



RiskMetrics Group

2010 Corporate Governance Policy Updates and Process

Frequently Asked Questions on U.S. Compensation

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The questions and answers in this FAQ page are intended to provide high-level guidance regarding the way in which RiskMetrics' Global Research Department will generally analyze certain issues in the context of preparing proxy analyses and vote recommendations for U.S. companies. However, these responses should not be construed as a guarantee as to how RiskMetrics' Global Research Department will apply its benchmark policy in any particular situation.

Section 1: Executive Compensation Evaluation

Q1.1: Is the RiskMetrics Executive Compensation Evaluation policy new?

A1.1: The Executive Compensation Evaluation policy is not a new policy. Instead, it integrates three previous RMG policies related to executive pay, which overlapped to some degree, into one comprehensive policy provision. The Executive Compensation Evaluation policy consists of three sections: Pay for Performance, Problematic Pay Practices, and Board Communication and Responsiveness. The policy guidelines in these section include, and replace, what were previously three separate policies: Pay for Performance, Poor Pay Practices, and Advisory Votes on Compensation (Management Say on Pay -- MSOP). Recommendations issued under the Executive Compensation Evaluation policy may apply to any or all of the following ballot items, depending on the pay issue (as detailed in the policy): Election of Directors (primarily compensation committee members), Advisory Votes on Compensation (MSOP), and/or Equity Plan proposals.

Q1.2: If a company has an MSOP resolution on the ballot, will RMG also apply compensation-related recommendations to members of the compensation committee who are up for election?

A1.2: In general, if a company has an MSOP resolution on the ballot, any compensation-related recommendations will be applied to that proposal; however, if egregious practices are identified, or if a company previously received a negative recommendation on an MSOP resolution related to an issue that is still on-going, RMG may also recommend WITHHOLD/AGAINST votes with respect to compensation committee members.

Q1.3. Under RMG's Executive Compensation Evaluation policy, which specific pay practices are considered most problematic and could result in a withhold/against recommendation regardless of other factors?

A1.3. All pay practices are evaluated on a case-by-case basis. However, based on input from client surveys and roundtables, RMG has identified certain adverse practices that are particularly contrary to a performance-based pay philosophy. The list below highlights those that carry greatest weight in this consideration and may result in negative recommendations on a stand-alone basis, in the absence of mitigating factors:

Egregious employment contracts:

- Contracts containing multi-year guarantees for salary increases, non-performance based bonuses, and equity compensation.

New CEO with overly generous new-hire package:

- Excessive "make whole" provisions without sufficient rationale
- Any of the problematic pay practices listed in this policy

Abnormally large bonus payouts without justifiable performance linkage or proper disclosure:

- Includes performance metrics that are changed, canceled or replaced during the performance period without adequate explanation of the action and the link to performance

Egregious pension/SERP (supplemental executive retirement plan) payouts:

- Inclusion of additional years of service not worked that result in significant benefits provided in new arrangements
- Inclusion of performance-based equity awards in the pension calculation

Excessive Perquisites:

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

Excessive severance and/or change in control provisions:

- Change in control payments exceeding 3 times of base salary and bonus
- Change-in-control payments without loss of job or substantial diminution of job duties (single-triggered)
- 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
- New or materially amended employment or severance agreements that provide for an excise tax gross-up. Modified gross-ups would be treated in the same manner as full gross-ups

Tax Reimbursements:

- Reimbursement of income taxes on certain executive perquisites or other payments (e.g., personal use of corporate aircraft, executive life insurance, bonus, etc; see also excise tax gross-ups above)

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.

Repricing or replacing of underwater stock options/stock appreciation rights without prior shareholder approval (including cash buyouts).

Q1.4. Which other pay practices are considered problematic under RMG’s Executive Compensation Evaluation policy?

A1.4. The list below identifies additional problematic pay practices that may receive a withhold/against vote recommendation or cautionary language upon case by case analysis:

Excessive severance and/or change in control provisions:

- Payments upon an executive's termination in connection with performance failure
- 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

Overly generous perquisites, which may include, but are not limited to the following:

- personal use of corporate aircraft
- personal security systems maintenance and/or installation
- car allowances
- executive life insurance

Internal pay disparity:

Excessive differential between CEO total pay and that of next highest-paid named executive officer (NEO)

Voluntary surrender of underwater options by executive officers

- May be viewed as an indirect option 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 the executives subsequently receive unscheduled grants in the future

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

Q1.5. The draft Pay-for-Performance section of RMG’s Executive Compensation Evaluation policy that was posted for comments indicated that a company may be identified as having a potential pay-for-performance disconnect if it has unchanged or marginally decreasing CEO pay in conjunction with below-industry-median 1- and 3-year TSR; and that RMG will also assess the alignment of CEO’s total direct compensation and total shareholder return over a period of at least five years. How will this policy work in practice?

A1.5. RiskMetrics will continue to examine more closely the Russell 3000 companies that have one-year and three-year total shareholder returns in the bottom half of their industry group (i.e., four-digit GICS - Global Industry Classification Group) to determine if there is any pay-for-performance disconnect. This examination will include analysis of the year-over year and long-term changes in total direct compensation of the company’s CEO (provided the CEO has at least two fiscal years’ tenure), including both the direction of the change and the most recent pay elements.

