RiskMetrics Issues Policy Updates for 2010 Proxy Season

RiskMetrics Group, the prominent risk management and corporate governance services firm, has updated its U.S. corporate governance policies. This latest annual update addresses, among other things, the corporate governance and compensation policies that RiskMetrics will use to determine its voting recommendations for its proxy advisory clients during the upcoming 2010 proxy season.

With the likely adoption of a universal requirement that public companies provide their shareholders with an annual advisory vote on executive compensation looming on the horizon, RiskMetrics has begun to consolidate its various analyses of executive and equity compensation issues into a single, unified "Executive Compensation Evaluation" policy. This "holistic" approach to evaluating a company's executive compensation policies and practices to formulate its voting recommendations will require companies to familiarize themselves with the totality of RiskMetrics corporate governance and compensation policies and develop appropriate strategies for addressing potential trouble spots in their executive and equity compensation programs.

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

Significance of Policies

As a long-time advisor to the institutional investor community, RiskMetrics (on its own and through its predecessor, Institutional Shareholder Services) has established itself as a bellwether for the key shareholder issues to be addressed each proxy season. For several years, RiskMetrics has regularly published and annually updated its standards on good corporate governance and compensation policies and practices. These standards, which are contained in a series of policy statements, are used by RiskMetrics to formulate the voting recommendations that it provides to its clients for the election of directors and other proposals submitted for shareholder action at annual shareholders' meetings, as well as to analyze companies' corporate governance and executive compensation policies and practices.

Four Things Companies Should Know about the 2010 Policy Updates

- RiskMetrics has significantly reduced its equity award 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 an unfavorable 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.

RiskMetrics Issues Policy Updates for 2010 Proxy Season (continued)

While most companies focus on the policy updates that affect their corporate governance structure and executive compensation programs, the updates actually encompass a broader range of social and environmental issues.

This article summarizes the policy updates for 2010 that affect executive and equity compensation matters.

Move to Comprehensive Policy Statement

For 2010, RiskMetrics has integrated its existing compensation-related policy statements – Pay for Performance, Poor Pay Practices, and Advisory Votes on Compensation (Management Say on Pay – MSOP) – into a single, comprehensive "Executive Compensation Evaluation" policy. This integration eliminates the overlap that existed between these policies and anticipates the prominence that the advisory vote on executive compensation ("Say on Pay") will have once it becomes a mandatory requirement for all public companies (expected in late 2010 or 2011).

The new Executive Compensation Evaluation policy consists of three sections:

- Pay for Performance;
- Problematic Pay Practices; and
- Board Communication and Responsiveness.

The recommendations issued under the policy may apply to any or all of the following ballot items, depending on the compensation issue under consideration:

- The election of directors (primarily compensation committee members);
- Advisory votes on executive compensation; and
- Equity plan proposals (either new plans or the addition of shares to existing plans).

Generally, if a company conducts a "Say on Pay" vote at its annual shareholders' meeting, RiskMetrics will apply its compensation-related voting recommendations to that item, with one significant exception: where an egregious pay practice is identified, or if a company previously received a negative vote recommendation on a "Say on Pay" resolution related to an issue that is still on-going, RiskMetrics may also recommend a "withhold" or "against" vote for any compensation committee members who are up for re-election to the company's board of directors. (For a discussion of potential "egregious pay practices," see below.) If the concerns raised in the "Say on Pay" vote are not sufficiently addressed in the subsequent year, thereafter RiskMetrics may recommend a "withhold" or "against" vote for compensation committee members.

Observations. The decision to implement a single, integrated compensation policy is a welcome development, as it should make it easier for companies to understand and respond to RiskMetrics' various standards. With the introduction of "Say on Pay" votes in the next few years, the new policy should also make it clearer how a company's existing compensation policies and practices will impact specific voting recommendations for a "Say on Pay" resolution, the election of directors, and equity plan proposals.

