourage inappropriate risks; and finally, the SEC's new proposed additional executive compensation and corporate governance disclosure rules will, if finalized in present form, require that the annual proxy statement's Compensation Disclosure and Analysis (CD&A) section discuss any employee pay incentives that might affect a company's risk profile. (Proxy Disclosure and Solicitation Enhancements, Securities Act Release No. 33-9052 (July 10, 2009), 74 Fed. Reg. 35,075 (July 17, 2009)).

The compensation committee will have an enhanced and central role in assessing risk in executive compensation plan design and managing it over time. The discussion that follows seeks to facilitate this role by contributing to an understanding of the relationship between executive compensation and performance risk.

Although the attractiveness of the traditional and renewed goal of a long-term focus in executive compensation design is undeniable, shareholders are a diverse group, with many elements of that community being motivated directly, or through their investment management intermediaries, by only the very shortest term profit goals. Witness only the behavior of hedge funds, institutional investors more generally, and the effects of the quarterly earnings call on company stock price movements. Whether or not they invest for the long term or not, shareholders can and do easily diversify their investments, making them, at least in theory, risk neutral with respect to any single stock.

Executives, on the other hand, stake at least a few years, if not an entire career, on the financial well being of their firms. The risk of harm to one's professional reputation may be as important a consideration in executive behavior as the more common notion of the personal financial risk associated with the undiversified investment of financial and human capital.

The view that executives are naturally inclined, for these reasons, to be at least somewhat risk averse (more so than shareholders), has been a central tenet of "agency theory" (discussed further below), influencing executive compensation plan design efforts to seek ways to induce executives to take somewhat more, rather than less risk, through the reward structure, so that interests are aligned with shareholders. But in the context of the financial crisis, one must also consider a broader societal perspective and think about the impact of executive actions on all stakeholders, not just the shareholders, viewing risk from multiple perspectives, both in terms of who is being exposed to risk and to what degree, with respect to a single company, as well as how this affects systematic risk in the macro economy.<sup>6</sup> In this respect, the compensation committee will have to weigh the interests of the shareholders against those of other stakeholders, and incorporate regulatory guidance to balance these interests where they conflict.

**The Company's Perspective.** For senior management, and most particularly, for boards of directors and their compensation committees, there are increased oversight and reporting burdens to deal with in order to satisfy an increasingly large and diverse constituency of parties interested in how well companies are being gov-

<sup>6</sup> For an excellent treatment of this issue with respect to banks, executive compensation, and risk, and how traditional forms of annual and long-term incentives may favor shareholders, while ignoring depositors and creditors, as other bank stakeholders, see Lucian Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, Harvard Law School Discussion Paper No. 641, June, 2009, available at [http://www.law.harvard.edu/programs/olin\\_center/papers/641\\_Bebchuk.php](http://www.law.harvard.edu/programs/olin_center/papers/641_Bebchuk.php). Similar arguments might be made with respect to other industries, such as with respect to the interests of the ratepayer in the investor-owned utility industry, or the policyholder in the insurance industry – we would generally use the word "customer" to capture these interested parties.

erned.<sup>7</sup> This may in fact result in a slight retreat from aggressive, highly leveraged short-term “pay for performance” incentive plans to somewhat tempered notions of longer term responsible growth. But the retreat may only be temporary, and only with some, where government pressure is being applied and/or while memories of the most recent economic crisis last.<sup>8</sup> Some TARP recipient financial institutions, dealing with bonus caps imposed by Congress and regulators, and seeking to reset the balance between fixed and variable compensation, have quietly raised salaries for their executives.<sup>9</sup>

<sup>7</sup> This is to remind the reader that even prior to the height of the financial crisis in the fall of 2008, the influence of proxy advisory firms, other large institutional investors, the FASB, the SEC, the IRS, and even the media on the executive pay setting and governance process has been underway for some time. In particular, firms like Risk Metrics Group (formerly Institutional Shareholder Services) have become increasingly effective at influencing compensation committee decisions by recommending that shareholders withhold their votes where companies are deemed to be following poor pay practices (see RMG’s annual U.S. Corporate Governance Policy section on Compensation).

<sup>8</sup> Gretchen Morgenson, *The Quick Buck Just Got Quicker*, N.Y. TIMES, Aug. 15, 2009. The article notes that a recent study by one consultant of 191 of the nation’s largest companies in the first half of 2009 found that changes made to their pay plans resulted in just the opposite of the expectation that there would be more emphasis on long-term performance: short-term incentives ended up representing a bigger percentage of total compensation than before. The article goes on to note, however, that this result can be explained at least in part by companies reducing long term incentive grants (either by reducing the number of shares represented, or by holding the number of shares fixed but absorbing a decline in value due to lower share prices).

<sup>9</sup> See Eric Dash, *Citigroup has a plan to fatten salaries*, N.Y. TIMES, June 23, 2009. The article references similar plans by Bank of America and Morgan Stanley. Bloomberg News reported similarly on March 28 the following about Bank of America:

Bank of America Corp. plans to increase some investment bankers’ salaries by as much as 70 percent following the takeover earlier this year of Merrill Lynch & Co., people familiar with the proposal said.

‘The concepts we are considering would not increase total compensation,’ Brian Moynihan, Bank of America’s president of investment banking and wealth management, wrote yesterday in a memo to employees obtained by Bloomberg News. ‘Rather, we believe it is responsible, and consistent with the emerging public consensus, that a greater percentage of overall compensation come from fixed base salary.’

Bank of America, which has received \$45 billion of taxpayers’ money, may raise the annual base pay for some managing directors to about \$300,000 from \$180,000, said the people, who declined to be identified because the final numbers are still under discussion. Salaries for less-senior directors would climb to about \$250,000 from \$150,000, and vice presidents would get \$200,000, up from about \$125,000, the people said.

Bonuses will become a ‘smaller’ portion of total compensation, Moynihan wrote in the memo. The adjustments, which may be rolled out as soon as September, are designed in part to align the salaries of employees at Charlotte, North Carolina-based Bank of America with workers at New York-based Merrill, one person familiar with the plans said. Salaries for traders and other employees outside the investment bank may also be adjusted, the person said.

See also Aaron Lucchetti, *Morgan Stanley Boosts Salaries as Its Bonuses are Limited*, WALL ST. J., May 23, 2009. This article notes that the salaries for top corporate officers, i.e., the

**Improving Corporate Governance.** One can hope that new rules will enhance, rather than interfere with compensation committees and their boards’ ability to exercise informed discretion over the structure and level of executive pay at the companies where they exercise their fiduciary oversight responsibilities. Barney Frank, the Chairman of the House Financial Services Committee, has it only partly right, in principle, when in connection with his House passed “Say on Pay” bill he says that “the question of compensation amounts will now be in the hands of the shareholders and the question of systemic risk will be in the hands of the government.”<sup>10</sup> Clearly, while directors often don’t know enough, they are in a much better position than regulators or even investors to know and find out more about the operations of their companies and on that basis to structure incentives that encourage the appropriate degree of responsible risk taking best suited for each uniquely situated company.<sup>11</sup> Despite many well known lapses by directors in this regard,<sup>12</sup> it is hard to think of another group that is better positioned to deal with executive compensation, performance, and risk at the company level, than the compensation committee, audit committee, and other committees of the board of directors. In fact, with the help of regulators and institutional investors and their proxy advisers, the increasing professionalism of directors through membership organizations and academic seminars, there is no doubt that boards are doing a much better job, in general, in delving into and influencing the structure and levels of executive compensation.<sup>13</sup> And with the ever greater access to information that technology provides, there is no reason that

chief financial, administrative, and legal officers, were more than doubled from between \$300,000 to \$322,903 to \$750,000 for each of these officers.

<sup>10</sup> As quoted in *Pay and Politics – So far, Congress is taking a surprisingly sensible approach to the problem of pay*, The Economist, Aug. 6, 2009.

<sup>11</sup> The House passed “Say on Pay” bill (see supra n. 5) giving shareholders a nonbinding vote on executive compensation will do little to actually help structure better executive incentives, except to signal disapproval in the most egregious situations, because, as the experience in the UK suggests, shareholders rarely vote against a pay package, or when they do, management and the board can simply ignore it, as was the case with Royal Dutch Shell in May of 2009.

<sup>12</sup> See, for example, James Surowiecki, *Board Stiff*, The Financial Page, The New Yorker, June 1, 2009. Also, Heather Landy, *Executives Took, but the Directors Gave*, N.Y. TIMES, April 5, 2009.

