RiskMetrics' 2010 Policy Updates

RiskMetrics Group, the prominent risk management and corporate governance services firm, has updated the corporate governance and executive compensation policies that it will use to determine its voting recommendations for its proxy advisory clients during the upcoming 2010 proxy season.

With the adoption of a universal advisory vote on executive compensation ("Say on Pay") requirement looming on the horizon, RiskMetrics has consolidated its various analyses of executive and equity compensation issues into a single, unified "Executive Compensation Evaluation" policy. Under this new "holistic" policy, RiskMetrics will first direct its voting recommendation at a "Say on Pay" vote (assuming a company is conducting such at vote at its 2010 annual shareholders' meeting). Where no "Say on Pay" vote is being held, an unfavorable reaction to an executive compensation program may lead to a negative recommendation for compensation committee members (and, possibly, other directors) and any equity plan (or share reserve increase) that is being submitted for shareholder approval.

The updated policies are effective for shareholders' meetings held after February 1, 2010.

Reduced Burn Rate Limits

RiskMetrics will recommend a vote "against" an equity plan proposal if a company's average three-year "burn rate" (the total number of equity awards granted in a given year, expressed as a percentage of the total number of common shares outstanding) exceeds the greater of:

- its burn rate limit (based on the mean plus one standard deviation of the company's industry peer group); or
- two percent of the company's weighted common shares outstanding.

For 2010, RiskMetrics has reduced the burn rate limits for most industry sectors.

In the case of technology and life sciences companies in the Russell 3000, the reductions are as follows:

- For software and services companies, from 6.76% to 5.47%

Four Things Companies Should Know about the 2010 Policy Updates

- RiskMetrics has significantly reduced its burn rate limits for 2010 (on average, 20% for Russell 3000 companies and 15% for non-Russell 3000 companies); coupled with the likely reduction in stock price volatilities resulting from a return to a 200-day (from a 400-day) sampling period, many companies will have more difficulty complying with their applicable industry burn rate limit next year.
- RiskMetrics has once again identified several "egregious" compensation practices for 2010 that may, on a stand-alone basis, result in a negative vote recommendation. These egregious practices include overly-generous employment agreements, excessive perquisites, non-performance-based bonuses that are too large, and tax reimbursement payments.
- RiskMetrics also will be evaluating companies' compensation policies and practices in 2010 to see whether they "potentially encourage excessive risk-taking" – if they do, this will be considered an "egregious" pay practice that may trigger a negative vote recommendation.
- Where a company's one-year and three-year total shareholder return are in the bottom half of its industry peer group, RiskMetrics will look for a pay-for-performance "disconnect" by tracking CEO compensation and total shareholder return over the prior five years – so even if CEO pay stayed the same or even decreased between 2008 and 2009, a pay-for-performance issue may arise.

- For technology hardware and equipment companies, from 5.52% to 4.79%
- For semiconductor companies, from 5.72% to 4.82%
- For health care equipment and services companies, from 4.39% to 3.65%
- For pharmaceutical and biotechnology companies, from 5.76% to 5.16%

For technology and life sciences companies outside the Russell 3000, some limits increased while others decreased, as follows:

- For software and services companies, from 10.12% to 7.58%
- For technology hardware and equipment companies, from 6.30% to 7.08%
- For semiconductor companies, from 7.79% to 7.31%
- For health care equipment and services companies, from 6.64% to 7.92%
- For pharmaceutical and biotechnology companies, from 9.46% to 8.58%

Change to Volatility Assumption Sampling Period

For purposes of its Shareholder Value Transfer ("SVT") and burn rate policies, RiskMetrics calculates a company's stock price volatility by looking at its historic daily price movements equivalent to the standard deviation of the stock price over a specified sampling period. After using a 400-day sampling period in 2009 to offset the unprecedented volatility levels in the stock market, it is returning to a 200-day sampling period in 2010.

Although RiskMetrics did not change the volatility "premium" or multiplier that it uses for converting full-value shares awards to stock options when calculating SVT, the reduction of the volatility assumption sampling period should result in higher conversion rates for many companies, which will put further pressure on burn rate limit compliance.

Addition of Pay "Riskiness" to List of Egregious Pay Practices

As in past years, RiskMetrics has published a list of "egregious" compensation practices that, if part of an executive compensation program, may, on a stand-alone basis, result in a negative vote recommendation. While many of these problematic pay practices will be familiar to most companies, in 2010 RiskMetrics will also be evaluating whether a company's incentive compensation practices motivate inappropriate risk-taking by its executives. Such practices as guaranteed bonuses, overly-generous severance packages, high pay opportunities relative to industry peers, and large equity awards that provide unlimited upside with no downside risk are items that may be viewed as encouraging excessive risk-taking. It will also consider the extent to which program features such as clawback policies or stock ownership and holding requirements may mitigate risk.