Most comment letters submitted on the draft policy expressed strong approval of considering long-term alignment of pay and shareholder return, but a few expressed concern about how RiskMetrics will determine “marginal” pay decreases and what impact they would have on the evaluation. In response, RMG is clarifying that pay changes will not, on a stand-alone basis, result in unfavorable recommendations. If both of the company’s 1- and 3-year TSRs are below its peer group median, and the CEO has served for at least two fiscal years, RMG will consider all of the following factors in the pay-for-performance evaluation:

- 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- versus non-performance-based elements), and
- the long-term (at least five years) alignment of the CEO’s total direct compensation with the company’s total shareholder returns, with particular focus on the most recent three years.

In cases where a pay-for-performance disconnect is found, RiskMetrics may recommend votes against an MSOP proposal and/or compensation committee members. If more than half of the increase in total direct compensation is attributable to non-performance-based equity compensation, RiskMetrics may recommend a vote against the equity plan in which the CEO participates. If a company with a pay-for-performance disconnect makes a renewed commitment to pay-for-performance, RiskMetrics may recommend a vote FOR the compensation committee members.

Q1.6. Under RiskMetrics’ Pay for Performance evaluation, if an increase in year-over-year compensation is due to assumptions in the pension calculation, will it result in unfavorable vote recommendations on compensation committee members and/or the proposed equity plan?

A1.6. Generally not. However, we could envision scenarios where the change in pension value and deferred compensation was significantly higher due to a special arrangement where the executive has received additional pension years for purposes of his/her retirement package, which may result in withhold vote recommendations from the compensation committee.

Q1.7 RMG has recommended withholds on a company’s compensation committee or recommended against a company’s management say on pay or equity plan proposal on the basis of a CEO pay for performance disconnect. What prospective actions can the company take to address the concerns?

The pay for performance evaluation is a case-by-case analysis. Previously, the pay for performance commitment entailed a number of factors, some of which are no longer progressive in light of the updated SEC disclosure requirements on executive compensation in 2006.

The commitment should be tailored according to the underlying issues identified in the pay for performance disconnect. As an example, if the primary source of pay increase is due to time-vested equity awards, a renewed commitment could be for the company to commit making a substantial portion of equity awards to named executive officers performance-based. A substantial portion of performance-based awards would be at least 50 percent of the shares awarded to each of the named executive officers. Please note that this is 50 percent of the shares awarded rather than 50 percent of the value of the awards. Performance-based equity awards are earned or paid out based on the achievement of company performance targets.

The company should disclose the details of the performance criteria (e.g., return on equity) and the hurdle rates (e.g., 15 percent) associated with the performance awards. From this disclosure, shareholders will know the minimum level of performance required for any equity grants to be earned. Performance-based equity awards do not include standard non-qualified stock options or performance-accelerated grants. Instead, performance-based equity awards are performance-contingent grants, where the individual will not receive the equity grant if target performance is not achieved. Premium-priced options with a minimum of 25 percent premium over the fair market stock price on the date of grant, traded for at least 30 consecutive trading days before they would vest, may be considered performance-based. The 25 percent premium should serve as a guideline rather than a bright line test. A 25 percent premium may not be rigorous for a company trading at \$1.00.

As another example, if the primary source of pay increase is due to discretionary bonus, a renewed commitment could be to award only performance-based bonuses. In order for shareholders to assess the rigor of the performance-based bonus program, the company needs to disclose the performance measure and goals. Complete and transparent disclosure is critical. The company needs to disclose the following:

- the measure(s) used (and rationale for the selections);
- the goal(s) that were set for each metric and the target (and, if relevant, threshold and maximum) payout level(s) set for each NEO;
- the reason that each goal was determined to be appropriate for incentive pay purposes (including the expected difficulty of attaining each goal);
- the actual results achieved with respect to each goal; and
- the resulting award (or award portion) paid to the NEO with respect to each goal.

The actual results and the resulting award need not be disclosed until the performance cycle is complete.

The renewed pay for performance commitment must be made in a public filing, such as a Form 8-K or DEFA 14A. Based on the additional disclosure of a renewed commitment, RMG may recommend a vote FOR the compensation committee members up for annual election and/or vote FOR the management say on pay or equity plan proposal, if there is one on the ballot. However, RMG is not likely to recommend a vote FOR the compensation committee members and/or vote FOR the management say on pay or equity plan proposal if RMG believes the company has not provided compelling and sufficient evidence of a renewed commitment and transparent additional disclosure of executive compensation.

Section 2: Equity Related

Option Repricing

Q2.1. With the market rebound, fewer companies are seeking shareholder approval for option exchange programs. If a company were to consider such a program, can you

provide additional guidance besides the standard shareholder friendly features, such as value-for-value exchange, exclusion of named executive officers and directors, resetting vesting schedules?