Further, RiskMetrics' process for prioritizing client concerns (which is an outgrowth of its expanded annual policy survey) should help clarify which issues have the greatest practical consequences for companies. While RiskMetrics is unlikely to concede that an egregious pay practice will not have any implications on its voting recommendations, it is potentially helpful to know which issues may trigger a "withhold" or "against" vote recommendation on a standalone basis and which may not.

On the other hand, while the integrated policy focuses on "Say on Pay" resolutions (rather than the re-election of compensation committee members) as the principal avenue for addressing a company's compensation policies and practices, as a practical matter, it will be at least a year before this approach has an impact on most companies. In 2010, egregious pay practices may still result in negative vote recommendations against individual directors and, where applicable, equity plan proposals. For companies with a majority voting standard for director elections, this nuance may be significant, as, in light of the recent prohibition on broker discretionary voting of uninstructed shares in uncontested director elections, it potentially increases the impact of a "withhold" or "against" vote recommendation in re-electing their director slate.

Pay-for-Performance

In past years, RiskMetrics has recommended a vote "against" an equity plan proposal and/or a "withhold vote" or a vote "against" compensation committee members where there has been an increase in the CEO's total direct compensation

("TDC") while, at the same time, the company's one-year and three-year total shareholder return ("TSR") were in the bottom half of its industry peer group (based on the company's four-digit global industry classification standard ("GICS") code).

In 2010, this policy will also be extended to apply to "Say on Pay" resolutions. More significantly, RiskMetrics will expand the policy to include an analysis of the alignment of the CEO's TDC and the company's performance (as measured by TSR) over a time horizon of at least five years, focusing particularly on companies that have underperformed their GICS peer group over a sustained period. Thus, while a year-over-year increase in the CEO's TDC will remain a key consideration in assessing the pay-for-performance relationship, there will be additional emphasis on the long-term trend of the CEO's TDC relative to the company's TSR.

As a result of this change, in determining whether a company has a "pay-for-performance" disconnect, RiskMetrics will focus on two key factors:

- Whether a company's one-year and three-year TSR are in the bottom half of its GICS peer group; and
- Whether the TDC of a CEO who has served at least two consecutive fiscal years is aligned with the company's TSR over time, including both recent and long-term periods.

RiskMetrics will also consider whether the CEO's TDC has increased (or decreased) over the prior year – and the magnitude of the change, as well as the mix of performance-based compensation relative to total compensation. For this purpose, conventional stock options and time-vested restricted stock are not considered to be performance-based compensation.

Where RiskMetrics identifies a misalignment between CEO compensation and company performance with regard to shareholder value, it may recommend a vote "against" a "Say on Pay" resolution and/or a "withhold vote" or a vote "against" the election of directors (generally compensation committee members).

Where a significant portion of the CEO's misaligned compensation is attributable to equity awards, and if there is an equity plan proposal being submitted for shareholder approval in which the CEO participates, RiskMetrics will recommend a vote "against" the proposal. Additional considerations in recommending a vote "against" the equity plan proposal may include, but are not limited to, the magnitude of the CEO's pay increase in the last fiscal year, the source of a pay increase (cash or equity), and the proportion of equity awards granted in the last fiscal year concentrated at the named executive officer level.

To facilitate this "pay-for-performance" analysis (and, perhaps more importantly, to minimize misunderstandings), where a company uses performance-based incentives, RiskMetrics encourages full and complete disclosure in the Compensation Discussion and Analysis of the relevant performance measures and associated target levels (as well as the formula for any non-GAAP financial measure) so that it can assess the rigor of the incentives and better understand the pay-for-performance link.

A company that is found to have a "disconnect" may be able to avoid an unfavorable vote recommendation if it makes a renewed commitment to "pay-for-performance." In RiskMetrics' view, this commitment will need to be tailored to the underlying issues identified in the "pay-for-performance" disconnect. For example, if the primary source of a compensation increase is time-vested equity awards, a renewed commitment may be for the company to agree to make a substantial portion of future equity awards to its named executive officers performance-based. For this purpose, a "substantial" portion of performance-based awards will be at least 50% of the shares (and not value) awarded to each named executive officer, and "performance-based" equity means awards that are earned or paid out based on the achievement of pre-established performance objectives.