While the novelty of the issue may force RiskMetrics to be cautious in conducting its compensation-related risk evaluations in 2010, the addition of this item to its list of egregious compensation practices will give it another potent vehicle for recommending a "withhold" or "against" vote for compensation committee members if they are determined to have approved pay practices that are considered too risky.

New Test for Pay-for-Performance "Disconnects"

To ensure an appropriate "pay-for-performance" alignment, RiskMetrics looks at companies where one-year and three-year total shareholder return ("TSR") were in the bottom half of its industry peer group to correlate this performance with the chief executive officer's total direct compensation ("TDC"). In 2010, this analysis will focus on whether the TDC of a CEO who has served at least two consecutive fiscal years is aligned with the company's TSR over the preceding five years, with particular focus on the most recent three years.

This shift to long-term alignment will likely expand the number of situations where a company may be identified as having a pay-for-performance "disconnect." As a result of the new five-year look-back, companies with below-median one-year and three-year TSR will be subject to review (and a possible negative vote recommendation)

even if the CEO's TDC has remained flat or even marginally decreased in the last fiscal year.

A company that is found to have a "disconnect" may be able to avoid a negative vote recommendation if it makes a renewed commitment to "pay-for-performance," tailored to the underlying issues that RiskMetrics has identified as causing the disconnect While this alternative may prove helpful for some companies, most are likely to view the policy as RiskMetrics using its leverage to dictate the design and operation of the executive compensation programs of companies that it considers to be poor performers.

Stock Option Exchanges

In 2009, companies considering a stock option exchange program had to structure such programs as "value-for-value" exchanges, reset vesting schedules as a condition of participation, exclude named executive officers and directors from the program, and obtain shareholder approval to avoid a negative vote recommendation from RiskMetrics.

In light of the recent stock market turnaround, RiskMetrics has begun to take a harder line with respect to the approval of option exchange programs even though companies may still be facing retention issues related to "underwater" stock options. For example, for 2010, RiskMetrics may require that the threshold exercise price for eligible options be the greater of (i) the 52-week stock price high or (ii) 150% of the current stock price (instead of just the 52-week stock price high). While other factors, such as the timing of the request and whether the company has experienced a sustained stock price decline that is beyond management's control, may also influence the evaluation of the program, RiskMetrics focus on whether the options to be exchanged are deeply, or only marginally, "underwater," may make it difficult for many companies to implement an exchange program at a time of their choosing.

Implications of 2010 Policy Updates

As in past years, while the updated policies offer insight into RiskMetrics' position on current executive pay issues, they are not always an accurate forecast of its ultimate analysis or vote recommendations for an individual company. The specific issues that companies may encounter will continue to depend on the orientation and experience of the analyst reviewing the company's program, as well as the totality of its corporate governance and executive compensation picture.

Companies with unusual compensation structures or that find themselves making decisions that may deviate from their previously-disclosed program should treat their Compensation Discussion and Analysis as an opportunity to explain and justify their compensation policies (and related decisions) to ensure that RiskMetrics has access to appropriate information with which to formulate its 2010 voting recommendations.

Need Assistance?

Compensia has had significant experience in helping companies understand and address RiskMetrics' corporate governance and executive compensation policies. If you have any questions on the topics covered in this Thoughtful Pay Alert or would like assistance is assessing how the policies are likely to affect your executive compensation program, please feel free to contact us. ■

To obtain a copy of Compensia's comprehensive analysis of RiskMetrics' 2010 Policy Updates, please click here »

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

San Francisco

770 Tamalpais Drive
Suite 207
Corte Madera, CA 94925
415.462.2990

Mark H. Edwards, Chairman
medwards@compensia.com
415.462.2985

Michael Benkowitz
mbenkowitz@compensia.com
415.462.2996

Mark A. Borges
mborges@compensia.com
415.462.2995

Southern California

Anna-Lisa Espinoza
alespinoza@compensia.com
858.509.1179

Mathew T. Quarles
mquarles@compensia.com
323.919.7338

Silicon Valley

1731 Technology Drive
Suite 810
San Jose, CA 95110
408.876.4025

Timothy J. Sparks, President
tsparks@compensia.com
408.876.4024

Thomas G. Brown
tbrown@compensia.com
408.876.4023

Susan Gellen
sgellen@compensia.com
408.907.4302

Tom LaWer
tlawer@compensia.com
408.907.4309