<sup>13</sup> For example, the enhanced SEC proxy disclosure rules from 2006 as well as the new proposed additional disclosures, have forced compensation committees to examine and improve the rationale for executive pay practices as never before, both because of the additional tabular disclosures of executive compensation elements as well as because of the Compensation Discussion & Analysis (CD&A) section of the proxy statement. Meanwhile, proxy advisors like Risk Metrics Group have made explicit the most subtle or hidden aspects of executive compensation, such as the nature and magnitude of severance provisions in employment contracts relating to a change in control, and have put increasing pressure on boards, with detailed reference points, as to what to look for and what to approve. Finally, organizations like the National Association of Corporate Directors (NACD) continue to ramp up their educational offerings to member directors, offering both corporate governance principles and detailed Blue Ribbon Commission reports on subjects like Executive Compensation and the Role of the Compensation Committee (see Section VI., later in this

boards will not continue to improve their performance.<sup>14</sup>

## The Context: The Financial Crisis of 2008

Back in 1998, JP Morgan approached the Financial Products Group of AIG with a request for credit insurance on a structured finance deal that represented one of the earliest examples of what became known as a collateralized debt obligation (CDO). The J.P. Morgan structured deal consisted of layers, or ‘tranches’ of debt of various grades that were packaged as debt securities and sold to investors such that investors in the highest tranches would get their money back first, while those investing in the lower grade debt would get higher interest rates to compensate them for the added risk. To make the deal seem even safer to nervous investors, J.P. Morgan wanted AIG to provide credit default insurance (credit default swaps) on the highest grades of debt. Although Financial Products initially took a pass on the first deal, it was soon selling credit default swaps that generated huge fees for AIG based on computer models that suggested that the likelihood of having to pay up on the insurance was practically zero.<sup>15</sup> Notably, as private contracts, these CDOs were attractive to the banks because they were not subject to the same regulatory debt limits imposed on publicly traded debt. This additional leverage produced additional profits, but as we now know, eventually brought the credit markets to a near standstill.

In a little noticed or reported on meeting at the Securities and Exchange Commission (SEC) on April 28, 2004, the big investment banks convinced the regulators to grant an exemption for their brokerage units from a regulation known as the net capital rule allowing them to borrow greater amounts in relation to their assets and enabling greater investments in the increasingly complex and fast growing derivatives market, particularly mortgage backed securities. This led to greater debt to capital ratios, rising in some cases, as with Bear Stearns, to 30:1 when they had been limited under the rule to 12:1.<sup>16</sup>

On a micro level, the housing bubble supported a culture of easy credit, where in some extreme cases, mortgage loans in excess of \$400,000 were quite easily approved for houses that didn’t even exist. Everywhere in the system, banks were extending credit to borrowers that could not afford the loans, and then moving to shift their risk to third parties, who were also insuring against potential default and otherwise finding highly rated securitized debt to be an attractive investment. In this environment, no one really thought much about systemic risk, and when they did, the profits were simply too good not to double down on the investment risk.

article, *Principles of Compensation Committee Oversight*, and n. 59)

<sup>14</sup> See, for example, Robert J. Thomas, et al., *How Boards Can Be Better – a Manifesto*, MIT Sloan Mgmt. Review, Winter 2009, for an excellent treatment of the importance of access to information and the role of technology in this regard.

<sup>15</sup> See Brady Dennis & Robert O’Harrow Jr., *The Crash, What Went Wrong, A Crack in the System*, WASH. POST, Dec. 29-31, 2008, at A8, the second part of a three part narrative of the 21-year history of AIG Financial Products.

<sup>16</sup> Stephen Labaton, *Agency’s ‘04 Rule Let Banks Pile Up New Debt*, N.Y. TIMES, Oct. 3, 2008.

This lack of vision of how the entire global financial system was being increasingly levered on the strength of rising U.S. housing prices may have been due in part to the huge annual incentive payoffs waiting to be claimed at years’ end, or at least tied to the pursuit of greater profits that the leveraged securitized debt enabled, but it’s much more difficult to move beyond that conclusion to a finding that certain types of compensation arrangements are more likely than others to produce excessive risk taking.

To explore this further, it will be helpful to begin with a conceptual framework for analyzing executive compensation, then consider some of the conflicting evidence about how different types of compensation arrangements influence risk, and then end with suggestions that emphasize a process managed by the compensation committee and that argue for a balance of compensation elements to avoid, except in the most defensible situations, the always problematical extremes of either mostly fixed, guaranteed compensation on the one hand, or mostly variable, highly leveraged and lucrative, all or nothing compensation on the other hand.

**Executive Compensation: A Review of the Basic Concepts.** Executive compensation decisions are best guided, initially, and also understood, with the help of an overall conceptual framework. This in effect spells out the variables that need to be considered, and that are typically then further guided by a particular philosophy about the executive compensation program’s purpose at the company level. This usually states, in so many words, that it is the purpose of the compensation program to attract, retain, and motivate executives (and all employees) to achieve desired goals, most typically and broadly framed as achieving long term increases in total shareholder returns, although from a societal perspective, the goal should be to increase the long term value of the firm for all of its stakeholders (most obviously, creditors, customers, and employees, in addition to shareholders).<sup>17</sup>

The corporate compensation philosophy guides management and the board to address and answer two basic mechanical questions:

1. Pay Determination:<sup>18</sup> How is pay initially determined?

a. amounts for component parts and in total

<sup>17</sup> An excellent treatment of fundamental economic concepts underlying executive compensation can be found in Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We’ve Been, How We Got to Here, and What Are the Problems, and How to Fix Them*, Finance Working Paper No. 44/2004, ECGI Working Paper Series in Finance, July 2004, available at <http://ssrn.com/abstract=561305>. See, in particular, Chapter I, The Conceptual Foundations of Executive Remuneration, beginning at 15.

<sup>18</sup> Pay determination deals primarily with policies, procedures, and approaches to setting an amount of compensation for the job, including that of chief executive officer, as opposed to the individual, and for setting the parameters or boundaries that define the limits around a job’s pay, as typically reflected in the salary range for the job within an overall salary structure. An individual’s performance, per se, will not directly influence this determination initially, although the company’s performance can have an effect on how generous or limiting are the pay levels and salary ranges associated with particular jobs or with all jobs, and past and future performance do of course influence which jobs an individual holds.

b. reference points for setting amounts<sup>19</sup>

2. Pay Delivery:<sup>20</sup> In what forms and proportions is pay delivered and adjusted over time?

- a. fixed and variable
- b. annually and longer term
- c. immediate and deferred
- d. cash and stock

For both questions, the philosophical approach is further guided with reference to three fundamental concepts:

1. External competition
2. Internal equity
3. Performance

Each reference is essential but also inadequate in isolation. While conceptually distinct, one can rarely discuss pay determination and delivery, or analyze the resulting structure and level of executive compensation, without taking all three dimensions into account, along with, of course, a host of other, more technical considerations, such as the influence of tax, accounting, and other regulatory opportunities or constraints that may come into play in particular situations.

Exhibit A, while oversimplified, has the virtue of illustrating in one place these basic considerations, as well as identifying typical goals of an executive compensation program, the basic elements of total direct compensation, and the important time horizon consideration that comes into play both for purposes of measuring performance as well as paying for it (both the period over which compensation is earned as well as the period over which it is paid). Time horizon has become perhaps the most discussed design variable for addressing the effects of compensation on excessive risk taking as we shall see in the sections that follow.

<sup>19</sup> While the most common reference points consist of the appropriate samples of pay data, either published in the form of descriptive statistics that have been further cross-tabulated with the appropriate scope variables, or in the form of raw data drawn directly from a defined peer group of companies, pay determination also includes the processes and results of the negotiation between the prospective CEO and the board of directors to agree on the initial compensation package, including the terms of an employment contract. See Jensen & Murphy, *supra* n. 17, at 51-52, for an excellent treatment of the employment contract negotiation process, making the important point that the CEO has inherent advantages to extract very favorable contract terms and compensation levels due to the nature of the search process that typically involves first selecting the preferred candidate, so that price does not really enter into the selection process, and the fact that the CEO often employs an attorney to negotiate directly with management or the board, while the company does not typically employ an agent to act on its behalf. This has important implications for the notion, discussed later on in this article, that the executive behavior and risk taking is influenced by the degree to which the compensation package insulates the executive from risks that are ultimately borne by others.

<sup>20</sup> Pay delivery deals primarily with the forms, timing, and mix of the compensation that individuals actually receive, and is therefore more heavily influenced by how well the individual performs in the job. The amount of the salary increase each year, as well as the amount of any short term annual incentive bonus, and the long term incentive/capital accumulation opportunities, once the initial base amounts have been set, are usually a function of performance, primarily, in most companies, but can also be a function of seniority, the cost of living, relevant experience, the industry sector, competition for scarce talent, negotiated employment contracts, and other considerations.

*External competition* has had the strongest influence on executive pay determination and delivery for many years now and has become one of the focal points for demonstrating what is wrong with executive compensation.<sup>21</sup> Proponents will exaggerate its importance, but its utility as a tool for executive recruitment and retention is undeniable, if only because of the absence of a better alternative. Information about going rates of pay, typically obtained from surveys through a process known as competitive marketplace pricing, is essential to rational decisionmaking in the pay determination process. It is also used in employment contract negotiations as leverage, and is often a key influence on executive turnover. In addition to setting base salary, the fixed portion of pay, competitive market assessments are also used to determine the size of the short and longer term variable incentive award opportunities, often expressed as a percentage of base salary, the form(s) the award will take, and their timing.

