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Client Alert

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RiskMetrics 2010 Policy Updates:
Test of Pay for Performance and List of Problematic Pay Practices Fine-Tuned

Proxy advisory firm RiskMetrics Group (RMG) has issued important compensation-related updates to its voting policy that will apply to all shareholder meetings held on or after February 1, 2010. Depending on a company's shareholder base, an RMG voting recommendation can have a meaningful impact on the outcome of items submitted to a shareholder vote. RMG will host a webcast on December 10 to further discuss policy updates, which can be found at www.riskmetrics.com/policy.

This Client Alert addresses in Q&A format the important compensation-related updates applicable to U.S. companies, which include:

- **"Pay for Performance" Test**: Revised to take into consideration a longer horizon for company performance
- **"Problematic Pay Practices"**: Clarified and grouped by practices that will automatically trigger adverse voting recommendations, regardless of other factors
- **Risk Assessment**: Includes additional practices and policies RMG will consider in its review of compensation and risk
- **Say on Pay**: Clarified that RMG will express its concerns about pay practices through Say on Pay, if such a vote is available, rather than by a vote against Directors
- **Option Exchanges**: Added new guidance on approaches acceptable to RMG
- **Burn Rates**: Included new acceptable burn rates and calculation methodologies

What is the likely impact of RMG's updated voting recommendations on compensation-related matters?

RMG has four ways in which it may express concern over a company's pay practices, any of which could significantly affect the outcome of items submitted to a shareholder vote:

- Recommending a vote against a management Say on Pay proposal (MSOP);
- Issuing withhold or against vote recommendations for the entire Board of Directors;
- Issuing withhold or against vote recommendations for Compensation Committee members; and/or
- Issuing a recommendation against adoption of an equity plan on the ballot.

Until now, RMG's general policy with respect to a particular pay practice it considered to be "poor" has been to recommend a vote against the election of Board or Committee members or against an equity plan on the ballot. Under the updated 2010 Policy, if the company offers shareholders a Say on Pay vote (which is required of TARP companies and may be extended by the SEC to all public companies), RMG instead will issue a recommendation on that vote. However, RMG indicated it may bypass the Say on

Pay vehicle and vote against Compensation Committee members or the full Board if there are "egregious and continuing pay practices" or the concerns raised through its Say on Pay vote are not sufficiently addressed in the subsequent year.

> ***PM&P Observation:*** *RMG appears to be subtly encouraging companies to offer shareholders a Say on Pay vote by giving the company a year to "clean up" the pay program deemed problematic, before it recommends a vote against Directors.*

How has RMG's "Pay for Performance" test changed?

If RMG detects a disconnect between CEO pay and performance as measured by total shareholder return (TSR), otherwise known as the Pay for Performance test, it may take one or a combination of the four adverse actions listed above. The 2009 Policy had focused on whether the CEO's total direct compensation (TDC) increased in a year when the company ranked in the bottom half of its industry group (e.g., the company's 4-digit Global Industry Classification Standards (GICS) group developed by S&P) with respect to both its 1- and 3-year TSR. If so, RMG scrutinized the compensation practices to determine if adverse action should be taken.

The 2010 Policy has refined the Pay for Performance test to take a more holistic approach, by expanding consideration of the CEO's TDC in relation to TSR over a period of five years. Under this new Pay for Performance test, if both the 1- and 3-year TSRs are below a company's industry group median and the CEO has served for at least two fiscal years, RMG will consider all of the following factors in its voting recommendation:

- Whether the CEO's pay has increased *or decreased*, and the magnitude of the change;
- The reason for the change in pay with respect to the pay mix (i.e., performance-based versus non-performance-based 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 previous three years.

It is important to note that even if the CEO's pay is *unchanged* or has *marginally decreased,* under the new policy RMG will recommend a negative vote on Say on Pay and/or the election of Directors if it finds a significant misalignment between CEO pay and performance. Moreover, if more than half of the increased TDC is attributable to non-performance-based equity compensation, RMG may also recommend a vote against the equity plan in which the CEO participates. However, if a company identified as having such a disconnect makes a renewed commitment to pay for performance, RMG may reconsider taking adverse action.

> ***PM&P Observation:*** *We believe the RMG's formulation of TSR and TDC in the Pay for Performance test remains far too granular and may produce many "false positive" results[1]. RMG has attempted to alleviate this issue, in part, by stating that: (i) increases in the CEO's TDC due to assumptions about pension calculations may be disregarded in certain scenarios, and (ii) matching equity grants with the corresponding year of performance will be considered for purposes of calculating year-over-year TDC changes, but only if a supplemental table is provided in the CD&A with the information needed to value the grant.*

[1] For a detailed analysis of problems inherent in the Pay for Performance test, please see the comment letter submitted by PM&P to RMG at http://pearlmeyer.com/knowledgecenter/alerts/RMGCommentLetter.11.11.09.pdf

How have RMG's "Problematic Pay Practices" been updated for 2010?

