

## Should the Chief Ethics and Compliance Officer be Concerned with How His / Her Company Executives are Paid?

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London  
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### 1. Why the Public Interest Today in Remuneration?

- Recent public and shareholder interest in remuneration practices
- "Say-on-pay" and other developments
- Role of pension funds, proxy advisors and others

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### 3. Relationship to Corporate Governance

- **How are decisions made** at a company, including on risks?
- How is **power** is allocated and wielded?
- What **organizational dynamics**?
- What true **checks-and-balances** are in place?

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### How are decisions made on specific risks?

- Can remuneration be a risk?
- Financial Stability Board and others:  

“inappropriate compensation structures” that created the ‘wrong financial incentives’
- If it is a risk, who should decide on pay and bonuses at a company? With which standards?

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### Potential risks of remuneration

- Affordability, endangerment of capital or liquidity position?
- Consistency with fiduciary duty? Conflicts of interest?
- “Corporate waste”?
- Motivating risk taking beyond risk capacity?
- AIG, Lehman Brothers, and other examples

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**Can it motivate circumvention of controls and non-compliance?**

- Recent examples
- 2012 UK Payment Protection Insurance cases
  - Did misaligned incentives contribute to sales to customers who
    - did not need it?
    - sometimes didn't know they were buying it?
- Differences in the responses by the companies involved

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**4. How are Regulators Reacting?**

- Financial Stability Board and G-20
- FSB Principles on Sound Compensation Practices, plus Implementation Standards
- Spill-over effect beyond financial services

Internal Oversight

Risk

External Oversight

- Board of Directors led

- Alignment with risks taken

- Regulators review
- Companies disclose

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**FSB implementation expectations**

Effective Board of Director Remuneration Committee and Control Functions' involvement	Annual Reviews
Bonus pools to take into account risks, cost of capital and "timing" and "likelihood of future profit"	Restrictions on guaranteed bonuses, sign-on and departure payments
Deferral of large portion of variable remuneration	Clawbacks

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**Regional and national responses**

- Most mainly concerned with the “how”
- But others also with the “what”
  - Concerns with “excessive compensation”
  - Heated debates on possible market distortionary impact of “caps” and other such approaches
- New EU Rules (effective 1/2014)\*
  - Limit bonus to 1X base pay, unless a type of shareholder supermajority agree to up to 2X
  - But up to 25% not subject to cap if deferred at least 5 years

Limited to banks but collateral cross-industry impact possible

\*Status as of 3.3.2103 (c) 2012, 2013 Gabe Shawn Vargas 13

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**5. The Remuneration Levers**

- Compensation used to be a black box...even to most within the company
- Which are the nine main levers?
  - Quantitative and qualitative
  - Their relationship to pay mix, means of delivery, vesting duration, nature and length of performance taken into account, and ex and post ante adjustment mechanisms
- How to adjust these levers?

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**6. Who Does/Should Operate the Remuneration Levers?**

Iceland

Who decides on remuneration at the company?	Is such person or body objective?	Which standards apply to remuneration decisions?	Are these standards and the decisions made pursuant to them documented?	Do remuneration decisions reflect appropriate use of corporate assets?	Are objective risk reviews done to determine what risks remuneration instruments create?	Are there compliance, audit and other controls over the remuneration process?	Is there appropriate disclosure on remuneration?
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\*standards refer to performance standards and metrics

\*From G.S. Vargas, *Governing Remuneration* in S. Emmenegger (ed.), *Corporate Governance*, Uni. Of Bern, 2011

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**7. Governance Challenges**

- Board qualification and expertise: Are members “fit and proper”?
  - fitness and remuneration expertise
  - propriety
- Even if “fit and proper”, do they have time?
- Even if they have time, are they independent enough?
- Do they have any conflicts of interest?  

How can the “control functions” help?

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**FSB October 2011 Peer Review Report**

**“Recommendation 5: Effective governance of compensation....financial institutions deemed significant... [should] take immediate steps to align their practices with the key requirements in the area of effective governance of remuneration. Particular attention should be given to the independence and expertise of the institution’s remuneration committee...[and] the independence of the risk and compliance functions in the compensation process.”**

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**Does internal and external transparency help or hurt?**

- What should be transparent internally and what should not?
- What kind of external disclosures?
- Does it lead to “copy cat” behavior?
- Remuneration inflation?
- Do shareholders care?
- What could make disclosures more useful?

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### 8. Why, When and How Should the CECO Get Involved in Remuneration?

- Remuneration practices as a reflection of corporate culture and corporate values
- Can the prospect of a bonus cloud a manager’s risk and compliance judgment?
- Isn’t part of the CECO’s responsibility of protecting the company also protecting it against remuneration risks?

Some regulators expect Compliance to be involved in the remuneration process as a “control function”

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### Relevant questions for the CECO

- Do I know what behaviors are incented through our current remuneration system at all levels of my company?
- At the executive level, are bonuses adjusted for level of capital used and risk taken? Any self-dealing?
- Are salespersons or other employees or agents rewarded for sales volume, rather than quality of those sales? For immediate sales, rather than long-term customer loyalty?
- How does a manager’s ethics and compliance performance affect his / her compensation?
- Does our Code of Conduct cover remuneration duties and risks?

Do we have only negative or also positive incentives to motivate the right ethics and compliance behaviors?

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### When and where to get involved?