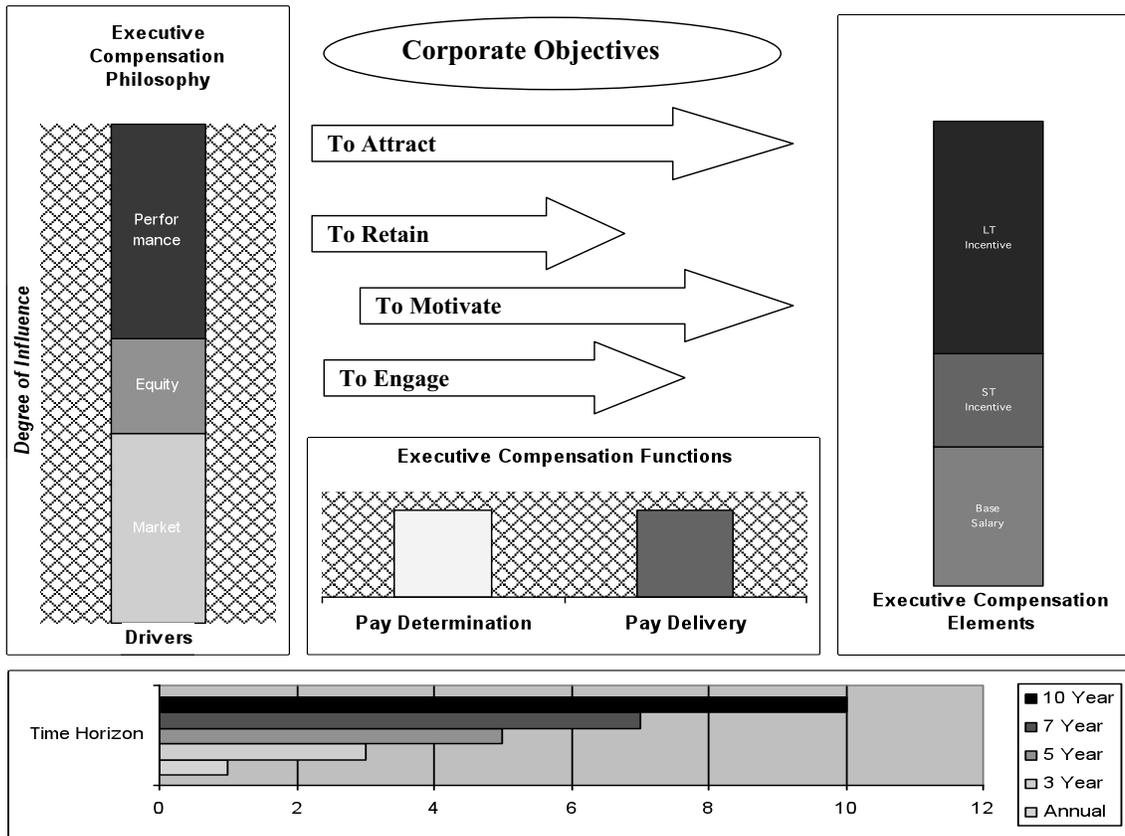
*Internal equity* can serve as a mechanism for countering the inflationary influence of the external marketplace in the pay setting process and has traditionally been associated more with the overall management of salaries of rank and file employees than with executive compensation. Even in this context it was once much more of a strong rationale and frequent tool for setting pay levels, controlling salary range penetration through “fairness”-based guidelines, and assigning positions to salary grades. In recent years, the concept of internal equity has been revived as a potential alternative pay setting methodology for executives, and in particular, the CEO in response to strong, legitimate arguments about the inherent inflationary effects of relying too heavily on published executive compensation surveys and proxy data to determine and deliver pay.<sup>22</sup> Internal pay relationships can be examined to ensure that competitive considerations do not become an overly dominant driver of pay determination and delivery.

*Performance* directly influences pay delivery, and has a strong indirect impact on pay determination. Once the incentive award opportunities are set and tied to the achievement of specific goals, performance at the

<sup>21</sup> The arguments are perhaps too important to simply footnote, but do fall somewhat outside the scope of this article. In brief, critics rightly point to the inherent inflationary dynamic of external competitive marketplace pricing where consultants provide management and compensation committees with pay survey data typically at the 25th, 50th and 75th percentiles of the survey sample, but implicitly or explicitly assume that pay should be targeted to be at least at the 50th percentile, if not higher. Naturally, if we recognize that pay levels (particularly fixed as opposed to variable pay, i.e., base salary) are less likely to be adjusted downwards than upwards as the result of an external market review, then at least half of any sample of companies is, by definition, under the target 50th percentile, and changes to pay within the sample to reach the 50th percentile inevitably produce, for the same sample in the following year, a 50th percentile that is higher by an amount equal to general merit increases for the entire sample **plus** special adjustments to bring at least some of those below the 50th percentile closer to the target.

<sup>22</sup> Edgar Woolard, former CEO of DuPont, gave the concept a boost several years ago in corporate governance circles, as a pointed response and criticism of the use of market pay surveys (see *supra* n. 19) arguing that companies should set the CEO’s pay in relation to the pay of his or her direct reports, as has been the practice at DuPont, rather than in relation to external market pay data for other CEOs.

## The Executive Compensation Roadmap



1

corporate, team and/or individual level determines the actual size of the award. Pay for performance has always been the mantra of every corporate compensation policy. More importantly, performance measurement is essential for directors to assess whether executives, as agents of the shareholders, are managing a healthy return on investment, or otherwise adequately executing corporate strategy.

**The Interaction Between External Competition and Performance.** In situations where cash is the main compensation element, and where it is not possible to offer equity, one way of rewarding sustained technical superiority and high performance over time is to aim for the 75<sup>th</sup> percentile of the relevant labor market(s) when determining and delivering pay. In these situations, and in particular for certain hard to fill positions requiring unusual experience, knowledge, or skills, external parity and performance combine as important drivers of pay determination and delivery. For example, in the context of the current debate about the size and nature of bonuses paid to Wall Street executives, it is past individual performance, easily quantifiable for certain types of financial trading positions, that defines top talent and

that is driving firms to negotiate guarantees to lure and keep that talent.<sup>23</sup>

The irony, and conceptual difficulty with this is that bonuses are ostensibly paid for high performance, but have been delivered on Wall Street in many instances as guarantees in the war for talent, even in light of massive losses. For example, Merrill Lynch lost \$27 billion last year but paid out \$3.6 billion in bonuses. This averaged out to \$91,000 per employee (based on a workforce of 39,000), but 696 employees received more than \$1 million each, and \$850 million of the \$3.6 billion in bonuses were guaranteed.<sup>24</sup>

<sup>23</sup> See, for example, Eric Dash, *Effort to Rein In Wall Street Pay Hits New Hurdle*, N.Y. TIMES, Aug. 10, 2009, for a discussion about the dilemma faced by Citigroup, as one of the financial firms receiving exceptional assistance under the TARP and therefore subject to its executive compensation limits, about what to do about the \$100 million promised to Andrew J. Hall, a top trader. This is discussed further in Stephen Labaton & Eric Dash, *Huge Bonus Hangs over Pay Review*, N.Y. TIMES, Aug. 13, 2009.

<sup>24</sup> Louise Story, *Judge Attacks Merrill Pre-Merger Bonuses*, N.Y. TIMES, Aug. 11, 2009.

These amounts, the short term orientation of the bonuses, and the nature of the guarantees, viewed in light of last year's financial crisis and tremendous loss of liquidity in the global financial system, have prompted current efforts to examine executive compensation in particular firms, set limits on amounts that can be paid, and assess whether compensation is structured to cause excessive risk taking.<sup>25</sup> Regulatory action has not been limited to the United States.<sup>26</sup>

With this in mind, it is probably helpful to revisit briefly several other concepts that relate to the problem of executive compensation and excessive risk, namely the Agency problem, Moral Hazard and the financial risk models commonly used by financial institutions to estimate the risk of portfolio losses.

This will help to frame the analysis more generally to see whether problems that occurred within the financial industry could manifest themselves elsewhere across Corporate America.

## Economic Theories Underlying Executive Compensation and Risk

**Agency Theory and Agency Costs.** In the early days of capitalism, it was quite common that the owner of the enterprise and the manager of the enterprise were one and the same. In modern capitalism, at least in the

<sup>25</sup> See the Treasury guidelines, *supra* n. 5 and, in particular, § 111(b)(2)(A) EESA required the Treasury Secretary to ensure that financial institutions selling troubled assets to the Treasury outside of a competitive bidding process in exchange for a financial stake in the institution had to have "limits on compensation that exclude incentives for senior executive officers of a financial institution to take unnecessary and excessive risks that threaten the value of the financial institution during the period that the Secretary holds an equity or debt position in the financial institution." EESA was later amended by § 7001 of ARRA, which added a limit on bonuses to be no more than one-third of total compensation (one-half of base pay, assuming total compensation is simply the sum of base pay and bonus), and other requirements. The latest version of the executive compensation rules for TARP companies was issued by Treasury as an Interim Final Rule: TARP Standards for Compensation and Corporate Governance (74 Fed. Reg. 28,394 (June 15, 2009)). The interim final rule requires that executive base pay be limited to \$500,000 and that any incentive pay be granted in the form of restricted stock; the rules can be waived through a shareholder vote of approval on compensation except for those companies receiving "exceptional financial recovery assistance." The regulations are available at <http://www.ustreas.gov/press/releases/tg165.htm>. Other provisions of the Recovery Act include prohibitions on golden parachute payments (§ 111(b)(3)(C)), limits on the deductibility of compensation (§ 111(b)(1)(B)), and provisions for recovery of bonuses paid to senior executive officers where the compensation was based on materially inaccurate financial statements (§ 111(b)(3)(B)).

