Risky Business – A Review of the 2010 Bay Area 150 Pay Risk Disclosures

During the 2010 proxy season, public companies were required to make a number of new corporate governance and compensation-related disclosures in their annual proxy statements. None of these were more problematic – and challenging – than the requirement to discuss the risks arising from a company's compensation policies and practices for its employees to the extent that these policies and practices were reasonably likely to have a material adverse effect on the company.

While few, if any, companies ultimately disclosed any such risks, investor and regulator interest in the subject, including the process that was used to evaluate their risk profile, led many companies to discuss their compensation-related risks in their proxy statements. This article summarizes the disclosures among the Bay Area 150, the 150 largest high-technology and life sciences companies headquartered in the San Francisco Bay Area, based on a review of definitive proxy statements filed as of May 28, 2010. A list of the companies reviewed (38 companies, or 25% of the Bay Area 150) may be found at the end of this article.

Risk Disclosure Requirement

Origin of Requirement

Following the global economic recession of 2008 and 2009, and amid a perception that poorly designed and misaligned compensation programs had contributed to the crisis, Congress and financial regulators began to focus on the risk profile of executive compensation plans and arrangements; requiring board compensation committees to vouch that their executive compensation programs did not encourage behaviors that would lead to excessive or unnecessary risk-taking.

Continuing this theme, in December 2009 the Securities and Exchange Commission adopted rules requiring public companies to disclose the risks arising from their compensation policies and practices to the extent that these policies and practices were reasonably likely to have a material adverse effect on the company. Unlike similar standards, this new rule applies to a company's compensation policies and practices for all employees, not just its executives. As envisioned by the SEC, this new disclosure is intended to help investors identify whether a company is employing a

The Bay Area 150 Risk Disclosures – What We Found

- No company disclosed that their compensation-related risks were reasonably likely to have a material adverse effect on its business
- Over two-thirds of the companies reviewed provided some level of "voluntary" disclosure about their compensation-related risks
  - The majority of the companies providing disclosure addressed the subject either in their Compensation Discussion and Analysis or in the corporate governance section of their proxy statement
  - Half of the companies providing disclosure included an affirmative statement indicating that they had concluded that their compensation-related risks were not reasonably likely to have a material adverse effect on their business
  - Typically, these companies also gave the specific reasons why they had reached this conclusion, including describing the specific risk mitigation features of their compensation programs
  - Only 20% of the companies providing disclosure described the process that they had used to assess their compensation-related risks

system of incentives that can lead to excessive or inappropriate risk-taking by its employees, as well as disclose any specific pay policies or practices that are likely to expose the company to material risk.

Disclosure Threshold

To avoid burdening investors with voluminous disclosure of potentially insignificant and unnecessarily speculative information about their compensation policies (not to mention the burden that would be experienced by companies in making such disclosure), the new rule only requires disclosure where a company's compensation policies and practices give rise to a risk that is reasonably likely to have a material adverse effect. Given this ambitious disclosure threshold, as well as the fact that the question is to be answered based on a particular risk's impact on the company as a whole and only after balancing incentives against any controls or other factors that may serve to influence behavior or mitigate risk, in most cases the likelihood of mandatory disclosure will be minimal.

Risk Assessment Required

Even so, the decision of whether disclosure is required is not to be made in a vacuum. As a practical matter, each public company has to conduct an assessment of its internal controls and compensation-related risk management practices in order to determine whether mandatory disclosure is required. Thus, most companies have now incorporated an annual risk assessment into their corporate and/or board of directors' calendar.

"Negative" Disclosure Not Required

Consistent with long-standing SEC practice, the new rule does not require a company to make an affirmative statement that it has determined that the risks arising from its compensation policies and practices are not reasonably likely to have a material adverse effect on the company. In other words, companies are not expected, nor required, to make a so-called "negative" disclosure statement.

Nonetheless, as we note below, in actual practice many companies are using such statements to reassure investors that they are effectively managing their compensation-related risks.

