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*Client Alert*

# RiskMetrics' 2010 Policy Updates

EXEQUITY

Independent Board and Management Advisors

On November 19, 2009, RiskMetrics Group released its updated policies for 2010.[1] These included policy updates to the U.S. Corporate Governance Policy as well as the International Corporate Governance Policy and region-/country-specific policy updates for Europe and Canada.

This Client Alert summarizes the key changes to the U.S. Corporate Governance Policies involving compensation (but note that the scope of the U.S. updates is broader).

## Changes for Shareholder Value Transfer (SVT) and Burn Rate Policies

RiskMetrics announced that it would revert to the pre-2009 methodology for determining stock price and volatility for purposes of its SVT and Burn Rate Policies. This means that for shareholder meetings on or after February 1, 2010, RiskMetrics will use the ***200-day average stock price*** and the ***200-day volatility*** when determining the SVT and a company's burn rate as part of its analysis of a company's share proposal.

## Burn Rate Maximums

RiskMetrics also released an ***updated GICS industry group burn rate table*** used to determine if a company's burn rate is excessive, i.e., if it exceeds the higher of (i) its four-digit GICS industry group median burn rate plus one standard deviation, or (ii) 2 percent (the maximum permitted under RiskMetrics' Burn Rate Policy). We have included this table in the Appendix to this Client Alert. The maximum burn rates set out in RiskMetrics' burn rate table for each GICS group have dropped compared to the 2009 table. The greatest change was a decrease of almost 52 percent for GICS 5510, Utilities, and the smallest change was a decrease of less than 1 percent for GICS 2550, Retailing.

## Pay-for-Performance Changes

RiskMetrics has added an additional consideration under its Pay-for-Performance Policy—the consideration of the alignment of a CEO's total direct compensation (TDC) and total shareholder return (TSR) over a period of at least five years.

Companies that grant equity awards at the beginning of a fiscal year based on an analysis of the company's or individual's performance during the prior fiscal year may have an issue under RiskMetrics' pay-for-performance analysis unless they provide sufficient information to enable RiskMetrics to sufficiently understand and incorporate such grants into its analysis. All such information should be included in the proxy statement itself—RiskMetrics will not go searching for this information.

[1] All of these policy updates can be accessed from the 2010 Policy Information page on RiskMetrics' Web site, at http://www.riskmetrics.com/policy/2010/policy_information.

## Problematic Pay Practices Changes

In addition to the U.S. Corporate Governance Policy Updates, RiskMetrics issued a set of Frequently Asked Questions (FAQs) related to its compensation policies.[2] Both of these documents introduced a new hierarchy for problematic pay practices (previously referred to as "poor" pay practices)—practices that are sufficient alone to warrant negative vote recommendations from RiskMetrics ("Major" Problematic Pay Practices), and practices that are not sufficient alone to warrant a negative vote recommendation but may be sufficient if a company displays enough of these practices or has other egregious compensation issues ("Minor" Problematic Pay Practices).