<sup>26</sup> Julia Werdigier, *British Regulator Issues Rules on Bank Bonuses*, N.Y. TIMES, Aug. 13, 2009. The rules issued by the British financial regulator, the Financial Services Authority, will be effective in January of 2010, and call for banks not to pay bonuses that are guaranteed for more than one year or that are several times a banker's salary. So far, Britain is the only European country to issue such regulations. For more information on international efforts to investigate the relationship between compensation and excessive risk taking, see Financial Stability Forum, "FSF Principles of Sound Compensation Practices," April 2, 2009. <http://www.financialstabilityboard.org/>.

United States,<sup>27</sup> the most common ownership structure is that of the public company where equity ownership is widely dispersed, and the owners must rely on "agents" to manage the firm. This structure, while common, creates the potential at least that the interests of the owners and the agents diverge. "Agency costs" refer to situations where the consequence of this divergence in interests causes a reduction in the value of the owners' equity interests.<sup>28</sup>

Efforts to address this "agency problem" of a potential divergence in interests between executives and shareholders find clear expression in executive compensation plan design, where the rationale, if not the effect, of most long term incentive plan designs is to try to align the interests of both parties as much as possible.

Unfortunately, even in the purest and historically most common type of long-term incentive, the stock option (where executives only gain when shareholders realize a gain due to an increase in the market price of the stock over the price at the date the options were granted to the executive<sup>29</sup>), the alignment is not symmetrical. For should the price of the stock decline following the date of grant, the executive loses nothing other than a degradation in the future opportunity to gain, while the shareholder suffers a loss in value, at least on paper.

This problem of alignment has bedeviled executive compensation plan design and takes us very naturally to the other concept of relevance here, that of Moral Hazard.

**Moral Hazard and Risk.** Moral Hazard is an awkward term that typically refers to the fact that a party that is insulated from risk may act differently from a party that is not. A simple example might be reckless driving in a snowstorm by someone in a jeep with four wheel drive. Or, another general example would be the lack of caution about the prospect of a loss of one's property because the property is fully insured.<sup>30</sup>

More to the point here is the special problem of moral hazard in companies that are regulated or otherwise backed by the good faith of the federal government. Banks, particularly very large banks ("too large to fail"), constitute a special case of moral hazard in that there has historically always been the expectation, as borne out in the most recent financial crisis, that the federal government will always come to their assistance

<sup>27</sup> The basis for this assertion is found in Lucian Bebchuk & Jesse Fried, *Pay without Performance, The Unfulfilled Promise of Executive Compensation* (Cambridge: Harvard University Press, 2004), on p. 15, where the authors cite the work of Rafael LaPorta, Florencio Lopez-de-Silanes, & Andrei Shleifer, *Corporate Ownership around the World*, J. of Fin. 54 (1999): 415-517; and Adolf A. Berle Jr. and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932).

<sup>28</sup> The economic and financial literature on the subject of Agency theory and costs is quite extensive. See, for example, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. of Fin. Econ. 305 (1976), at 4-10.

<sup>29</sup> Assuming the normal form of grant where the strike (exercise) price is not discounted, but rather set to equal the fair market value of the stock at the time of grant.

<sup>30</sup> One commentator used the example of smoking in bed because you have fire insurance.

to protect the public.<sup>31</sup> Perhaps the most acute cases of this within financial institutions are Fannie Mae and Freddie Mac. Always accused by their critics of having unfair advantages over competitors by virtue of their federal charters, these institutions were indeed rescued at the height of the financial crisis.<sup>32</sup> As the financial crisis evolved last year, the question of which institutions should be rescued, and why, plagued the Treasury and the Federal Reserve and have led to ongoing questions about why an acquisition of Bear Stearns was arranged, AIG was rescued, and Bank of America was encouraged to buy Merrill Lynch, but Lehman Brothers was allowed to fail.<sup>33</sup>

Did the compensation of executives<sup>34</sup> on Wall Street cause the crisis? Would the same risks have been taken if the bonuses had been much smaller? While these questions are impossible to answer with any great degree of certainty, many are arguing that even though the amounts paid may seem outrageous, all of those in a position of influence, not just executives and traders, but also the regulators, had no idea what risks were actually being taken.<sup>35</sup>

Other experts are quoted as saying that the amounts were simply too high, which caused people to “act like gamblers at a Casino – and let them collect their winnings while the roulette wheel was still spinning.”<sup>36</sup> This argument is not just that people felt insulated from risk to the extent that they could get paid before the consequences of the risk were realized, but that even had there been no perception of risk insulation, the rewards were simply too high and too good to cause anyone to seriously consider managing the risk if it meant a significant lowering of the rewards.<sup>37</sup>

<sup>31</sup> See supra n. 6, *Regulating Bankers’ Pay*, and the discussion on moral hazard in banks beginning on at 8.

<sup>32</sup> Congressional Research Service, Library of Congress, Report to Congress, *Fannie Mae and Freddie Mac in Conservatorship* (Mark Jickling, Specialist in Financial Economics, Government and Finance Division), Sept. 15, 2008.

<sup>33</sup> Edmund L. Andrews, *Forget Aloof, Bernanke goes Barnstorming*, N.Y. TIMES, July 26, 2009.

<sup>34</sup> While this article focuses on executive compensation, it is clear that the question of the influence of pay on risky behavior is not by any means restricted to executives. In fact, some of the most egregious examples of enormous pay days on Wall Street pertain to traders and other mid-level money managers. See, for example, Louise Story, *Wall St. Profits Were a Mirage, But Huge Bonuses Were Real, Questions on Role of Risk and Pay in Losses*, N.Y. TIMES, Dec. 18, 2008. The story provides specific examples, including Dow Kim, with a salary of \$350,000, who received in 2006 a bonus 100 times that amount - \$35 million; or a 20-something analyst: base salary - \$130,000, bonus - \$250,000; or a trader in his 30s with a base salary of \$180,000 who got a \$5 million bonus.

<sup>35</sup> Floyd Norris, *It May Be Outrageous, but Wall Street Pay Didn’t Cause This Crisis*, N.Y. TIMES, July 31, 2009.

<sup>36</sup> *Wall St. Profits Were a Mirage*, supra n. 34.

<sup>37</sup> The one notable exception here is of course Goldman Sachs, which took measures beginning in late 2006 to reduce its holdings in mortgage-backed securities and to buy additional insurance to mitigate that risk. See Jenny Anderson & Landon Thomas Jr., *Goldman Sachs Rakes in Profit in Credit Crisis*, N.Y. TIMES, Nov. 19, 2007. In particular, the following paragraph from the article is noteworthy: “At Goldman, the controller’s office – the group responsible for valuing the firm’s huge positions – has 1,100 people, including 20 Ph.D.’s. If there is a dispute, the controller is always deemed right unless the trading desk can make a convincing case for an alternate valuation. The bank says risk managers swap jobs with traders and bank-

The general notion of insulation from risk that is central to Moral Hazard, taking its special form for certain financial institutions as “too big to fail,” can really only be part of the explanation for what happened on Wall Street in the last decade. First of all, it was clear that many took risks not because they thought the government would eventually bail them out, but because they thought they had taken adequate precautions through credit default swaps and other forms of purchased insurance. Secondly, it seems pretty clear that most were simply unaware of the huge risks that had built up within the global financial system. As one article noted, people simply didn’t think there would be an end to the huge fees generated by the packaging of loans into collateralized debt obligations. In one typical example, a \$500 million CDO, which became known as Costa Bella, generated about \$5 million in fees for Merrill Lynch.<sup>38</sup>

**Value at Risk.** At the firm level, the dominant risk models, known generically as Value at Risk, or VaR, failed to accurately account for systemic risk.<sup>39</sup> VaR is a technique that has been used widely by banks and financial institutions to estimate the probability of portfolio losses based on the statistical analysis of historical price trends and volatilities. Because these models are generally designed to forecast the probability of losses on a portfolio based on the current market over a relatively short time period (1 day to one month), it is obvious, at least in hindsight,<sup>40</sup> that they failed to take into account abnormal shocks to the system, which occur more frequently than is often acknowledged.<sup>41</sup> *The Turner Review* of the Financial Services Authority cites the assumption in these models that “each institution is an individual agent whose actions do not themselves affect the market,” going on to say that “interconnected

ers over a career and can be paid the same multimillion-dollar salaries as investment bankers.” “The risk controllers are taken very seriously,” Mr. Moszkowski said. “They have a level of authority and power that is, on balance, equivalent to the people running the cash registers. It’s not as clear that that happens everywhere.”

<sup>38</sup> *Wall St. Profits Were a Mirage*, supra n. 34. “There didn’t seem to be an end in sight” said one person about the record profits in 2006, while another was quoted as saying “No one wanted to stop this thing, it was a machine, and we all knew it was going to be a very, very good year.”