SEC Staff Oversight

Comments on Risk Disclosure

Given the perceived public interest in compensation-related risk, during the 2010 proxy season the SEC Staff closely monitored public company filings to both ensure compliance with the new disclosure requirement and to develop an understanding of how companies were addressing the subject. At various public forums, senior SEC officials announced that companies which had their proxy statements selected for review would be asked to confirm that they had addressed the compensation-related risk disclosure requirement if there otherwise was no mention of the subject. And, in fact, the Staff has sought to affirmatively confirm that the absence of any compensation-related risk disclosure reflects a conscious decision resulting from a comprehensive risk assessment rather than an inadvertent oversight. While we expect this policy to be in place for the remainder of this initial year of compliance, it remains to be seen whether the Staff intends to continue this practice in future proxy seasons.

Comments on Risk Assessment

In addition to the foregoing, the SEC Staff has also been issuing comments about the process employed by a public company to reach the conclusion that its compensation policies and practices do not result in any material adverse effect for the company. In spite of some initial confusion, we understand that this comment is not intended to suggest that a company must describe its assessment process in its proxy statement. Instead, it is intended to merely confirm that the company conducted a robust evaluation in reaching its disclosure conclusion. Consequently, you should ensure that you have adequately documented your risk assessment so that, if selected for review, you will be able to respond appropriately. As noted below, some companies may opt to address their assessment process in their disclosure. However, it is not required.

Future Practice

Going forward, you should be aware that, if your company is selected for review (something that, under current SEC policy, is likely to occur at least once every three years), you may be asked to address the compensation-related risk disclosure requirement, even though you have determined that no mandatory disclosure was necessary. Accordingly,

we expect that it will become "best practice" to provide some level of disclosure to both inform investors of your company's efforts to manage and monitor compensation-related risk and foreclose an SEC Staff comment. While it will probably take at least one more proxy season for a "best practice" to emerge, we recommend that you affirmatively address the subject in your proxy statement, indicating that you monitor compensation-related risks on an ongoing basis and identifying the principal reasons why your company believes that these risks are not reasonably likely to have a material adverse effect on the company.

Presence of Disclosure

In our review of the Bay Area 150, none of the reviewed companies disclosed that, following a review of its overall compensation policies and practices, it had concluded that these policies and practices were reasonably likely to have a material adverse effect on the company. This is consistent with the experience of the broader corporate community where, to date, only a single mandatory disclosure has been identified. Consequently, the disclosure question faced by virtually every company in 2010 has been whether to provide some level of voluntary disclosure about its compensation-related risks.

In spite of the SEC Staff's pronouncements, nearly one-third of the companies reviewed (12 of 38 companies) provided no disclosure at all about compensation-related risk in their definitive proxy statements. While this would be understandable in the case of filings made early in the proxy season (for example, through mid-March) when awareness of the Staff's position was limited, only one of the reviewed companies filed its proxy statement before March 15 (this company filed in February). The remaining companies filed their definitive proxy statements on or after March 23, 2010, including seven which filed in April. These companies were either unaware of the Staff's position, or elected not to address the subject notwithstanding the risk of a Staff comment if selected for review.

Future Practice

As noted above, we expect that, as the year continues and certainly for the 2011 proxy season, "best practice" will be to provide some level of disclosure; most likely in one of the forms discussed below.

Location of Disclosure

In adopting the new compensation-related risk disclosure requirement, the SEC decided that, because it is to cover company-wide (not just executive) compensation programs, any resulting disclosure should not be part of the Compensation Discussion and Analysis, which is intended to provide discussion and analysis of executive compensation policies and practices only. Subsequently, the SEC Staff indicated that, while the new rules do not specify where the disclosure should be presented, to ease investor understanding, it recommends that any required disclosure be presented as part of a company's other executive compensation disclosure (for example, before or after the CD&A or the compensation tables).

In spite of this guidance, the compensation-related risk disclosure of the 26 reviewed companies that provided such information in 2010 were varied:

- Ten companies addressed the subject in their Compensation Discussion and Analysis;
- Nine companies addressed the subject in the Corporate Governance section of their proxy statement;
- Five companies addressed the subject following the Compensation Discussion and Analysis and before their Summary Compensation Table;
- One company addressed the subject following its executive compensation disclosure and before its director compensation disclosure; and
- One company addressed the subject following its executive and director compensation disclosure.