Observations. The changes that RiskMetrics has made to its "pay-for-performance" policy reflect a significant expansion of the policy in two respects. First, the number of situations where a company may be identified as having a "pay-for-performance" disconnect is likely to increase. 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 even if the CEO's TDC has remained flat or even marginally decreased in the last fiscal year.

To allay concerns about this change, RiskMetrics has indicated that it will consider all of the following factors in its evaluation:

- whether the CEO's TDC has increased or decreased, and the magnitude of the change;
- the reason for the change in TDC with respect to the pay mix (that is, performance-based versus non-performance-based compensation elements); and
- the long-term (at least five years) alignment of the CEO's TDC with the company's TSR, with particular focus on the most recent three years.

Second, although RiskMetrics willingness to spare companies an unfavorable vote recommendation if they are willing to make a renewed commitment to pay-for-performance provides a needed degree of flexibility to the policy, this is likely to be viewed negatively by some companies with RiskMetrics seen as using its leverage to dictate the design and operation of the executive compensation programs of companies that it considers to be poor performers. This development is likely to be met with alarm by the business community, particularly at a time when concerns are on the rise about RiskMetrics' influence in light of the elimination of broker discretionary voting of uninstructed shares in uncontested director elections.

Problematic Pay Practices

For several years, RiskMetrics has been identifying what it considers to be "poor pay practices," the presence of which may result in a "withhold vote" or "against" recommendation for directors (particularly, the CEO and compensation committee members) who are up for re-election. Under the new Executive Compensation Evaluation policy, companies will continue to be evaluated on a case-by-case basis for "egregious pay practices" that may lead to a negative vote recommendation as follows:

- Initially, against a "Say on Pay" resolution (assuming one is being submitted for shareholder action);
- "Withhold vote" or "against" compensation committee members (or, in instances where the entire board of directors is deemed responsible for the practice, all directors, including the CEO) in egregious situations, or when no "Say on Pay" resolution is on the ballot, or when the board has failed to respond to concerns raised in prior "Say on Pay" evaluations; and
- Against an equity plan proposal if excessive non-performance-based equity awards are the major contributor to a pay-for-performance misalignment.

The following non-exclusive list reflects examples of the type of practices that are the most problematic and, thus, could result in a "withhold vote" or an "against" recommendation on a stand-alone basis, in the absence of any mitigating factors:

- "Egregious" employment contracts (that is, contracts containing multi-year guarantees for salary increases, non-performance-based bonuses, and equity compensation);
- A new CEO with an overly generous new hire package, including a package with excessive "make whole" provisions without a sufficient rationale or any of the pay practices reflected in the policy;
- "Abnormally large" bonus payouts without a justifiable performance linkage or proper disclosure, including arrangements where performance metrics have been changed, canceled, or replaced during the performance period without an adequate explanation of the action and the link to performance;
- "Egregious" pension or supplemental executive retirement plan ("SERP") payouts, including arrangements that include additional years of unworked service that result in significant additional benefits or include long-term equity awards in the pension calculation;
- Excessive perquisites, including perquisites for former or retired executives, such as lifetime benefits, car allowances, personal use of corporate aircraft, or other inappropriate arrangements, and extraordinary relocation benefits (including home buyouts) for current executives;
- Excessive severance or change-in-control provisions that involve practices such as change-in-control payments with a multiplier in excess of three times base salary and target bonus, "single trigger" change-in-control payments without loss of job or a substantial diminution of job duties, new or materially amended employment or severance agreements that provide for modified "single triggers" under which an executive may voluntarily leave for any reason and still receive the change-in-control package, and new or materially amended employment or severance agreements that

provide for an excise tax gross-up (modified gross-ups will be treated in the same manner as full gross-ups);

- Reimbursement of income taxes on certain executive perquisites or other payments (for example, personal use of corporate aircraft, executive life insurance, or bonuses);
- Dividends or dividend equivalents paid on unvested performance shares or units;
- Executives using company stock in hedging activities, such as "cashless" collars, forward sales, equity swaps, or other similar arrangements; and
- Repricing or replacing of underwater stock options or stock appreciation rights without prior shareholder approval (including cash buyouts).