<sup>39</sup> Financial Services Authority, *The Turner Review: A Regulatory Response to the Global Banking Crisis*, March 2009.

<sup>40</sup> Some predicted the financial collapse well ahead of its occurrence, in part by explaining why models like VaR will fail to take into account cataclysmic events that ultimately prove, in retrospect, to have a far greater impact than usual day-to-day events. See the bestseller by Nassim Nicholas Taleb, *The Black Swan, The Impact of the Highly Improbable*, Random House, New York, 2007, for an in depth treatment of what has become known as “fat-tailed risks,” referring to the tail of a normal probability distribution where the least likely to occur events are in the tail of a generally bell-shaped curve (the greater the frequency of an historical observation, the closer to the middle of the probability distribution it falls).

<sup>41</sup> See Christopher C. Finger, *VaR Is From Mars, Capital Is From Venus*, Research Monthly, Risk Metrics Group, April, 2009, [http://www.riskmetrics.com/publications/research\\_monthly/20090400](http://www.riskmetrics.com/publications/research_monthly/20090400), for a good discussion of the appropriate uses of VaR and the models shortcomings, particularly in the context of the recent financial crisis.

market events can produce self-reinforcing cycles which models do not capture.”<sup>42</sup>

## Investigations Into the Relationship Between Executive Compensation and Risk

As we have seen, there has been both considerable speculation in the media and elsewhere about the relationship between Wall Street’s compensation levels, structure, and practices and the overall failure of the financial system. Even though this will no doubt be studied for some time, it is, at least at this stage, doubtful that a clear consensus will emerge as to whether or to what extent the compensation of financial sector employees contributed to the crisis.

**The Regulatory View.** Among regulators, both in the United States, and abroad, there does appear to be a general consensus that compensation practices at large financial institutions were at least one of the factors that contributed to the financial crisis.<sup>43</sup> This view, in general, assumes either overtly, or implicitly, that:

- high levels of short-term incentive pay are associated with a higher degree of firm risk,
- higher levels of variable to fixed pay are associated with a higher degree of firm risk, and/or
- higher levels of equity compensation, and in particular, stock options, are associated with higher degrees of firm risk.

But other studies tend to contradict, or at least undermine, to some extent, this view. For example, the consulting firm Watson Wyatt Worldwide released a study recently that tended to contradict several assumptions about the association between high executive compensation and financial distress.

**Results of Recent Studies.** Watson Wyatt studied over 1,000 firms in the *Fortune 1500* between 2005 and 2007 and calculated the Z score for each, a statistical measure that has been commonly used and is considered a good predictor of the likelihood of bankruptcy.<sup>44</sup> The Wyatt study examined the structure of executive compensation programs at each of the firms in the study and found high Z-scores (low risk of default) and low Z-scores (high risk of default) were associated with the following program characteristics, termed “risk mitigators” and “risk aggravators” respectively:<sup>45</sup>

Risk Mitigators	Risk Aggravators
High proportion of long-term incentives (generally including all forms equity compensation) in the total direct compensation mix	Excessive pay opportunity relative to the industry
Use of market-based metrics	Number of performance metrics used
High annual incentive leverage	Use of return-based metrics
Higher level of stock options (in relation to other forms, such as restricted stock, or performance shares) in the LTI mix	High accumulated executive pension value

This suggests, at the very least, that other factors should be examined before one reaches the conclusion that greater leverage in the executive compensation program necessarily implies excessive risk taking by the executive. Admittedly, design elements associated with extending the time horizon over which performance is measured, awards are earned, and compensation is paid free of encumbrances is consistent with the use of higher proportions of long term incentives (LTI) in total direct compensation, and higher levels of options in the LTI mix, as long as there are vesting schedules of appropriate length in place.

While the some of the risk mitigators listed above may come as a surprise to some, the risk aggravators listed are more in line with conventional wisdom, with many echoing the concept of Moral Hazard:

- the excessive pay opportunity associated with enormous annual cash bonuses based on high fees to package and sell complex mortgage-backed securities certainly seemed to propel many traders and firms onwards despite troubling signs that began to develop that many of the mortgage investments were worth less than what was originally thought;<sup>46</sup>

- where plans incorporate a high number of performance metrics, the risk of not achieving a particular metric is diversified;

- return-based metrics, particularly accounting measures, are more readily subject to manipulation by executives, again insulating them from risk;<sup>47</sup> and

- high accumulated pension values obviously provide the ultimate insurance against poor performance.

<sup>42</sup> See supra nn. 39 and 41.

<sup>43</sup> See supra nn. 5, 25, and 26, and in particular, Financial Stability Forum, “FSF Principles of Sound Compensation Practices,” April 2, 2009, available at [http://www.financialstabilityboard.org/press/pr\\_090402a.pdf](http://www.financialstabilityboard.org/press/pr_090402a.pdf). This report notes in its introduction that: “High short-term profits led to generous bonus payments to employees without adequate regard to the longer-term risks they imposed on their firms. These perverse incentives amplified the excessive risk-taking that severely threatened the global financial system and left firms with fewer resources to absorb losses as risks materialized.”

<sup>44</sup> The Z-score is a well accepted and widely used formula that was developed by Edward I. Altman of New York University in 1968 and uses multiple variables, such as the ratio of working capital to total assets, the ratio of retained earnings to total assets, the ratio of earnings before interest and taxes to total assets, the ratio of the market value of equity to the book value of total liabilities, and the ratio of sales to total assets, to predict the probability that the firm will go into bankruptcy within two years.

<sup>45</sup> See Watson Wyatt Insider, Going Beyond Conventional Wisdom: Designing Executive Pay to Balance Risk and Performance, June 2009, found at <http://www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=21310> for a brief description of the study results.

<sup>46</sup> See supra n. 34, on why people persisted in pushing risky investments even after the housing and mortgage markets began to weaken. The article quotes Mr. Lin, a trader for Merrill, who noted that “You want to pull for the market because you are vested,” and Paul Hodgson, senior research associate at the Corporate Library, a shareholder activist group, who noted “What happened to their investments was of no interest to them, because they would already be paid.”

<sup>47</sup> See Jensen & Murphy, supra n. 17, at 77-78, where the authors generally point to flaws in various types of performance measures because they are too readily influenced by the executive to produce results that increase compensation but lower the long-term value of the firm, and where they argue that performance measures should avoid ratios altogether unless you can control the decision rights of agents, by letting them, for example, control only the type of assets to invest in, but not the quantity.

Another recent study (Fahlenbrach & Stulz, 2009),<sup>48</sup> tends to partially contradict the finding in the Wyatt study that higher levels of long-term incentives and stock options in the CEO compensation program is a “risk mitigator,” although the variables examined are somewhat different.

But, the authors also found that stock option compensation did not have an adverse effect on bank performance, and this is more consistent with conclusions from the Wyatt study

Several other studies worth referencing are:

- Coles, Daniel, & Naveen, 2003, providing empirical evidence that higher CEO wealth sensitivity to stock volatility is associated with riskier policy choices, such as relatively more investment in R&D, more focus on fewer lines of business, and higher leverage;<sup>49</sup> and

- Moody’s Investors Service, 2005, finding found that excessive compensation packages are associated with higher levels of credit risk.<sup>50</sup>

More generally, these results suggest that any particular executive compensation program design needs to weigh and balance two competing design objectives: whether to introduce more or less risk/leverage into the executive compensation program. If we believe in the concept of Moral Hazard, then the danger to watch for is that the executive is too insulated from the risks otherwise borne by the shareholders and other stakehold-

<sup>48</sup> Rudiger Fahlenbrach & Rene M. Stulz, *Bank CEO Incentives and the Credit Crisis* (Dice Center for Research in Financial Economics, Working Paper 2009-13 Fisher College of Business, Ohio State University, July 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1439859](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1439859). In this case, the authors looked at CEO holdings of bank stock before the crisis, and found that banks where CEOs had higher amounts invested in bank stock (i.e., a greater alignment with shareholders in this sense) did not perform any better during the crisis than banks where there was less of an alignment between CEOs and shareholders (where CEOs had less of an investment in bank stock). In fact, the study found some evidence that the banks with high degrees of CEO/shareholder alignment actually performed worse. In other words, the study finds a substantial negative correlation between long-term incentives and firm financial health. Contrary to conventional wisdom, the bank executives did not seem to be able to anticipate the crisis because they did not trade out of their substantial positions in bank stock prior to and during the crisis, suffering instead substantial losses in wealth as a result of the crisis.

<sup>49</sup> Jeffrey L. Coles, Naveen D. Daniel, & Lalitha Naveen, *Executive Compensation and Managerial Risk-Taking*, Jan. 24, 2003 (EFA 2003 Annual Conference Paper No. 892; Arizona State University and Georgia State University Working Paper), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=391102](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=391102).