We suspect that the variations in the placement of the disclosure reflect either a lack of familiarity with the SEC Staff's guidance and/or a belief that the company has greater latitude in locating the disclosure when it is voluntary, rather than mandatory. This latter conclusion is reinforced by the fact that, of the 10 companies providing disclosure in their CD&A, only three discussed their overall compensation programs; the rest limited their disclosure to a discussion of the risks associated with their executive compensation program. We expect that, where the discussion is focused on executive compensation-related risk, many companies will continue to include it in their CD&A.

Future Practice

Consistent with past revisions to the executive compensation disclosure rules, the SEC Staff has largely allowed companies to experiment with the placement of their compensation-related risk discussions in 2010. And, as evidenced by the companies that we reviewed, there are numerous locations for covering this subject; most of which are perfectly reasonable.

While there is nothing wrong with presenting a voluntary discussion of your compensation-related risk as part of your corporate governance disclosure or following your executive compensation disclosure, in view of the Staff's express concerns that any required disclosure not be difficult to find or be presented in a fashion that obscures the information, we expect that, eventually, these locations will lose favor. Instead, starting next year, we should begin to see more companies position their disclosure so that it is located following the CD&A and before the Summary Compensation Table.

In this manner, the disclosure should satisfy everyone's objectives. Consistent with the SEC's directive, technically it will not be part of the CD&A (although from the company's perspective, it will still appear "associated" with the CD&A). It will also satisfy the SEC Staff's expectations, as it will be incorporated into the company's executive compensation disclosure. Finally, it should meet investor needs as they will not be forced to search for this information in an unfamiliar part of the proxy statement.

Content of Disclosure

While the voluntary disclosure provided by the reviewed companies varied in length and content, typically it consisted of one or more of the following components:

- Identification of who has overseen the risk assessment process (for example, management or the compensation committee);
- a "negative" disclosure statement;
- a discussion of the reasons why the company believed that its compensation programs were not reasonably likely to have a material adverse effect on it;
- a discussion of the process undertaken by the company to assess the risk profile of its compensation programs.

"Negative" Disclosure Statement

Half of the 26 companies providing voluntary disclosure included a "negative" disclosure statement in their compensation-related risk discussion (that is, a statement that their compensation program does not create risks that are reasonably likely to have a material adverse effect on the company). In addition, many of the companies also noted that their compensation programs did not encourage "excessive or unnecessary" risk-taking; a compliance standard imposed on companies receiving financial assistance through the federal government's Troubled Asset Relief Program ("TARP"), but not part of the SEC's disclosure requirement. Omnicell's disclosure is representative of this formulation:

> The Compensation Committee has reviewed our compensation policies as generally applicable to our employees and believes that our policies do not encourage excessive and unnecessary risk-taking, and that the level of risk that they do encourage is not reasonably likely to have a material adverse effect on the Company.

Basis for "Negative" Disclosure

Given that the critical aspect of every risk assessment is ensuring that the risks generated by a compensation program are balanced with appropriate safeguards, it comes as no surprise that half of the 26 companies providing voluntary disclosure identified the reasons, including the risk mitigation features, that contributed to their conclusion that the risks arising from their compensation programs were unlikely to have a material adverse effect on their business as a whole. The nature of the mitigation features disclosed varied from company to company, but typically included, among other things, the presence of stock ownership guidelines or requirements and/or a compensation recovery ("clawback") policy.

Cadence Design System's disclosure offers a representative example of this approach:

> The Compensation Committee, in consultation with [its compensation consultant], reviews Cadence's compensation practices, policies and programs for all employees, including the Named Executive Officers, to assess the risks associated with such practices, poli-

cies and programs. The risk-mitigating factors considered by the Compensation Committee include:

- the use of different types of compensation that provide a balance of short-term and long-term incentives with fixed and variable components;
- Cadence's Stock Ownership Guidelines;
- Cadence's Clawback Policy which, in the event of a restatement of Cadence's financial results, allows Cadence to seek to recover or cancel performance-based bonuses and awards to the extent that performance goals would not have been met under such restated financial results;
- caps on bonus awards to limit windfalls;
- the Named Executive Officers must obtain permission from Cadence's General Counsel before the sale of any shares of Cadence common stock, even during an open trading period; and
- the Compensation Committee's consideration of ethical behavior as integral in assessing the performance of all executive officers, including the Named Executive Officers.