For more see G.S. Vargas, "Incentives and Disciplinary Procedures to Promote and Protect the Compliance Program" in C. Basri (ed.) Corporate Compliance Practice Guide: The Next Generation (LexisNexis, last edition 2012)

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### Eight Stages of CEO Involvement

1. My workload is tough enough already. I leave remuneration issues to others.
2. Sure, I provide "tone from the top" on how "incentives" are important. But I don't have the support to dig into how managers are paid.
3. I work with the HR Head to add compliance and ethics elements to performance evaluation forms.
4. I work to secure for Compliance a permanent role in reviewing adherence to the remuneration plan rules.
5. I work with the CEO to get support for Compliance to provide input on the performance evaluation of business units.
6. I work with the CEO to get support for Compliance to provide input on the performance evaluation of individual managers (also the CEO?)
7. I work with the Chair of the Compensation Committee of the Board to provide input on the overall remuneration system design and operation.
8. I work with all needed persons for Compliance to provide input on the annual bonus pool and its allocation.


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### How to prioritize?

- Emerging best practice of identifying and focusing on "Key (or Material) Risk Takers"
  - Those who can influence the risk profile of the company
- Example: EU Capital Requirement Directive expects focus on:
  - Executive members, senior management
  - Others who take major risks
  - Staff responsible for control functions
  - Those who are in similar remuneration bracket as senior management

What adjustments to HR, Risk, Compliance and other systems and processes are needed to focus properly on KRTs?


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### The needed analysis on KRTs


From the FSB Principles:

"An employee's compensation should take account of the *risks* that the *employee* takes on"

"Employees' incentive payments should be linked to the contribution of the *individual* and business to such performance"

"The mix will vary depending on the *employee's position and role.*"

"Two *employees* who generate the same short-run profit but take *different amounts of risk* on behalf of their firm should *not be treated the same* by the compensation system."


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### 9. Remaining Challenges

- Degree of sensitivity to remuneration risk differs among companies and industries
- Not just a financial services issue
- The FSB recognizes that “achieving lasting change in behavior and culture within firms is a long-term challenge, and requires ongoing monitoring...”

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### Remaining Challenges (cont.)

- The connection of remuneration to culture provides an optimal opportunity for Compliance and CECE contribution
- One place to start is with the remuneration of the Control Functions and the avoidance of wrong incentives at such functions
- But there is only limited evidence of CECE leadership in remuneration thus far

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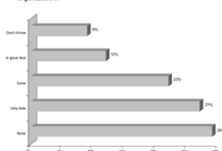
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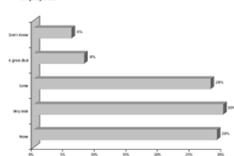
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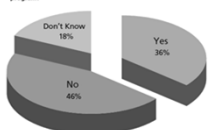
How much impact does the ethics and compliance function have in the compensation process for the executives at your organization?



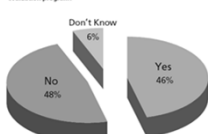
How much impact does the ethics and compliance function have in the compensation process for non-executive employees?



Does your organization include compliance and/or ethics metrics as a part of its executive performance evaluation program?



Does your organization include compliance and/or ethics metrics as a part of its non-executive employee performance evaluation program?



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Compensation, Performance, Compliance and Ethics Survey 2009-2012

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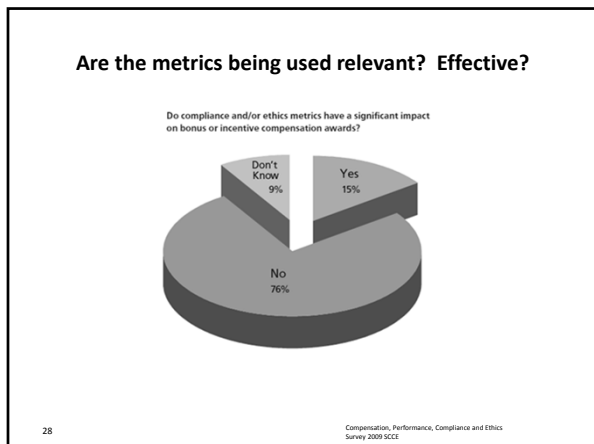
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### Remaining Challenges (cont.)

- In the U.S. the Sentencing Guidelines also recognize the importance of this topic, though perhaps not explicitly enough. The current wording has not yet led to a meaningful Compliance role across the full remuneration system of most companies.

(6) The organization's compliance and ethics program shall be promoted and enforced consistently throughout the organization through (A) appropriate incentives to perform in accordance with the compliance and ethics program; and (B) appropriate disciplinary measures for engaging in criminal conduct and for failing to take reasonable steps to prevent or detect criminal conduct.]

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### But also critical to remember the rightful place of appropriate remuneration for the success of a company

- Remuneration and high performance
- Remuneration and innovation
- Remuneration and the recruitment and retention of needed talent

Figure 1. Difficulties attracting and retaining key employee groups continue despite variable economic conditions

To what extent is your organization experiencing problems attracting/retaining employees in the following groups?	Problems attracting*	Problems retaining*
All employees	31%	25%
Critical/skill employees	72%	56%
High-potential employees	60%	55%
Top-performing employees	59%	50%
Diverse employee populations	43%	31%
Recent university graduates	18%	20%
Employees with tenures between 18 months and three years	NA	43%

\*Percentages represent the percentage of respondents having difficulty to a moderate or great extent.

Chart from Towers Watson "Next High Stakes Quest", 2012

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**If you are interested in further reading see:**



Gabe Shawn Vargès  
*"Incentives and Disciplinary Procedures to Promote and Protect the Compliance Program"*  
*(LexisNexis, last edition 2012)*



Gabe Shawn Vargès  
*"Governing Remuneration"*  
*(University of Bern, 2011)*



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