<sup>50</sup> Kenneth Bertsch & Chris Mann, *CEO Compensation and Credit Risk*, Moody’s Investors Service, Special Comment, July 2005. This study looked at base salary, annual bonuses, and equity compensation (stock options and restricted stock), and found that from a cross-section of 865 firms with senior unsecured bond ratings of B3 or higher (excluding financial firms) and 4,485 annual observations between 1993 and 2003, large, positive, unexplained bonus and option awards are predictive of both default and large rating downgrades during the time period. Explanatory variables used in the study were firm size, past operating performance, CEO tenure, and industry. It is interesting that although this study measured credit risk differently than the Wyatt study, and found that most of the “excessive” compensation was derived from options, the result is not really inconsistent with the Wyatt finding that excessive pay opportunity relative to the industry is a risk aggravator. (An “observation” for each firm in a year includes its rating at the beginning of the year, a dummy variable indicating whether the firm defaulted within the next 12 months, and another dummy variable indicating whether the firm experienced a “large” rating downgrade of three or more refined rating notches during the subsequent year.)

ers. If so, then the program should be designed to ensure that the risk of loss is great enough to off set the chance of gains, so as to induce intelligent, thoughtful risk-taking rather than reckless bets to maximize gains.

If, on the other hand, we think that executive compensation programs already have too great a portion contingent on performance results, encouraging actions that might be too risky to the firm, but likely to pay off to the executive, at least in the short term, then we might follow the general regulatory response to the TARP companies, which has been to limit overall compensation and annual bonuses, and to take a hard look at long term incentives to ensure that they do not encourage excessive risk taking.

**Reconciling the Evidence—Differentiating Between Risky Behavior and Exposure to Compensation Risk.** Of course, prior to the financial crisis of 2008, much of the literature on executive compensation and risk tended to explore, with agency theory as its starting point, how executive compensation could be structured to induce executives to take more, not less risk (Gray, Cannella).<sup>51</sup> This is because, as noted earlier in this article, while shareholders are generally deemed to be risk neutral with respect to any particular holding of company stock because they can diversify their investments among many stocks in order to minimize their overall risks, executives have their human capital concentrated in one firm at any given point in time and may have to expend many years to reallocate that capital, particularly since their reputations can suffer because of poor firm performance. In extreme cases, their employment is terminated and they have difficulty obtaining similar employment elsewhere.<sup>52</sup> This supports the general notion that executives tend to be, if anything, risk averse, since they have so much more at stake than the average shareholder.

This finding does not contradict a related assumption in the literature, that despite the investment in human capital, and the lack of proportionate diversification of personal wealth beyond their firm equity interests, the executive is still generally more insulated from performance risk than other stakeholders in many cases. The reasons for this, while not necessarily true in a particular instance, have colored the general view of executive compensation for some time now, and include a long list of risk insulators, of which the following are illustrative:<sup>53</sup>

- leverage in negotiating the employment contract,
- large stock option grants which, even if underwater, convey no risk of loss to the executive,

<sup>51</sup> Samuel R. Gray & Albert A. Cannella, Jr., *The Role of Risk in Executive Compensation*, J. of Mgmt., July – August 1997. This paper contains a thorough review of the many contributions over the years to the research on executive compensation, particularly with regard to agency theory.

<sup>52</sup> We know from various surveys that average CEO tenure has been decreasing in recent years and that more generally, only the most successful are able to either maintain long tenures as CEO at one company or are able to repeat outstanding performance at several different companies (Jack Welch would be a good example of the former, and Lou Gerstner of the latter).

<sup>53</sup> Jensen & Murphy, supra n. 17, in particular, Chapter V., *Executive Remuneration as an Agency Problem*, at 50–77, which provides excellent examples of traditional problems with executive hiring, the pay setting process, equity-based plans, and annual bonuses.

- influence over the performance measures used to determine future incentive compensation,

- large grants of restricted stock requiring no personal investment,

- generous termination of employment benefits (pensions, severance generally, and “golden parachute” payments in the event of a change in control), and

- “golden handshake” guarantees used to induce an executive to leave a company’s employment; these are typically designed to replace unvested awards at the prior firm.

In other words, actions that executives may take to shield themselves from risk may not shield the shareholder or the firm from performance risk. The executive will seek to maximize compensation, tenure, and reputation, and unfortunately, these actions may not always translate into long term firm success.

Thus, it is logical to think about the problem of managing performance risk in executive compensation design as not just the traditional agency problem of trying to ensure that executives only gain when the shareholder gains, but conversely, keeping in mind Moral Hazard, to ensure that executives also lose when shareholders and other stakeholders lose, so that executive losses and gains are in balance with shareholder losses and gains and executives are given an incentive to take moderate but not excessive risks.

The current concern is less with how little or great the risk is to the executive, but rather, taken together, which program design elements are most likely to motivate the executive to act in the best long term interests of the firm. If we assume that shareholders can and will diversify, then risk mitigation for the firm is to ensure a greater societal good that the interests of all other stakeholders are well served.<sup>54</sup> More generally, it is understandable that the regulators need to consider potential problems in executive compensation design in societal terms, not just from the perspective of the individual firm.

The subject of executive compensation and risk is complex, and the considerable academic literature provides evidence to support a number of hypotheses. Overall, it seems pretty clear that:

- overly high levels of compensation are to be avoided because they tend to insulate the executive from compensation risk while drawing on resources that could otherwise be allocated to shareholders and other stakeholders;

- longer performance measurement and award payment time horizons should constitute a significant portion of the overall compensation mix because they tend to reinforce the desired alignment amongst all parties with long term interests in the firm, including the executive;<sup>55</sup> and

<sup>54</sup> This echoes both Jensen & Murphy, *supra* nn. 17 and 538, and Bebchuk & Spamann, *supra* n. 6, on the idea that executives leverage the entire assets of the bank (deposits and debt, in addition to equity) to gain higher returns for the shareholder, but at levels of risk that may hurt the depositors and creditors.

<sup>55</sup> With some exceptions, such as, for example, where the CEO already has a very significant ownership interest in the firm based on the investment of personal wealth, or perhaps where the CEO is already very close to retirement. See Gray & Cannella, *supra* n. 51, for an examination of some of these intervening variables.

- compensation arrangements need to be balanced to encourage risk-averse executives to take enough risk to profitably grow the firm without providing windfalls that shield the executive from the consequences of overly risky decisions that hurt the firm over the long run.

It is always tempting to draw global conclusions from the evidence. But the question of managing performance risk in executive compensation is ultimately one that must be solved by each company, based on a host of variables relating both to overall systematic risk as well as firm-specific risks, pursuant to the strategies of the firm, as governed by its board of directors and pursued by the management team.

Perhaps more promising are suggestions for what types of pay structures are most likely to be effective in motivating prudent risk taking behavior in the future.<sup>56</sup> With that in mind, this last section explores how the compensation committee and the board can best try to manage the level of performance risk to the company through the process of setting and delivering executive compensation.

## Managing the Relationship Between Risk and Reward in Executive Compensation

As suggested earlier, the compensation committee of the board, simply by virtue of its core responsibilities in corporate governance, is best situated to direct, oversee, and manage the level and structure of the firm’s executive compensation, particularly that of the CEO, and by extension, the CEO’s direct reports, and by virtue of the tone at the top, the entire firm compensation structure.

I noted earlier that laws and regulations affecting executive compensation have played an important role in guiding directors in this role, as have the watchful eyes of proxy advisory firms that are primarily concerned about compensation plans that provide for excessive transfers of shareholder value to executives. Compensation consultants, traditionally hired directly by management, and in those situations posing a clear challenge to effective corporate governance, are now in-

<sup>56</sup> In remarks at the Council of Institutional Investors Spring Meeting on April 7, 2009, chairman and CEO of the Goldman Sachs Group, Lloyd C. Blankfein, said the following with respect to future compensation guidelines for the industry:

- “Compensation should include an annual salary plus deferred compensation, which is appropriately discretionary because it is based on performance over the entire year.

- “The percentage of compensation awarded in equity should increase significantly as an employee’s total compensation increases.

- “For senior people, most of the compensation should be in deferred equity. Only the firm’s junior people should receive the majority of their compensation in cash.

- “As I mentioned earlier, an individual’s performance should be evaluated over time so as to avoid excessive risk taking and allow for a “clawback” effect. To ensure this, all equity awards should be subject to future delivery and/or deferred exercise over at least a three-year period.

- And, senior executive officers should be required to retain the bulk of the equity they receive until they retire. In addition, equity delivery schedules should continue to apply after the individual has left the firm.”

creasingly hired directly by the compensation committee, affording directors a relatively new tool for making effective decisions, assuming the consultant has no serious conflicts of interest and is acting solely on behalf of the directors.

**Principles of Compensation Committee Oversight.** A good starting point for examining the special case of risk oversight in the executive compensation governance process can be found in a more general framework for directors to examine virtually any executive compensation matter. While many have noted core principles, those that have been developed and refined by a series of “Blue Ribbon Commissions” of directors for the National Association of Corporate Directors (NACD) are probably most appropriate to repeat here.<sup>57</sup> The Blue Ribbon Commission Report on Executive Compensation and the Role of the Compensation Committee identifies the following core principles:

- *Independence* – The notion that all compensation committee and board decisions be totally independent from the CEO and management.<sup>58</sup>

- *Fairness* – Echoing the concept of “internal equity” mentioned earlier, this principle is particularly relevant to the setting of CEO pay, both in relation to other executives and employees of the company, but also, although not explicitly included here,<sup>59</sup> to encompass the concept of “external competition” mentioned earlier, or “external parity,” whereby pay levels and structure fall within a reasonable range defined by other, similarly situated companies that serve as external market reference points.