Other suspect pay practices that may lead to a "withhold vote" or an "against" recommendation or that may result in a cautionary warning from RiskMetrics include:

- Excessive severance or change-in-control provisions that involve practices such as payments upon an executive's termination of employment in connection with performance failure or a liberal "change-in-control" definition in individual agreements or equity plans which could result in payments to executives without an actual change-in-control occurring;
- Overly generous perquisites, including, but not limited to, the personal use of corporate aircraft, personal security systems maintenance or installation, car allowances, and executive life insurance; and
- An excessive differential between the total compensation of the CEO and that of the next most highly-compensated executive officer.

In addition, the voluntary surrender of underwater options by a company's executives may be viewed as an indirect stock option repricing or exchange program, especially if the shares underlying the cancelled options are returned to the equity plan where they can be regranted to executives at a lower exercise price and the executives subsequently receive unscheduled awards in the future.

Observations. These "egregious pay practices" are effectively the current version of RiskMetrics' historic "poor pay practices," which it has taken into consideration in formulating its voting recommendations. Clearly, they will continue to have a significant impact on whether RiskMetrics is willing to support the re-election of a company's directors (particularly compensation committee members) and equity plan proposals. Companies should review their existing executive compensation arrangements in light of this list to identify any potentially problematic program features. For example, companies with severance arrangements that contain a modified "single-trigger" provision or allow accelerated vesting of outstanding equity awards even where a proposed change-in-control transaction is not consummated may want to re-evaluate the merits of such provisions.

Compensation and Risk

Given the current focus on the relationship between executive compensation and excessive risk-taking, RiskMetrics' evaluation of problematic pay practices will also include consideration of whether a company's incentive compensation plans may motivate inappropriate risk-taking by its executives. This will involve an assessment of a company's compensation policies and practices that could potentially encourage excessive risk-taking, such as:

- Guaranteed bonuses;
- The use of a single performance metric for short-term or long-term incentive compensation plans;
- Lucrative severance packages;
- High pay opportunities relative to industry peers;
- Disproportionately large supplemental pensions; and
- "Mega annual" equity awards that provide unlimited upside with no downside risk.

This assessment will also consider the extent to which program features such as clawback policies or stock ownership and holding requirements may mitigate this risk.

Observations. RiskMetrics consideration of the risk aspects of executive compensation programs is not unexpected, although, given the novelty of the issue, it will likely take more than a single proxy season to develop an appreciation of how this issue will influence its vote recommendations. Like most companies, RiskMetrics will undoubtedly be looking to next year's proxy disclosures to better understand how companies (and industries) view and manage risk in the context of their executive compensation pro-

RiskMetrics Issues Policy Updates for 2010 Proxy Season (continued)

grams. Still, the introduction of this item into the evaluation process will give RiskMetrics another potent vehicle for recommending a "withhold" or "against" vote for compensation committee members if they are found to have approved pay practices that are considered to encourage excessive risk-taking.

The compensation policies and practices that have been identified by RiskMetrics as potentially encouraging excessive risk-taking should be helpful to companies when conducting their own risk assessments, as they reflect many of the key areas where companies are likely to focus their attention when responding to the anticipated new SEC proxy disclosure requirements on compensation-related risks.

Updated Burn Rate Table

Each year, RiskMetrics updates its "burn rate" table and allowable limits for the upcoming proxy season. "Burn rate" is measured using the total number of time-based equity awards (stock and options) granted in a given year and performance-based equity awards paid in a given year and is expressed as a percentage of the number of common shares outstanding. This table sets the acceptable burn rate limits using global industry classification standard ("GICS") codes.

Currently, RiskMetrics will recommend a vote "against" an equity plan proposal if the company's average three-year burn rate exceeds the greater of:

- the mean plus one standard deviation of the company's GICS peer group segmented on the basis of whether or not it is in the Russell 3000; or
- two percent of the company's weighted common shares outstanding.

