Compensation Committee Checklist for Assessing Incentives and Risk

As Board Compensation Committees consider and finalize executive compensation arrangements, they will seek to confirm that the company's incentive programs are appropriately structured for the company and discourage executives from taking "excessive risk." Many Committees will also voluntarily disclose how their compensation programs address the subject of risk, in light of the 2009 SEC regulations which require analysis of risk for compensation programs aimed at employees below the executive level. The Center On Executive Compensation has created the following checklist to help guide Compensation Committees on these issues. The questions that form the basis of the checklist are provided below and in greater detail on the subsequent pages.

1. **Do the performance criteria and corresponding objectives represent a balance of performance and the quality and sustainability of such performance?**
2. **Is the mix of compensation overly weighted toward annual incentive awards or is there a balance of annual and long-term incentive opportunities?**
3. **When compared to a carefully chosen peer group, is the relationship between performance and incentive plan payouts within the range of competitive practices?**
4. **Is there a relationship between performance criteria and payouts under the annual incentive award consistent with targeted performance under the long-term incentive awards?**
5. **Are the long-term incentive performance measures or equity devices overly leveraged and thereby potentially encourage excessively risky behavior?**
6. **Is there a requirement that a meaningful portion of the shares received from incentive award payouts be retained by the participants?**
7. **Has the Board of Directors adopted a recoupment policy which provides for the clawback of incentive payouts that are based on performance results that are subsequently revised or restated and would have produced lower payouts from incentive plans?**
8. **Does the Compensation Committee discuss the concept of risk when establishing incentive performance criteria and approving incentive payouts? Are such discussions recorded in the minutes of the Committee meeting? Does the Compensation Discussion and Analysis articulate how the company's incentive plans mitigate risk?**
9. **If the company includes non-financial metrics, such as DE&I, safety, and climate, as incentive objectives, does the Compensation Committee ensure that the targeted levels of performance on such metrics do not motivate participants to engage in unintended actions to achieve them?**

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Role of the Compensation Committee in Assessing Excessive Risk

The Center On Executive Compensation believes that the Compensation Committee is in the best position to assess the appropriate relationship between the risk inherent in executive compensation arrangements and how that level of risk corresponds to the overall business strategy and competitive environment of the company. The Compensation Committee is responsible for establishing company-specific performance goals and potential incentive payouts that will motivate and reward performance supporting the long-term success of the company. The following updated checklist is offered to aid Compensation Committees in assessing the extent to which the design and administration of executive compensation encourages or reinforces excessive risk-taking by management.

Since 2009, companies have increasingly included some or all of the items in this checklist in their proxy disclosures. This has been reinforced by SEC final rules requiring disclosure of risk in certain incentives for employees below the named executive level that took effect in 2010. Guidance finalized by the Federal Reserve in 2010 and the proposed rules issued by a consortium of financial regulators under Section 956 of the Dodd-Frank Act also contain elements in the checklist, especially items 1 and 2 which deal with incentive designs that mitigate risk, items 4 and 5 which address potential risk aggravators and items 6 and 7 which focus on ways to ensure alignment of pay and performance over the long term.

1. **Do the performance criteria and corresponding objectives represent a balance of performance and the quality of such performance?**

   - The committee should evaluate whether performance criteria under annual and long-term incentive plans include measures of performance (such as financial or managerial goals) and measures of the quality of that performance (such as return measures or measures of sustainability of performance).
     - For example, incentive plans may focus on performance such as revenue, market share or other growth measures, and profitability, return on invested capital, or other measures of efficiency and return.
   - This dual approach mitigates the potential that executives will aim to achieve increases in measures such as sales or growth while not focusing on the ultimate value creation or sustainability of such performance.

2. **Is the mix of compensation overly weighted toward annual incentive awards or is there a balance of annual and long-term incentive opportunities?**

   - Does the annual incentive make up more than 50 percent of the total compensation opportunity?
     - To avoid placing too much focus on achieving short-term results, the annual incentive should not comprise a disproportionate share of the total annual executive compensation opportunity (base salary, annual incentive, estimated value of long-term incentive).
       - Too much emphasis on short-term results may jeopardize long-term performance.
     - Recognizing that each company will be slightly different, the median division among the elements of compensation for Fortune 500 companies are:
       - Salary ≈ 15-20 percent
       - Annual Incentive ≈ 15-20 percent
       - Long-Term Incentive ≈ 60-70 percent
     - Annual incentive in excess of 50 percent of annual compensation opportunity should trigger additional Compensation Committee scrutiny and potentially re-allocation of the annual pay opportunity to other components of the pay package.
   - Does the annual incentive plan have unlimited payout potential?
     - The annual incentive plan should limit total payouts and the range of payouts should be set at a reasonable level, as determined by the Compensation Committee, to avoid encouraging decisions that maximize short-term earnings opportunities (swinging for the fences) at the expense of long-term viability.
   - Do the annual incentive plan criteria and administration mitigate excessive risk?
     - It may be advisable to provide the Compensation Committee discretion in the incentive plan to adjust above-target payouts downward in the face of excessively risky behavior and discuss why this discretion was exercised in the proxy statement.