- *Long-term value for shareholders* – In addition to the main point echoed time and again regarding the appropriate longer term time horizon for executive performance measurement and payment of awards, the report notes that this does not crowd out the role of shorter-term incentives (typically with full award payment shortly after the end of a 12 month performance measurement period), but instead is meant to ensure that the total value of the compensation package is not primarily due to the magnitude of the short-term element.

<sup>57</sup> “Executive Compensation and the Role of the Compensation Committee,” Report of the NACD Blue Ribbon Commission, National Association of Corporate Directors, 2007 edition.

<sup>58</sup> Of course, following on the corporate scandals of 2001, and the Sarbanes-Oxley Act of 2002, the SEC approved rules for director independence developed by the New York Stock Exchange and the NASDAQ as part of the stock exchange listing requirements for public companies.

<sup>59</sup> The author has added the implication of external parity here to convey the intended result of an external benchmarking process for ensuring reasonableness, even though the Commission report specifically excludes it because of legitimate arguments noted earlier that external market-based pricing of positions promotes executive pay inflation because adjustments are generally upward to reach the 50th percentile, if not the 75th percentile, and rarely downward to bring those over the 50th back to the middle of the distribution. Nevertheless, compensation committees will not get very far in the pay setting process if they do not have some awareness of competitive market levels with which to negotiate CEO pay. As noted earlier, some have argued that the CEO’s pay should simply be some multiple of the next level of executives, because the external data for the next level is more reliable and less prone to the inflationary pressures that plague CEO pay (see *supra* n. 21).

- *Transparency* – This principle has been reinforced by regulators, most notably in a series of SEC proxy disclosure rule updates (in 1992 and again in 2006), including those proposed on July 17, 2009, that require extensive discussion of both the process, rationale and results of compensation committee and board deliberations in the CD&A section of the annual proxy statement.

With these general principles in mind, we can take a closer look at what compensation committee members, the board, and management might consider, or be obliged, to do to specifically assess the degree of risk in the executive compensation package. Before doing so, it will be important to carefully keep in mind several dimensions of risk generally, as it relates to executive compensation:

- *Compensation level risk* – the risk that the compensation arrangement is so excessive that its sheer magnitude insulates the executive from risk;

- *Compensation leverage risk* – the risk that the compensation arrangement incorporates too much contingent variability, causing the executive to take more risks to achieve certain performance milestones and associated award levels than are ultimately warranted, thereby jeopardizing the long term value of the firm;

- *Compensation entitlement risk* – the risk that the compensation arrangement provides insufficient incentive to take risks, so that the executive gets paid irrespective of firm or individual performance (this is perhaps the most typically cited aspect of the agency problem discussed earlier); and

- *Compensation payment risk* – the risk that the compensation arrangement does not pay anything to the executive (or that pays amounts below expectations – this is the risk that the executive naturally seeks to minimize, often with consequences that cause “agency costs” as discussed earlier).

We can see that these dimensions of compensation-related risk interact in various ways to create suboptimal results for some or all of the company’s stakeholders. Wall Street compensation provides examples of both compensation leverage and compensation level risk. The leverage risk was in the structure of the compensation arrangements, where disproportionate cash award opportunities in relation to total compensation were contingent on achieving short-term profits to be paid immediately following the end of the annual accounting period. The level risk was intertwined with the leverage risk in that the award amounts were so large as to overwhelm other risk considerations having to do with the financial health of the bank, stock owned in the bank, or the career of the executive. Wall Street was paid for achieving short-term profits even as they began to evaporate with asset values plunging as investors fled the market and liquidity dried up.

Entitlements do not provide the right incentives to encourage executives to act in the best interests of shareholders, but they are not necessarily excessive, and in proper proportion, they provide the necessary insurance against failures that are essentially beyond the executive’s control. But when the compensation elements are both mostly fixed, instead of variably related to performance, and overly high, then you have compensation level risk that leaves the executive potentially indifferent about taking too much or too little risk, indeed, possibly unconcerned about firm or individual performance altogether. This is perhaps most evident

with excessive pension benefits or other termination of employment benefits such as very large golden parachute payments.

Finally, we can see that executive concerns about compensation payment risk lead executives to negotiate guarantees that insulate them from the risk of nonpayment, creating compensation level and entitlement risks to the shareholder and other stakeholders.

We can perhaps more easily visualize the strategic implications of these different forms of risk if we consider them in the context of the extremes, where they are most likely to produce unwanted results, along two dimensions, the risk as it affects the executive and the risk as it affects the enterprise. Since the enterprise must take calculated risks to prosper, and the executive's risks must be balanced with his or her rewards, the implication is that risks to both should be commensurate across different industry risk profiles.

### **Conducting Executive Compensation Risk Assessments.**

As of the writing of this article, it is clear that all companies receiving financial assistance from the Treasury under the various relief programs have to assess executive compensation risk. More specifically, the compensation committees must provide an explanation of why the compensation programs for their senior executives do not encourage the taking of excessive and unnecessary risk.<sup>60</sup>

In addition, it seems virtually certain that such requirements will be imposed to a greater or lesser extent on most public companies through new SEC disclosure regulations proposed on July 17, 2009, as well as possibly through "Say on Pay" legislation already passed by the House of Representatives on July 31, 2009.<sup>61</sup>

While little guidance has been provided as to how these risk assessments should be conducted, it is clear that such responsibility will rest ultimately with the board of directors through the compensation committee and that many others within the company's senior management ranks and below will have to be involved. Even though some companies have appointed a senior risk officer (SRO), knowledge of potential risks will naturally be dispersed throughout the organization and involve input from many, including the human resource, legal, audit, and finance functions, if not other operational units within the business. Logically, a relatively small management committee of objective, disinterested parties representing and/or receiving input from these functions, with input also from the CEO and senior management, would prepare a report for the board of directors that would logically go first to the compensation committee to initially review, share with other committees overseeing risk, such as audit or investment, before receiving final CEO and board review and approval.

The risk assessment process will necessarily require a thorough understanding of all business risks as well as all elements of compensation and how these might interact. Strategically, it would be best to conduct an analysis that goes beyond just assessing risks to examining risks in light of fundamental compensation principles as they find expression in the mix of major compensation elements and the structure of each. This

could be done in such a way as to identify company strengths and opportunities, not just company weaknesses and threats (risks). This more holistic approach would help to put risk in its traditional strategic context so that identified risks are weighed against expected rewards, allowing for a degree of risk taking appropriate to the company, its industry, and its various stakeholders.

Such an approach would help to ensure that the business strategy continues to drive the setting of company goals and objectives, coloring the compensation philosophy and the level and structure of the compensation plans in a way that manages rather than seeks to completely avoid risk.

For example, one could overlay the traditional business strategy matrix that identifies strengths, weaknesses, opportunities, and threats with compensation principles and elements, as shown in Exhibit B.

The empty cells in the matrix force hard questions about each compensation element as it relates back to fundamental compensation design principles, teasing out aspects of each that constitute strengths, weaknesses, opportunities, or threats. Clearly, this type of overlay of different dimensions may produce empty cells in some cases.

Since every company will face different circumstances, with different risk profiles, strategies, and supporting compensation plans, one can only suggest what some of the most fundamental questions the compensation committee should be asking to assess risk in executive compensation plan design. The following are suggestions:

#### **Questions for Assessing Risk in Executive Compensation Plan Design**

##### **What are the risks to the Enterprise?**

- Strategic, operational, catastrophic
- How are these tied to current executive compensation plan design?

##### **Are Executive Incentives Promoting the Right Type and Degree of Risk?**

- Appropriate to the business strategy and industry?
- In relation to overall systemic risks?
- In line with shareholder and other stakeholder risks?

##### **Is the Degree of Award Leverage Aligned with Shareholder Leverage?**

- Do executives gain in proportion to shareholders?
- Are the time horizons for performance measurement and award payment balanced and appropriate?

##### **What Do Worst Case Scenarios Look Like?**

- For shareholders, executives, employees, and other stakeholders?
- Are executives exposed to sufficient risk of loss on the downside?

##### **How Do We Compare to Peers and Other Typical or Best Practices?**

- Are we radically different in any respect?
- Are there good reasons for the differences?
- If there are no differences, should there be?
- Are our incentive payouts consistent with the type and level of performance we want?
- Is our pay comparable to peers' pay after factoring in peer performance?

##### **Are We Trapped by Predetermined Incentive Plan Formulas?**

- Do we exercise appropriate discretion to alter awards when circumstances change?

<sup>60</sup> Section 111(b) of EESA as amended by § 7001 of ARRA, Securities Act Release No. 33-9052, supra n. 5.

<sup>61</sup> See supra n. 5.