RiskMetrics has updated its burn rate table for 2010 below.

If a company grants both full value awards and stock options, RiskMetrics applies a premium or "multiplier" to the full value awards for the past three fiscal years to equate them economically with stock options. For 2010, this premium or "multiplier," is unchanged from 2009, as shown on the following page:

2010 Burn Rate Table

		Russell 3000				Non-Russell 3000			
GICS	Description	Mean	Standard Deviation	Mean + SDEV	Change from 2009	Mean	Standard Deviation	Mean + SDEV	Change from 2009
1010	Energy	1.07%	1.08%	2.14%	-30.7%	2.04%	2.26%	4.30%	-16.5%
1510	Materials	0.94%	0.68%	1.63%	-23.8%	1.97%	2.57%	4.54%	19.5%
2010	Capital Goods	1.10%	0.85%	1.95%	-44.6%	2.07%	2.62%	4.69%	-8.9%
2020	Commercial Services & Supplies	1.67%	1.23%	2.89%	-27.9%	1.82%	1.71%	3.53%	-24.7%
2030	Transportation	1.20%	0.93%	2.13%	-33.0%	1.36%	0.95%	2.31%	-33.0%
2510	Automobiles & Components	1.36%	1.63%	2.99%	-2.0%	1.36%	1.63%	2.99%	-2.0%
2520	Consumer Durables & Apparel	1.76%	1.21%	2.97%	-13.7%	1.56%	1.81%	3.37%	-29.6%
2530	Hotels Restaurants & Leisure	1.69%	1.11%	2.80%	-15.7%	1.52%	1.65%	3.17%	-38.3%
2540	Media	1.36%	0.93%	2.28%	-29.8%	2.14%	1.88%	4.03%	-34.3%
2550	Retailing	1.69%	1.41%	3.10%	-0.6%	2.19%	1.82%	4.01%	-13.2%
3010, 3020, 3030	Food & Staples Retailing	1.25%	1.67%	2.92%	-6.4%	1.52%	1.65%	3.17%	-28.8%
3510	Health Care Equipment & Services	2.19%	1.46%	3.65%	-16.9%	3.77%	4.16%	7.92%	19.3%
3520	Pharmaceuticals & Biotechnology	3.19%	1.97%	5.16%	-10.4%	4.52%	4.05%	8.58%	-9.3%
4010	Banks	1.02%	1.04%	2.05%	-6.0%	0.81%	1.31%	2.12%	-26.6%
4020	Diversified Financials	2.21%	2.94%	5.15%	-7.4%	4.25%	4.05%	8.30%	-24.9%
4030	Insurance	1.07%	0.94%	2.02%	-9.0%	1.03%	1.28%	2.31%	-51.0%
4040	Real Estate	0.56%	0.49%	1.04%	-49.3%	0.99%	2.14%	3.13%	9.8%
4510	Software & Services	3.15%	2.32%	5.47%	-19.1%	4.32%	3.26%	7.58%	-25.1%
4520	Technology Hardware & Equipment	2.60%	2.18%	4.79%	-13.2%	3.32%	3.76%	7.08%	12.4%
4530	Semiconductors & Semiconductor Equipment	2.94%	1.88%	4.82%	-15.7%	4.33%	2.98%	7.31%	-6.2%
5010	Telecommunication Services	1.30%	1.20%	2.50%	-33.2%	2.63%	2.45%	5.08%	-14.2%
5510	Utilities	0.41%	0.39%	0.80%	-51.2%	0.76%	0.88%	1.64%	-11.8%

RiskMetrics Issues Policy Updates for 2010 Proxy Season (continued)

Stock Price Volatility	Multiplier
54.6% or higher	1 full-value award will count as 1.5 option shares
36.1% or higher and less than 54.6%	1 full-value award will count as 2.0 option shares
24.9% or higher and less than 36.1%	1 full-value award will count as 2.5 option shares
16.5% or higher and less than 24.9%	1 full-value award will count as 3.0 option shares
7.9% or higher and less than 16.5%	1 full-value award will count as 3.5 option shares
Less than 7.9%	1 full-value award will count as 4.0 option shares