For several years, RMG has annually refined a list of "poor pay practices" that may warrant negative voting recommendations, while reiterating that each practice is considered in the context of the company's overall pay program. However, it became obvious in 2009 that some poor pay practices were considered more toxic than others (e.g., excise tax gross-ups in new or materially amended contracts) and could trigger adverse RMG recommendations, regardless of other factors.

In its 2010 Policy update, RMG has renamed its list "problematic practices" and has further designated each item as either "egregious" or "bad," with the former potentially resulting in an automatic negative voting recommendation.

The designated "egregious" pay practices include:

- <u>Egregious employment contracts</u> with multi-year guarantees for salary increases, non-performance based bonuses and/or equity compensation

- <u>Overly generous new hire package for CEOs</u> with excessive "make whole" provisions, absent sufficient rationale, or other problematic pay practices listed in the policy

- <u>Abnormally large bonus payouts without justifiable performance linkage or proper disclosure</u>, including performance metrics that are changed, canceled or replaced during the performance period without adequate explanation of the action and its link to performance

- <u>Egregious pension or SERP payouts</u>, such as counting additional years of service not worked that result in significant new benefits or including performance-based equity awards in the pension calculation

- <u>Excessive Perquisites</u> for former and/or retired executives, such as lifetime benefits, car allowances, personal use of corporate aircraft, extraordinary relocation benefits (including home buyouts), or other arrangements deemed inappropriate

- <u>Excessive severance and/or change-in-control (CIC) provisions</u>, such as:
  - CIC payments exceeding 3 times base salary and bonus
  - CIC payments without loss of job or substantial diminution of job duties (single-trigger)
  - New or materially amended employment or severance agreements that provide for modified single triggers, such that an executive could voluntarily leave for any reason and receive CIC severance
  - New or materially amended employment or severance agreements that provide for a full or modified excise tax gross-up

- <u>Reimbursement of income taxes</u> on executive perquisites or other payments such as personal use of corporate aircraft, executive life insurance, bonus, etc. (see excise tax gross-ups, above)

- <u>Miscellaneous Actions</u>
  - Dividends or dividend equivalents paid on unvested performance shares or units
  - Use of company stock in hedging activities, such as "cashless" collars, forward sales, equity swaps or similar arrangements
  - Repricing or replacing of underwater stock options/stock appreciation rights without prior shareholder approval (including cash buyouts)

Other problematic pay practices that will be considered by RMG (but will not in and of themselves cause a negative vote recommendation) include:

- Excessive severance and/or CIC provisions, such as payments upon an executive's termination in connection with performance failure or liberal changes in the definition of CIC that could provide payment absent an actual CIC

- Overly generous perquisites, including but not limited to personal use of corporate aircraft; personal security systems maintenance and/or installation; car allowances; and executive life insurance

- Internal pay disparity, such as excessive differential between the total pay of the CEO and the next highest-paid named executive officer (NEO)

- Voluntary surrender of underwater options by executive officers, which may be viewed as an indirect option repricing/exchange program, especially if the cancelled options are returned to the equity plan where they could be re-granted to executive officers at a lower exercise price, and/or the executives subsequently received unscheduled grants

- Other pay practices deemed problematic but not covered in the categories above

What is RMG's new policy on compensation-related risk?

The 2010 Policy updates put increased emphasis on risk-taking. While not clarifying whether risk-related activities are "egregious" or merely "bad," RMG will assess compensation-related policies that it believes could encourage excessive risk-taking, including:

- Guaranteed bonuses
- A single performance metric used for short- and long-term plans
- Lucrative severance packages
- High pay opportunities relative to industry peers
- Disproportionately high supplemental pensions
- Mega annual equity grants that provide unlimited upside but no downside risk

RMG will consider as potentially mitigating factors the existence of rigorous clawback provisions and robust stock ownership/holding guidelines.

What is RMG's updated guidance on option exchange programs?

RMG has emphasized that option exchanges should be a last resort tool to re-incentivize employees and used only in the case of options that are deeply underwater. In addition to the need for shareholder-friendly features such as value-for-value exchanges, the exclusion of officers and Directors and prior shareholder approval, RMG offers some further guidance in the 2010 policy:

- The threshold exercise price for eligible options should be the higher of the stock's 52-week high or 50% (or more for low value stocks) above the current stock price. Previously, RMG required using only the 52-week high as the threshold exercise price in the context of an exchange.