## Executive Compensation Strategy

## Exhibit B

		STRENGTHS			WEAKNESSES		
Elements		BASE	STI	LTI	BASE	STI	LTI
PAY PRINCIPLES	Performance	Base salary increases are tied to performance	Annual plan awards are not excessive	Pay for performance has a long term focus	Base may not adequately reflect past performance	Annual plan performance measures need to be refined	Do we have too much restricted stock in the mix?
	Internal Equity		There is good internal alignment and line of sight				
	External Parity	Base salaries represent a small portion of total direct compensation		LTI opportunities are competitive and reasonable	Base salary may need to be increased to retain talent		
		OPPORTUNITIES			THREATS		
Elements		BASE	STI	LTI	BASE	STI	LTI
PAY PRINCIPLES	Performance		Greater differentiation through retrospective assessments	More balanced long term incentive mix	Adequate career development through promotions	Incentive award cut-off points may cause overly risky bets	Are plans sufficiently aligned with all stakeholders?
	Internal Equity	Update job evaluation process	Achieving greater differentiation in performance assessments under a common framework		Transparency of succession planning process	Internal alignment of STI measures	Impact of greater differentiation on turnover and collaboration
	External Parity	Continue to refine position benchmarking		More refined peer group comparisons on LTI design		Reliance on 100% target achievement for competitive TCC	Executive departures due to underwater options

■ What constraints do we face in this respect and can we overcome them, if necessary?

■ Are we employing retrospective and prospective considerations in award determinations?

***Measuring the Relationship Between Executive and Investor Risks and Rewards***

One of the fundamental questions in executive compensation noted repeatedly in this article, rooted in agency theory, and also tied to the concept of moral hazard, is whether the compensation plans successfully align the interests of the executives with the shareholders. Many have examined this alignment in numerous ways, particularly by analyzing whether there is a significant correlation between compensation levels and performance. Most studies have found little or no correlation historically.<sup>62</sup>

On a new twist to the traditional focus on the relationship between executive gains and shareholder

gains, RiskMetrics Group has developed a quantitative model that looks at both gains and losses for executives and investors based on a fixed percentage increase or decrease in a company's stock price.<sup>63</sup> The model takes into account, for the executive, not only the amount of stock options as well as stock beneficially owned, but also the executive's cash in base salary and bonus, and the value of the retirement benefits, thus capturing the proportion of an executive's total compensation that is in stock or stock related (and therefore more directly aligned with investors) versus the proportion that is in cash or cash equivalents (which will tend to interfere with the alignment). The model presents four possible profiles, and as applied to the S&P 100, found the following percentages of companies that fit each of the profiles as shown in the table below:

<sup>62</sup> See Gray & Cannella, supra n. 51, citing numerous studies showing little or no positive correlation between firm performance and executive compensation, and also showing that the strongest positive correlations are between firm size and executive compensation.

<sup>63</sup> The model has received some press coverage, is still in a developmental stage, and is described here as presented by its author, Martin Nemeth, at a seminar sponsored by the Capital Area Chapter of the National Association of Directors on April 14, 2009. Mr. Nemeth's presentation was titled *Measuring the Alignment of Executive and Investor Risk*.

<b>Risk Metrics Group - Executive and Investor Risk Alignment – Study of S&amp;P 100</b>			
<b>% of S&amp;P 100 in each category</b>	<b>Stock Drops</b>	<b>Stock Rises</b>	<b>Difference in Return Profile Causes Executive Towards:</b>
Profile 1 <b>15%</b>	Executive loses less than the shareholder	Executive gains less than the shareholder	Risk Aversion Less risk taking Smaller potential returns
Profile 2 <b>1%</b>	Executive and shareholder lose the same	Executive and shareholder gain the same	No Difference Risk neutrality
Profile 3 <b>76%</b>	Executive loses more than the shareholder	Executive gains more than the shareholder	Measured Risk Taking Potential for greater gains Threat of greater losses
Profile 4 <b>8%</b>	Executive loses less than the shareholder	Executive gains more than the shareholder	Potential risky behavior Any stock movement is more advantageous to the executive

Although this is based ultimately on a fairly small sample of companies, it is interesting to note that a solid majority of the S&P 100 fall into Profile 3, where one would assume most investors would want to be, with executives losing more than investors when the stock drops, but gaining more than investors when the stock rises, to encourage measured, as opposed to reckless, risk taking. These results seem to strike a hopeful note in the context of the recent financial crisis and the concern by many that executive compensation encourages excessive risk taking.

I have made some reference throughout this article to specific executive compensation design elements and practices that might encourage excessive risk taking. In this final section, I have tried to assemble these in one place. The list captures most of the areas that, when encountered, have engendered concern, or that have been mentioned by other experts as potentially troublesome.<sup>64</sup> Each should be viewed in isolation with some skepticism and evaluated only in the context of the entire executive compensation program and the company's business context since as I have sought to demonstrate throughout, the question of what types of compensation arrangements might cause executives to make overly risky decisions has had multiple, and sometimes contradictory answers, and remains complex and somewhat murky. In that spirit, I have listed elements that tend to border on the extreme, counseling, in the absence of evidence to the contrary, moderation and balance as the best form of insurance against catastrophic risk.

#### **Executive Compensation Elements That Potentially Induce Overly Risky Behavior**

##### **Performance Measures**

- exclusive use of financial measures, reliance on a single measure, or use of a multitude of measures such that the executive becomes overly insulated from loss;
- overly complex formulas with no allowance for retrospective assessment and discretion;

<sup>64</sup> In addition to the studies already referenced in this article, I should point out that most, if not all of the larger executive compensation consulting firms have posted client alerts or issue briefs dealing, in various ways, with the subjects of executive compensation, moral hazard and risk. In addition to the Watson Wyatt study covered earlier in this article, I should mention Pearl Meyer & Partners, Towers Perrin, Hewitt Associates, and Mercer, among others, as commentators on this subject.

- measures with only a short term orientation that fail to measure performance longer term; and

- measures over which the executive has little or no direct control.

##### **Targeted Performance Results and Associated Awards**

- inflexible goals and payouts allowing no adjustments for unforeseen circumstances;
- very challenging financial goals that might encourage undue risk taking;
- other formula-driven awards which preclude any exercise of Board discretion; and
- overly leveraged payout curves that produce sharply higher payouts for attaining certain thresholds, or where high payout is associated with cliff attainment of unrealistic goal.

##### **Overall Pay Mix**

- where fixed pay (salary) is unusually low relative to variable pay (short and long term incentives, including stock options);
- or where most or all pay is guaranteed (salary, guaranteed bonuses, restricted stock, overly generous termination of employment benefits) and levels are very high (moral hazard).

##### **Equity Incentives**

- grants that vest and can be cashed immediately;
- infrequent but very large ("mega") equity grants;
- mostly or all stock options, especially if they have discounted strike prices;
- highly leveraged restricted stock awards based on shorter term performance goals (i.e., greater than 200 percent of target payouts);
- large equity grants tied to unlikely or extreme performance outcomes; and
- all or most of LTI awards are paid in cash.

##### **Equity Ownership and Disposition**

- no equity ownership requirements;
- ability to convert all net gains from exercise of mega grants of stock options into cash without any holding requirement;
- no prohibitions against buying company shares on margin or using owned shares as collateral for loans; and

- no requirement for top executives with large stock ownerships requirements to hold some shares for a period of time following retirement or other termination.

##### **Broader Performance Management Culture**

- an overly one dimensional executive evaluation system that focuses single-mindedly on attaining stretch financial goals regardless of risks undertaken;

- a culture that is obsessed with maximizing short-term profits and shareholder returns, and

- a culture where it is clear that the ends justify the means.

The flip side of this list would be design elements that align executive risks and rewards with shareholders and other stakeholders<sup>65</sup> and that are more likely to ensure that the executive's opportunity for gains is balanced by sufficient exposure to potential losses to avoid moral hazard. These design elements generally involve ways to make the compensation more contingent on longer term results:

- *Stock ownership policies* that require executives to hold some percentage of their equity grants until retirement;

- Design features that *extend both the performance measurement and award payment time horizon*, such as, for example, three year, overlapping (rolling) performance measurement cycles and vesting schedules;

- *Opportunities to recoup* ("claw back") incentive payments based on severe future losses;

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<sup>65</sup> A recent example of an incentive that is focused on a broader set of stakeholders (i.e., creditors) is Charter Communications, where the cable company is offering incentives to its executives to restructure its debt: Stephen Taub, *Charter Ties Incentives to Debt Restructuring*, CFO.com, Jan. 14, 2009.

- Paying at least *part of a short-term annual bonus in restricted stock* instead of cash in order to extend the time it would otherwise take for the executive to monetize the award; and

- *Mandatory deferrals of a portion of the bonus*, subject to forfeiture under certain extreme circumstances, or where a portion of the annual bonus is placed in a bonus bank that grows or shrinks based on subsequent company financial results.

## Conclusion

The relationship between executive compensation program design and risk is complex and unsettled. Precise influences will be difficult to gauge and will depend on one's perspective. The compensation committee is primarily charged with protecting the interests of shareholders, but these interests can conflict with longer term interests of other stakeholders. The executive's interests can and should be long term but are often influenced by shorter term considerations. Understanding the motivations and interests of all parties that influence and are subject to risk can lead to better executive compensation program design. Each company will have to balance these considerations to suit their particular circumstances in the context of regulations that ideally leave enough flexibility to do this while also protecting broader societal interests.