Where a company does not meet RiskMetrics applicable burn rate cap, it can avoid an "against" vote recommendation for an equity plan proposal if it commits to a prospective gross three-year average burn rate (excluding options with a reload feature granted prior to 2005) equal to the higher of 2% of the company's common shares outstanding or the mean plus one standard deviation of its GICS peer group. The company's burn rate may exceed the GICS peer group average in the first two years, as long as the prospective three-year average burn rate remains below the commitment level.

This commitment must be publicly disclosed, either in a current report on Form 8-K or in the company's definitive proxy statement.

Observations. In the case of Russell 3000 companies, burn rate limits decreased across the board. For technology and life sciences companies, these reductions are as follows:

- for software and services companies, from 6.76% to 5.47%
- 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 non-Russell 3000 companies, the burn rate limits also generally decreased. For technology and life sciences companies, the limits changed 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%

While the volatility premium or "multipliers" for full value awards did not change, the volatility assumption sampling period did change (from a 400-day to a 200-day period), as noted below, which should result in higher conversion rates for at many companies, which will put further pressure on burn rate limit compliance.

Volatility Assumptions in Equity Plan Proposals

Under RiskMetric's Shareholder Value Transfer ("SVT") and burn rate policies, stock price volatility is calculated using historic daily price movements equivalent to the standard deviation of the stock price over a specified sampling period. In response to the unprecedented volatility levels in the stock market, during 2009 RiskMetrics moved to a 400-day volatility sampling period (from its traditional 200-day sampling period) for purposes of these policies to minimize the possibility of unintended consequences, such as a company's stock option valuations approaching the valuations for full value shares. Further, to counter the problem with many options becoming significantly "underwater," RiskMetrics moved to a 90-day, rather than a 200-day, stock price to minimize any measurement discrepancies.

RiskMetrics has decided to revert to 200-day volatility and stock price sampling periods beginning with the December 1, 2009 data download and for all subsequent quarterly data downloads.

Observations. These shifts were not unexpected as RiskMetrics had indicated that it would wait until fall 2009 to make a decision on whether to return to its previous volatility and stock price measures based on market conditions at that time. The return to the use of the 200-day sampling period and 200-day average stock price are further indications that observers believe that the recent market turnaround is a positive signal of greater market stability for the immediate future. As RiskMetrics has noted, at present the 200-day volatility values for many companies are now actually lower than a 400-day volatility measurement.

Stock Option Repricings and Exchanges

The volatility in the markets during 2009 led to a marked increase in stock option repricing and exchange programs. Companies seeking to avoid a negative vote recommendation from RiskMetrics (with respect to programs submitted for shareholder approval) tended to structure such programs as "value-for-value" exchanges, reset vesting schedules as a condition of participation, and exclude named executive officers and directors from the program. Moreover, programs that were not submitted for shareholder approval tended to trigger "withhold vote" or "against" recommendations for compensation committee members without regard to whether their terms aligned with RiskMetrics' preferred structure.

RiskMetrics offers the following additional guidance to companies considering such programs:

- Only deeply "underwater" options (rather than marginally "underwater" options) should be eligible for the program, especially if the company has a history of significant stock price volatility.
- As a "rule of thumb," the threshold exercise price for eligible options should 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).

This rule of thumb should not be considered in isolation, however, as there are several 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, which may influence the evaluation of the program. Further, a company's current stock price can be a consideration as well. A premium of 50% for a company with stock trading at $1.00 per share may be deemed too low of a threshold if the company's stock price is particularly volatile.

A company should also provide disclosure clearly identifying the various levels of employees (management versus non-management) who will be eligible to participate in the program to avoid any assumption that the equity awards are being granted primarily to management. Absent such disclosure, RiskMetrics will assume that the equity awards are generally weighted towards management-level employees.