### *Problematic Pay Practices*

| "Major" | "Minor" |
|---|---|
| • Multi-year guarantees for salary increases, non-performance-based bonuses, and equity compensation<br>• Including additional years of service that result in significant additional benefits, without sufficient justification, or including long-term equity awards in the pension calculation<br>• Perquisites for former and/or retired executives, and extraordinary relocation benefits (including home buyouts) for current executives<br>• Change-in-control payments exceeding three times base salary and target bonus<br>• Change-in-control payments without job loss or substantial diminution of duties ("single triggers")<br>• New or materially amended agreements that provide for "modified single triggers"<br>• New or materially amended agreements that provide for an excise tax gross-up (including "modified gross-ups")<br>• Tax reimbursements related to executive perquisites or other payments such as personal use of corporate aircraft, executive life insurance, bonus, etc.<br>• Dividends or dividend equivalents paid on unvested performance shares or units<br>• Executives using company stock in hedging activities, such as "cashless" collars, forward sales, equity swaps, or other similar arrangements<br>• Repricing or replacing of underwater stock options/stock appreciation rights without prior shareholder approval (including cash buyouts and voluntary surrender/subsequent regrant of underwater options) | • Excessive severance and/or change-in-control provisions<br>— Payments upon an executive's termination in connection with performance failure<br>— Liberal change-in-control definition in individual contracts or equity plans which could result in payments to executives without an actual change in control occurring<br>• Overly generous perquisites, which may include, but are not limited to, the following:<br>— Personal use of corporate aircraft<br>— Personal security system maintenance and/or installation<br>— Car allowances<br>— Executive life insurance<br>• Internal pay disparity/excessive differential between CEO total pay and that of next highest-paid executive officer<br>• Voluntary surrender of underwater stock options by executive officers<br>— May be viewed as an indirect repricing/exchange program especially if those cancelled options are returned to the equity plan, as they can be regranted to executive officers at a lower exercise price, and/or executives subsequently receive unscheduled grants in the future<br>• Other pay practices deemed problematic but not covered in any of the above categories |

*Note: It is unclear whether "voluntary surrender of underwater stock options" is a Major or Minor Problematic Pay Practice. RiskMetrics included it in both groups and has not offered guidance on how it will view such a practice.*

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[2] RiskMetrics Group, *2010 Corporate Governance Policy Updates and Process, Frequently Asked Questions on U.S. Compensation* (November 19, 2009) ("Compensation FAQs"); available at http://www.riskmetrics.com/policy/2010_compensation_FAQ.

RiskMetrics announced that as part of its Problematic Pay Practices Policy, it will **assess company policies and practices** related to compensation that **could incentivize excessive risk-taking.** Some **factors** that could **potentially mitigate** the impact of risk incentives are **rigorous clawback provisions** and **robust stock ownership/holding guidelines**.

If a company maintains a "Major" Problematic Pay Practice or several "Minor" Problematic Pay Practices (how many and of what type is still unknown), RiskMetrics may recommend votes:

- First, **against** MSOPs;
- Next, **against/withhold** from compensation committee members or, in rare cases where the full board is deemed responsible for the practice, all directors including the CEO in egregious situations, or when no MSOP item is on the ballot, or when the board has failed to respond to concerns raised by RiskMetrics in prior MSOP evaluations and the poor pay practice continues; and
- Finally, **against** an equity-based incentive plan proposal if excessive non-performance-based equity awards are the major contributor to a pay-for-performance misalignment.

## *FAQs: Equity-Related Questions*

RiskMetrics' Compensation FAQs address a number of equity-related questions:

- ***Option Repricing***—RiskMetrics indicates that only deeply underwater stock options should be eligible for an exchange or other action. As a rule of thumb, this typically means that the threshold exercise price for eligible options should be the higher of the 52-week high or 50 percent above the current stock price. Companies should consider how this relates to their current stock price as well, since a 50 percent premium on a $1 stock price may be perceived by RiskMetrics as a low threshold. Companies also should ensure that they discuss the various levels of employees who will be eligible to participate in the program.
- ***Burn Rate Commitment***—If a company fails to meet RiskMetrics' Burn Rate Policy (i.e., its three-year average burn rate is above its industry median burn rate plus one standard deviation or, if higher, 2 percent), it can commit on a prospective basis in a public securities filing to maintain a gross three-year average burn rate (excluding stock options with a reload feature granted prior to 2005) equal to the higher of 2 percent of the company's common shares outstanding or the mean of its GICS peer group.