For companies that have not yet addressed the subjects to stock ownership guidelines and clawback policies, the Atmel disclosure demonstrates how the subject may be handled:

> Our Compensation Committee has discussed the concept of risk as it relates to our compensation program, and the Committee does not believe our compensation program encourages excessive or inappropriate risk taking for the following reasons:
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> - Our use of different types of compensation vehicles provide a balance of long and short-term incentives with fixed and variable components.
> - We grant equity based awards with time based vesting and performance based vesting, both of which encourage participants to look to long-term appreciation in equity values.
> - The metrics used to determine the amount of an executive's bonus under the 2009 Bonus Plan included Company-wide metrics, and for certain employees, business unit-wide metrics, which we believe promote long-term value. In addition, a participant's overall bonus cannot exceed two times the target amount, no matter how much financial performance exceeds the metrics established at the beginning of the year.
> - Our Compensation Committee retains discretion to modify or to eliminate incentive bonuses that would otherwise be payable based on actual financial performance under our 2009 Bonus Plan.
> - Our system of internal control over financial reporting, standards of business conduct, and whistleblower program, among other things, reduce the likelihood of manipulation of our financial performance to enhance payments under our 2009 Bonus Plan.
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> The Company's management reviews the primary elements of our compensation program on an annual basis and reviews the other elements from time to time to ensure that compensation levels remain competitive.

Risk Assessment Process Disclosure

Only 19% of the 26 companies providing voluntary disclosure (5 companies) described the process that they used to assess their compensation-related risks in their disclosure. Of these companies, Intel's disclosure is the most fulsome:

> Consistent with new SEC disclosure requirements, we have assessed the company's compensation programs and have concluded that our compensation policies and practices do not create risks that are reasonably likely to have a material adverse effect on the company. Intel management assessed the company's executive and broad-based compensation and benefits programs on a worldwide basis to determine if the programs' provisions and operations create undesired or unintentional risk of a material nature. This risk assessment process included a review of program policies and practices; program analysis to identify risk and risk control related to the programs; and determinations as to the sufficiency of risk identification, the balance of potential risk to potential reward, risk control, and the support of the programs and their risks to company strategy. Although we reviewed all compensation programs, we focused on the programs with variability of payout, with the ability of a participant to directly affect payout and the controls on participant action and payout. Intel's egalitarian culture

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supports the use of base salary, performance-based compensation, and retirement plans that are generally uniform in design and operation throughout the company and with all levels of employees. In most cases, the compensation policies and practices are centrally designed and administered, and are substantially identical at each business unit. Field sales personnel are paid primarily on a sales commission basis, but all of our officers (including those in the Sales and Marketing Group) are paid under the programs and plans for non-sales employees. Certain internal groups have different or supplemental compensation programs tailored to their specific operations and goals, and programs may differ by country due to variations in local laws and customs.

Future Practice

We expect that many companies will expand their future disclosures to highlight the principal risk mitigation features of their compensation programs, as this information has been well-received by investors, as well as demonstrating a thoughtful and thorough understanding of the relationship between compensation and risk. In addition, given the SEC Staff's recent practice of inquiring about the nature of the assessment conducted, we will probably see an increase in the number of process-oriented discussions next year. Notwithstanding this attention on process, we believe that a discussion of the company's reasons for its conclusion that it is effectively managing its compensation-related risks is probably more important than a process-oriented discussion.

Need Assistance?

If you need assistance in evaluating the risks associated with your executive compensation program or in developing a statement about compensation-related risk for your annual proxy statement, or if you would like further information on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact us. ■

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Companies Reviewed

Actuate
Adobe Systems, Inc.
Advanced Micro Devices, Inc.
Altera
Atheros
Atmel
Autodesk
BigBand Networks
Cadence Design Systems
Cypress Semiconductor
eBay
Echelon
Exponent
Gilead
Google
Intel
Intersil
Juniper Networks
LSI
McAfee
Netflix
Novellus Systems
nVidia
Omnicell
Power Integrations
Rambus
SanDisk
SonicWall
SunPower
Sybase
Synnex
Tessera Technologies
Trident Microsystems
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Zoran