

# ClientAlert

January 2010

## RiskMetrics 2010 Executive Compensation Policy Updates

Recently, RiskMetrics Group released [updates to its corporate governance policy](#), which governs its proxy voting recommendations for the upcoming 2010 proxy season, and [related 2010 compensation FAQs](#), available on the RiskMetrics website. This client alert summarizes the key points of the executive compensation provisions in the U.S. corporate governance policy 2010 updates and the related 2010 compensation FAQs.

For a description of the updated policy guidelines on U.S. corporate governance matters, please see our separate [client alert](#).

The executive compensation policies for 2010 will be effective for annual meetings beginning on and after February 1, 2010. RiskMetrics may also adopt policies before its next formal annual update to cover new issues that may arise due to regulatory developments and shareholder proposals.

### **New Consolidated Executive Compensation Evaluation Policy**

RiskMetrics has consolidated existing executive compensation policies into a new integrated executive compensation evaluation policy. Under its new executive compensation evaluation policy, RiskMetrics will evaluate (1) pay-for-performance, (2) problematic pay practices, and (3) board communication and responsiveness.

RiskMetrics will apply its executive compensation evaluation policy to recommend a “vote against” or “withhold” vote with respect to compensation-related matters, including elections of directors (mainly compensation committee members), management say on pay (MSOP) proposals and equity plan proposals.

In most cases, if a company has an MSOP proposal on its ballot, RiskMetrics will apply its compensation-related recommendations to the MSOP. However, if RiskMetrics identifies “egregious practices,” or if a company has previously received a negative recommendation with respect to an MSOP resolution related to an ongoing issue, RiskMetrics may recommend a “vote against” or “withhold” vote with respect to compensation committee members or, in some cases, the entire board.

### ***Pay-for-Performance***

RiskMetrics will evaluate the connection between the Chief Executive Officer's (CEO) total direct compensation and the company's stock price. RiskMetrics may determine that there is a potential pay-for-performance disconnect if the company's total shareholder returns (TSRs) are in the bottom half of its four-digit GICS Global Industry Classification Group. The updated corporate governance policy makes clear that RiskMetrics may, in certain cases, find a potential pay-for-performance disconnect even if a CEO's pay has remained unchanged or has been marginally decreased. In addition, RiskMetrics will now assess the potential pay-for-performance disconnect over at least a five-year period.

In its 2010 compensation FAQs, RiskMetrics clarified that pay changes will not, on a stand-alone basis, result in negative recommendations. Instead, if a company's one- and three-year TSRs are below its peer group median, and the CEO has served at least two fiscal years, RiskMetrics will consider the following factors in determining whether there is a pay-for-performance disconnect:

- whether the CEO's pay has increased or decreased in the most recent year-over-year comparison, and the magnitude of such changes;
- the reason for the change in pay with respect to the pay mix (for example, performance versus non-performance); and
- the long-term (at least five years) alignment in the CEO's total direct compensation with the company's TSR, focusing on the most recent three-year period.

If RiskMetrics finds a disconnect in pay-for-performance, it may recommend a "vote against" or "withhold" vote on an MSOP proposal or the election of committee members. If more than half of the increase in the CEO's total direct compensation is attributable to non-performance based equity compensation and there is an equity plan proposal on the ballot, RiskMetrics may recommend a "vote against" or "withhold" vote on an equity plan in which the CEO participates.

RiskMetrics may recommend a vote for the election of compensation committee members if a company with a pay-for-performance disconnect renews its commitment to pay-for-performance. In its 2010 compensation FAQs, RiskMetrics outlines certain steps that a company may take to show its commitment to pay-for-performance. For example, if the primary source of the pay increase is a discretionary bonus, a company may make a renewed commitment to award only performance-based bonuses. The renewed commitment must be made in a public filing such as a Form 8-K or filed proxy solicitation materials.

### ***Problematic Pay Practices***

Under the updated policy, in making recommendations with respect to compensation-related proposals, RiskMetrics will consider whether a company has problematic pay practices. RiskMetrics will evaluate pay practices on a case-by-case basis. RiskMetrics has identified the most problematic pay practices that may warrant a negative recommendation on a stand-alone basis, unless there are mitigating factors. RiskMetrics has also identified other problematic pay practices that may receive a "vote against" or "withhold" vote recommendation or cautionary language. A list of the most problematic pay practices and other problematic pay practices is set forth in Attachment A.