- The company should disclose to shareholders the eligibility for management and/or non-management, since institutional investors otherwise may assume that equity grants are generally awarded to management.

What is the significance of RMG's Burn Rate Policy?

RMG will vote against a new or amended equity plan if a company's 3-year average burn rate exceeds the greater of: (1) the mean plus one standard deviation of the company's GICS group segmented by Russell 3000 index and non-Russell 3000 index; or (2) 2% of the weighted common shares outstanding. Companies may avoid a negative vote recommendation by agreeing to a maximum future 3-year burn rate of the higher of 2% or the industry group's mean plus one standard deviation.

Have the volatility and stock price periods for computing burn rates changed?

In light of the recovering market and increased stability, RMG is reverting to a 200-day period for measuring both volatility and average stock price measurement, beginning with the 12/09 quarter. Previously, in the wake of the 2008 economic crises, RMG had extended the stock price volatility period used for its burn rate policy and plan cost analysis from 200 to 400 days and reduced the stock measurement period from 200 days to 90 days. This effectively minimized the measurement discrepancy in valuing potential underwater options for the 12/08, 3/09, 6/09 and 9/09 quarterly downloads.

What are the new allowable burn rates for 2010?

Updated burn rate caps for Russell 3000 and Non-Russell 3000 GICS groups are shown below compared to 2009; notably, 2010 burn rates significantly declined in most sectors.

		Mean + Standard Deviation			
		Russell 3000		Non-Russell 3000	
GICS	Description	2009	2010	2009	2010
1010	Energy	3.09%	2.14%	5.15%	4.30%
1510	Materials	2.14%	1.63%	3.80%	4.54%
2010	Capital Goods	3.52%	1.95%	5.15%	4.69%
2020	Commercial Services & Supplies	4.01%	2.89%	4.69%	3.53%
2030	Transportation	3.18%	2.13%	3.45%	2.31%
2510	Automobiles & Components	3.05%	2.99%	3.05%	2.99%
2520	Consumer Durables & Apparel	3.44%	2.97%	4.79%	3.37%
2530	Hotels Restaurants & Leisure	3.32%	2.80%	5.14%	3.17%
2540	Media	3.25%	2.28%	6.13%	4.03%
2550	Retailing	3.12%	3.10%	4.62%	4.01%
3010 3020 3030	Food & Staples Retailing	3.12%	2.92%	4.45%	3.17%
3510	Health Care Equipment & Services	4.39%	3.65%	6.64%	7.92%
3520	Pharmaceuticals & Biotechnology	5.76%	5.16%	9.46%	8.58%
4010	Banks	2.18%	2.05%	2.89%	2.12%
4020	Diversified Financials	5.56%	5.15%	11.05%	8.30%
4030	Insurance	2.22%	2.02%	4.71%	2.31%
4040	Real Estate	2.05%	1.04%	2.85%	3.13%
4510	Software & Services	6.76%	5.47%	10.12%	7.58%
4520	Technology Hardware & Equipment	5.52%	4.79%	6.3%	7.08%
4530	Semiconductors &Semiconductor Equipment	5.72%	4.82%	7.79%	7.31%
5010	Telecommunication Services	3.74%	2.50%	5.92%	5.08%
5510	Utilities	1.64%	0.80%	1.86%	1.64%

How are full-value shares converted to option equivalents for purposes of the burn rate calculation?

No changes were made to the existing six volatility categories for converting full-value shares to option equivalents in calculating the burn rate, which remain as follows:

Stock Price Volatility	Multiplier
54.6% and 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

What should your company be doing now?

- Decide whether your company should voluntarily include an MSOP for the 2010 proxy season. Most observers believe a Say on Pay vote will be required for all public companies by 2011 at the latest. The cost of early adoption should be weighed against the benefit of a one-year pass on adverse director recommendations if your pay practices are deemed to be outside RMG's guidelines.

- Check your company's TSR with respect to the RMG industry group. RMG periodically updates its website to show which companies are failing the median performance test. If your company is on the list, be prepared to work with RMG to explain mitigating factors.

- Assess your company's programs against RMG's new list of problematic practices. Educate your Directors regarding RMG's new differentiation between "egregious" and "bad" practices, as well as its views on compensation-related risk.

About Pearl Meyer & Partners

For 20 years, PM&P has served as a trusted independent advisor to Boards and their senior management in the areas of compensation governance, strategy and program design. The firm provides comprehensive solutions to complex compensation challenges through the development of programs that align rewards with business goals to create long-term value for all stakeholders: shareholders, executives and employees. The firm maintains offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, Los Angeles and San Jose.

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