3. **When compared to a carefully chosen peer group, is the relationship between performance and incentive plan payouts within the range of competitive practices?**

   - The range of performance, and corresponding payouts, should be within a realistic range of results as compared to the performance of the company's peer group.

4. Is there a relationship between performance criteria and payouts under the annual incentive award consistent with targeted performance under the long-term incentive awards?

- While the annual and long-term incentive plans play different roles in the compensation plan, it is important that annual and long-term incentive plan objectives, metrics and targets are aligned to ensure that both types of awards encourage consistent behaviors and sustainable performance results.

5. Do the long-term incentive performance measures or equity devices potentially encourage excessively risky behavior?

- Do the long-term incentive performance measures require excessively risky behavior to realize target or above target payouts? (*e.g.*, do the targets require performance at so high a level that executives would take improper risks to achieve them?)
- Do the performance criteria and vesting periods of long-term incentive awards overlap and thereby reduce the incentive to maximize performance in any one period?
  - With overlapping awards, an attempt to increase short-term performance may jeopardize company performance in future years and thus payouts under other outstanding awards.
- Does the mix of long-term incentive awards meet the Committee’s pay for performance objectives?
  - The Compensation Committee should determine the specific mix of long-term incentive awards that serve the best interests of the shareholders and the company, and may include:
    - performance-vested performance shares or units (which reward the attainment of key financial objectives);
    - time-vested or performance-vested restricted stock or restricted stock units (which may aid in retaining key talent); and
    - stock options or stock appreciation rights (which provide value only if share price appreciates thereby producing direct gains to shareholders).

6. Is there a requirement that a meaningful portion of the shares received from incentive award payouts be retained by the participants?

- Require meaningful stock ownership requirements to link executives' interests to shareholders' interests.

- In the Compensation Committee's discretion, require executives to hold a percentage of net equity received as a continuing link between shareholder and management interests.

- The level of share ownership should build over the executive's career
  - As the executive approaches a targeted retirement date the compensation committee may determine it advisable to approve a phased-diversification plan.
  - If the Compensation Committee determines appropriate, ownership may be also be required for some period after retirement.
    - consistent with Internal Revenue Code Section 409A, which requires "key executives" to delay payout of deferred compensation for six months' after departure.
  - Holding requirements should not be so great as to potentially encourage overly conservative management decisions that would harm shareholder value.

7. Has the Board of Directors adopted a recoupment policy which provides for the clawback of incentive payouts that are based on performance results that are subsequently revised or restated and would have produced lower payouts from incentive plans?

- Adopt a strong clawback provision to provide for recoupment in the event of a material restatement.

- The Compensation Committee, in its discretion, should determine when the need for a clawback is triggered, to whom the clawback should apply and the mechanism for recouping incentive payments.

8. **Does the Committee discuss the concept of risk when establishing incentive performance criteria and approving incentive payouts? Are such discussions recorded in the minutes of a Committee meeting? Does the Compensation Discussion and Analysis articulate how the company's incentive plans mitigate risk?**

   - In addition to competitiveness and the linkage of pay and business strategy, the relationship between business risk and incentive compensation should be a key consideration in setting performance criteria, the corresponding mix of awards and the range of incentive plan opportunities.
   - The Compensation Committee should meet with the company's principal financial officer and/or corporate risk officer prior to approving financial incentive criteria and meet with him/her periodically to facilitate a complete understanding of how the company's financial performance interacts with its strategy and compensation programs.
   - Company proxy disclosures should briefly explain how incentive designs mitigate risk to help demonstrate how risk is considered and addressed by the Committee in approving incentive plans.

9. **If the company includes non-financial metrics, such as DE&I, safety, and climate, as incentive objectives, does the Compensation Committee ensure that the targeted levels of performance on such metrics do not motivate participants to engage in unintended actions to achieve them?**

   - As with financial objectives, use of non-financial objectives as incentive metrics has the potential to motivate unintended behavior that would be detrimental to the company. The Compensation Committee should ensure the amount of stretch required to achieve non-financial objectives is not excessive and could not potentially motivate participants to expose the company to excessive legal or other risk.
   - For example, an overly aggressive or unrealistic annual objective for employee safety may lead to under-reporting of accidents. Similarly, in the area of climate, establishing overly aggressive objectives may result in outsourcing of polluting activities, thereby potentially negating the positive environmental impact of including climate as an incentive metric. Finally, even well-intentioned diversity and representation targets may inadvertently incentivize inappropriate or even illegal behaviors if managers are not appropriately trained on how to achieve goals.