In addition, RiskMetrics will assess whether a company has "risk-motivating" incentive practices such as:

- guaranteed bonuses;
- a single performance metric used for short- and long-term plans;
- lucrative severance packages;
- high pay opportunities relative to industry peers;
- disproportionate supplemental pensions; and
- "mega" annual equity grants that provide unlimited upside with no downside risk.

RiskMetrics will also consider factors that mitigate the impact of risky incentives, such as “rigorous” clawbacks and “robust” stock ownership/holding guidelines.

If RiskMetrics determines that a company maintains problematic pay practices, it will generally recommend:

- a “vote against” on MSOP proposals;
- a “vote against” or “withhold” vote on the election of committee members (or in rare cases the full board) in egregious situations or where there is no MSOP proposal on the ballot or where the board has not responded to issues raised in prior MSOP evaluations; and
- a “vote against” on an equity plan proposal if excessive non-performance-based equity awards are the major contributor to the pay-for-performance disconnect.

### ***Board Communication and Responsiveness***

In evaluating compensation-related proposals, RiskMetrics will also consider board communication and responsiveness, including:

- poor disclosure practices, such as an unclear explanation of how the CEO is involved in the pay setting process or the failure to discuss retrospective performance targets, benchmarking and/or peer group methodology; and
- board responsiveness to investor input and engagement on compensation issues, such as failure to respond to majority-supported shareholder proposals on executive pay topics or failure to respond to concerns raised in connection to significant opposition to MSOP proposals.

### **Equity Plans**

***Option Repricing.*** In evaluating equity plan proposals, RiskMetrics will generally recommend a “vote against” or “withhold” vote on option exchanges unless certain standard shareholder-friendly features are included, such as value-for-value repricing and exclusions from participation of named executive officers and directors. In its 2010 compensation FAQs, RiskMetrics makes clear that option exchanges should be viewed as a last resort by management and should only apply to “deep” (as opposed to “somewhat”) underwater options, especially if the company’s stock is volatile. As a general rule, for purposes of determining whether options are deeply underwater, the exercise price should be the higher of the company’s 52-week high or 50% above the current stock price. However, RiskMetrics may also consider 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. Companies should also consider the company’s current stock price — as RiskMetrics has stated that a 50% premium on a \$1 stock price may be considered to be low. RiskMetrics advises companies to discuss the various levels of employees eligible for the repricing. In the absence of such disclosure, investors may assume that equity grants are generally awarded only to management.

***Burn Rate Commitment.*** In evaluating equity plan proposals, RiskMetrics will consider a company’s three-year burn rate and may recommend to vote against an equity plan proposal if the average three-year burn rate exceeds the greater of (1) the mean plus one standard deviation of the company’s GICS

group segmented Russell 3000 index and non-Russell 3000 index, or (2) 2% of the weighted common shares outstanding.

In its 2010 compensation FAQs, RiskMetrics discusses progressive action a company may take if it fails to meet RiskMetric's three-year burn rate policy. Specifically, RiskMetrics states that a company:

- may commit to a prospective gross three-year average burn rate, which excludes stock options with a reload feature granted before 2005, equal to the higher of (1) 2% of the company's common shares outstanding or (2) the mean plus one standard deviation of its GICS peer group;
- may exceed the three-year burn rate in the first year, as long as the prospective three-year average burn rate remains below the company's commitment level; and
- must notify shareholders of its commitment in public filings, such as a Form 8-K or filed proxy solicitation materials, or the summary plan description of the stock plan proposal in the filed proxy solicitation materials.

RiskMetrics makes clear that a company's burn rate commitment will not guarantee that RiskMetrics will change its voting recommendation, especially where RiskMetrics finds that a company's equity plan will perpetuate a problematic pay practice.

***Stock Option Overhang Carve-Out.*** In determining whether RiskMetrics stock option overhang guidelines are met, RiskMetrics permits companies to carve out certain in-the-money stock options. To rely on this exception:

- the company must have a "sustained positive stock performance" and high overhang cost attributable to in-the-money options outstanding in excess of six years;
- the dilution attributable to the new share request must be reasonable;
- the company must exhibit "sound compensation practices;"
- the company must show that the in-the-money options outstanding in excess of six years have been continuously in-the-money after they were vested; and
- the company should provide a breakdown of options by grant dates, option exercise prices and vesting schedules so RiskMetrics can properly analyze whether the options meet the carve-out exception.