  *Comment: We have been informed that this is a typo in the Compensation FAQs and will be corrected so that companies can continue to commit to maintaining their burn rate equal to their GICS industry mean plus one standard deviation.*
- ***Stock Option Overhang Carve-Out***—Companies desiring to utilize this exemption to exclude in-the-money stock options that have been outstanding for more than six years from the SVT analysis must have sustained positive stock price performance and high overhang cost attributable to such options. Specifically, RiskMetrics put several additional requirements in place for companies that want to use this policy, including requirement surrounding: sustained stock price performance; additional proxy disclosures; high overhang costs for outstanding equity awards and shares available under existing plans; and, acceptable equity concentration ratios (number of equity awards granted to named executive officers divided by all equity awards granted to employees and directors).

If you have any questions about this ***Client Alert***, please contact any of the following:


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RMG 2010 Policy Updates_Summary_20091216

# Appendix

### 2010 Burn Rate Table

***RiskMetrics' Burn Rate Table for Shareholder Meetings On or After February 1, 2010***

| | | Russell 3000 | | | Non-Russell 3000 | | |
|---|---|---|---|---|---|---|---|
| GICS | Description | Mean (%) | Std Dev (%) | Mean + Std Dev (%) | Mean (%) | Std Dev (%) | Mean + Std Dev (%) |
| 1010 | Energy | 1.07 | 1.08 | 2.14 | 2.04 | 2.26 | 4.30 |
| 1510 | Materials | 0.94 | 0.68 | 1.63 | 1.97 | 2.57 | 4.54 |
| 2010 | Capital Goods | 1.10 | 0.85 | 1.95 | 2.07 | 2.62 | 4.69 |
| 2020 | Commercial Services & Supplies | 1.67 | 1.23 | 2.89 | 1.82 | 1.71 | 3.53 |
| 2030 | Transportation | 1.20 | 0.93 | 2.13 | 1.36 | 0.95 | 2.31 |
| 2510 | Automobiles & Components | 1.36 | 1.63 | 2.99 | 1.36 | 1.63 | 2.99 |
| 2520 | Consumer Durables & Apparel | 1.76 | 1.21 | 2.97 | 1.56 | 1.81 | 3.37 |
| 2530 | Hotels Restaurants & Leisure | 1.69 | 1.11 | 2.80 | 1.52 | 1.65 | 3.17 |
| 2540 | Media | 1.36 | 0.93 | 2.28 | 2.14 | 1.88 | 4.03 |
| 2550 | Retailing | 1.69 | 1.41 | 3.10 | 2.19 | 1.82 | 4.01 |
| 3010, 3020, 3030 | Food & Staples Retailing | 1.25 | 1.67 | 2.92 | 1.52 | 1.65 | 3.17 |
| 3510 | Health Care Equipment & Services | 2.19 | 1.46 | 3.65 | 3.77 | 4.16 | 7.92 |
| 3520 | Pharmaceuticals & Biotechnology | 3.19 | 1.97 | 5.16 | 4.52 | 4.05 | 8.58 |
| 4010 | Banks | 1.02 | 1.04 | 2.05 | 0.81 | 1.31 | 2.12 |
| 4020 | Diversified Financials | 2.21 | 2.94 | 5.15 | 4.25 | 4.05 | 8.30 |
| 4030 | Insurance | 1.07 | 0.94 | 2.02 | 1.03 | 1.28 | 2.31 |
| 4040 | Real Estate | 0.56 | 0.49 | 1.04 | 0.99 | 2.14 | 3.13 |
| 4510 | Software & Services | 3.15 | 2.32 | 5.47 | 4.32 | 3.26 | 7.58 |
| 4520 | Technology Hardware & Equipment | 2.60 | 2.18 | 4.79 | 3.32 | 3.76 | 7.08 |
| 4530 | Semiconductors & Semiconductor Equipment | 2.94 | 1.88 | 4.87 | 4.33 | 2.98 | 7.31 |
| 5010 | Telecommunication Services | 1.30 | 1.20 | 2.50 | 2.63 | 2.45 | 5.08 |
| 5510 | Utilities | 0.41 | 0.39 | 0.80 | 0.76 | 0.88 | 1.64 |