Observations. In light of the recent market turnaround, RiskMetrics has begun to take a harder line with respect to the approval of exchange programs even though companies may still have retention problems related to "underwater" stock options.

For example, previously RiskMetrics would not endorse an exchange program unless it was limited to outstanding stock options with exercise prices in excess of the company's 52-week stock price high. Now it has determined that, while using a company's 52-week stock price high as the threshold exercise price for program eligibility may be reasonable in a depressed economy, it may not be appropriate in the midst of a market rebound, as the 52-week high may be its current stock price (suggesting that the "underwater" options are only marginally "underwater.")

This additional guidance on determining option eligibility for program participation represents a significant policy shift and may pose a problematic hurdle for some companies. While this standard will be applied on a case-by-case basis, which allows companies some leeway to argue their individual situation where the standard cannot be satisfied, undoubtedly it will make it more difficult for some companies to implement an exchange program at a time of their choosing.

Stock Option "Overhang" Issues

In considering a share reserve increase request, RiskMetrics takes the position that companies with sustained positive stock performance and high overhang cost attributable to "in-the-money" stock options that have been outstanding in excess of six years may receive a carve-out of these options from their overhang calculation as long as the dilution attributable to a new share request is reasonable and the company exhibits sound compensation practices. To receive this preferential treatment, the company must demonstrate that these long-term "in-the-money" options have been continuously

RiskMetrics Issues Policy Updates for 2010 Proxy Season (continued)

"in-the-money" after they were vested. This will require submitting detailed information about the individual tranches of each option, including grant dates, exercise prices, and vesting schedules so that RiskMetrics can determine the portion of the options that are eligible for the carve-out. RiskMetrics cites the supplemental materials to its definitive proxy statement filed by Myriad Genetics on October 28, 2009 as an example of a company that has provided adequate information about continuously "in-the-money" long-term options.

Additional details about this carve-out policy are as follows:

- "Sustained positive stock performance" is considered to exist where a company demonstrates positive five-year TSR as well as positive year-over-year performance over the past five fiscal years at the time of the analysis. An exception to this five-year lookback may be made if stock performance was negative for the first two years of the period and then strongly positive for the remaining three years. Vested options that have been "underwater" for a substantial time during the five-year period, however, will not be eligible for the carve-out. These options should be deeply "in-the-money" for the periods where the company's stock performance was only high for the latest three years.
- RiskMetrics will take the ongoing global recession into consideration when evaluating a company's stock performance during this period.
- "High overhang cost" means that the sum of outstanding stock options and other stock awards and the shares remaining available for future issuance under existing equity plans should exceed or approach a company's specific allowable cap in the RiskMetrics' dilution model. Outstanding options and stock awards must be a significant driver of the high overhang, and should be in the range of 75%–100% of the total overhang.

In applying the carve-out policy, RiskMetrics will also consider a company's "concentration ratio (that is, the distribution of equity awards between executives and other employees). Specifically, it will look at the total equity awards granted to the company's named executive officers during the past fiscal year divided by the total equity awards made to all employees and directors during the past fiscal year. Concentration ratios in excess of 50% may raise concerns that preclude the application of the policy.

Implications of Updated Policies

With the looming implementation of "Say on Pay," companies are likely to be more interested than ever in RiskMetrics' policy positions. RiskMetrics response to this increased interest – an integrated Executive Compensation Evaluation policy – should make it easier for companies to identify potential "red flags" in their executive compensation programs and fashion an appropriate response to avoid negative vote recommendations.

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 and equity compensation picture.

Companies with unusual compensation structures or that find themselves making decisions that may deviate from their previously-disclosed program should treat their CD&A 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 compensation policies. If you have any questions on the topics covered in this Thoughtful Pay Alert or would like assistance in assessing how the policies are likely to affect your executive compensation program, please feel free to contact us.

To obtain a copy of the RiskMetrics "US Corporate Governance Policy – 2010 Updates," please click here »

To obtain a copy of the Frequently-Asked Questions on RiskMetrics Executive Compensation Policies, please click here »

About Compensia

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

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