In determining whether there has been a "sustained positive stock performance," RiskMetrics will generally look for positive five-year TSRs as well as a positive year-over-year performance for the last five fiscal years.

Subject to certain exceptions, vested grants that have been underwater for a substantial time during the five-year period will not be eligible for the carve-out.

***Pay-for-Performance.*** The 2010 compensation FAQs also provide guidance on how the timing of equity awards may impact RiskMetrics pay-for-performance evaluations.

## PROBLEMATIC PAY PRACTICES

### Most Problematic Pay Practices

Type	Examples
Egregious Contracts	<ul style="list-style-type: none"> <li>▪ Contracts containing multi-year guarantees for salary increases, non-performance based bonuses, and equity compensation</li> </ul>
New CEO with Overly Generous New-Hire Package	<ul style="list-style-type: none"> <li>▪ Excessive “make whole” provisions without sufficient rationale</li> <li>▪ Any of the problematic pay practices listed in the policy</li> </ul>
Abnormally Large Bonus Payouts Without Justifiable Performance Linkage or Proper Disclosure	<ul style="list-style-type: none"> <li>▪ Includes performance metrics that are changed, canceled or replaced during the performance period without adequate explanation of the action and the link to performance</li> </ul>
Egregious Pension/Supplemental Executive Retirement Plan Payouts	<ul style="list-style-type: none"> <li>▪ Inclusion of additional years of service not worked that result in significant benefits provided in new arrangements</li> <li>▪ Inclusion of performance-based equity awards in the pension calculation</li> </ul>
Excessive Perquisites	<ul style="list-style-type: none"> <li>▪ Perquisites for former and/or retired executives, such as lifetime benefits, car allowances, personal use of corporate aircraft or other inappropriate arrangements</li> <li>▪ Extraordinary relocation benefits (including home buyouts)</li> </ul>
Excessive Severance and/or Change-in-Control Provisions	<ul style="list-style-type: none"> <li>▪ Change-in-control payments exceeding three times base salary and bonus</li> <li>▪ Single-trigger change-in-control payments without a second step loss of job or substantial diminution of job duties</li> <li>▪ 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 severance package</li> <li>▪ New or materially amended employment or severance agreements that provide for an excise tax gross-up</li> <li>▪ Modified gross-ups would be treated in the same manner as full gross-ups</li> </ul>
Tax Reimbursements	<ul style="list-style-type: none"> <li>▪ Reimbursement of income taxes on certain executive perquisites or other payments (for example, personal use of corporate aircraft, executive life insurance, bonus, etc; see also excise tax gross-ups above)</li> </ul>

Dividends or Dividend Equivalents	<ul style="list-style-type: none"> <li>Dividends or dividend equivalents paid on unvested performance shares or units</li> </ul>
Company Stock Hedging Activities	<ul style="list-style-type: none"> <li>Executives using company stock in hedging activities, such as “cashless” collars, forward sales, equity swaps or other similar arrangements</li> </ul>
Underwater Stock Options	<ul style="list-style-type: none"> <li>Repricing or replacing of underwater stock options/stock appreciation rights without prior shareholder approval (including cash buyouts)</li> </ul>
<b>Other Problematic Pay Practices</b>	
Excessive Severance and/or Change-in-Control Provisions	<ul style="list-style-type: none"> <li>Payments upon an executive's termination in connection with performance failure</li> <li>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</li> </ul>
Overly Generous Perquisites	<ul style="list-style-type: none"> <li>Perquisites such as: <ul style="list-style-type: none"> <li>personal use of corporate aircraft</li> <li>executive life insurance</li> <li>personal security systems maintenance and/or installation</li> <li>car allowances</li> </ul> </li> </ul>
Internal Pay Disparity	<ul style="list-style-type: none"> <li>Excessive differential between CEO total pay and that of next highest-paid named executive officer</li> </ul>
Voluntary Surrender of Underwater Options by Executive Officers	<ul style="list-style-type: none"> <li>May be viewed as an indirect option repricing/exchange program especially if canceled options are returned to the equity plan, as they can be regranted to executive officers at a lower exercise price, and/or the executives subsequently receive unscheduled grants in the future</li> </ul>

**Our client alerts are for general informational purposes and should not be regarded as legal advice. If you would like additional information or have any questions, please contact:**

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