A2.1. Option exchange creates a gulf between the interests of shareholders and management, since shareholders cannot reprice their stock. Option exchange should be the last resort for management to use as a tool to re-incentivize employees. Only deep underwater options should be eligible for the program rather than somewhat underwater options, especially if the company's stock is volatile. Using a company's 52-week high as the threshold exercise price may be reasonable in a depressed economy, but it may not be rational in a market rebound. A company's 52-week high may be its current stock price which may suggest that these options are marginally underwater. As a rule of thumb, the threshold exercise price for eligible options should be the higher of the 52-week high or 50 percent above the current stock price. That way, only deep underwater options are eligible for the program. However, this rule of thumb should not be considered in isolation, 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 among others. Further, a company's current stock price can be a consideration as well. A premium of 50 percent for a company trading at \$1 may be a low threshold if the company's stock price is particularly volatile.

A company should discuss the various levels of employees (management versus non-management) who will be eligible participants in the program. Some companies have broad-based option programs whereas others tend to grant to management at the Vice President level. Absent such disclosure, institutional investors may assume that equity grants are generally awarded to management.

Burn Rate Commitment

Q2.2. What progressive action may a company take if it fails to meet the three-year average burn rate policy?

A2.2. A company may commit to a prospective gross three-year average burn rate, which excludes stock options with a reload feature granted prior to 2005, equal to the higher of two percent of the company's common shares outstanding or the mean plus one standard deviation of its GICS peer group. A company's burn rate may exceed the peer group average in the first year, provided the prospective three-year average burn rate remains below the commitment level. The company would need to publicly notify shareholders of its commitment via, e.g., a form 8-K, DEF14A, or in the summary plan description of the stock plan proposal in the DEF14A.

Making a commitment does not guarantee a vote change if RMG has concerns with the company's equity plan design. In cases where the company's equity plan will perpetuate a problematic pay practice, RMG may continue to recommend an AGAINST vote on the plan regardless of the prospective burn rate commitment.

Stock Option Overhang Carve-Out

Q2.3. When will RMG apply the stock option overhang carve-out policy?

A2.3. Companies with sustained positive stock performance and high overhang cost attributable to in-the-money options outstanding in excess of six years may receive a carve-out of these options from overhang as long as the dilution attributable to the new share request is reasonable and the company exhibits sound compensation practices. A company needs to demonstrate that these in-the-money options outstanding in excess of six years have been continuously in-the-money after they were vested. The fact that employees had the opportunity to exercise these options but chose not to exercise them may reflect the confidence they have in the company's future prospects. Presenting in-the-money options in excess of six years is not sufficient

information for RMG to determine whether these options were continuously in-the-money after they were vested. Companies are advised to provide the individual tranches of option grants with grant dates, option exercise prices and vesting schedules so that RMG can analyze the portion of in-the-money options to potentially carve out from the overhang

Q2.4. In the stock option overhang carve-out policy, what does RMG consider to be sustained positive stock performance?

A2.4. RMG generally looks for positive 5-year total shareholder return (TSR) as well as positive year over year performance for the past five fiscal years at the time of the analysis. Exceptions may be made if stock performance was negative for the first two years and then strongly positive for the remaining three years, but vested grants that have been underwater for a substantial time during the 5-year period 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.. A comparison of the company's five-year TSR against its four-digit GICS group can be helpful.

Q2.5. Is RMG making any exceptions to the sustained positive stock performance criteria in light of the financial debacle experienced by almost all companies in 2009?

A2.5. RMG recognizes that companies are affected by the global recession and would take that into consideration of the company's stock performance during this tumultuous period. Strong performing companies have experienced significant market rebound and should reflect that the stock price decline is temporary.

Q2.6. Can RMG provide an example of a company providing such disclosure in order for RMG to carve out continuously in-the-money options outstanding in excess of six years?

A2.6. Please see Myriad Genetics' DEFA 14A filed October 28, 2009. We plan to add more examples over time. It will be difficult for the company to pre-determine the portion of in-the-money options in excess of six years to be carved out. Additional disclosure in the form of supplementary proxy filings may be required.

Q2.7. How does RMG define high overhang cost in applying the stock option overhang carve-out policy?

A2.7. High overhang cost means that the sum of outstanding options and stock awards and remaining shares available under existing equity plan(s) should exceed or approach the company's specific allowable cap. Outstanding options and stock awards must be a significant driver of the high overhang, and should be in the range of 75 to 100 percent of the total overhang.

Q2.8. What does RMG look for with respect to the distribution of awards to executives vs. other employees (concentration ratio) in the stock option overhang carve-out policy?

A2.8. RMG will calculate the concentration ratio in the past fiscal year, defined as total equity grants to the top five executives divided by total equity grants to employees and directors. Concentration ratios greater than 50 percent to named executive officers may be concerning.

Pay for Performance

Q2.9. A company makes equity grants near the beginning of each year based on the evaluation of the company and/or the executive's performance in the immediately preceding year. Such grant information will appear in the following year's proxy statement. Will RMG take into account the timing of these early equity grants made in the current fiscal year and make adjustments to the top executives' total compensation when conducting its pay-for-performance evaluation?

A2.9. Such timing issue can be problematic for investors evaluating the relationship between performance and pay. The value of equity grants generally represents a significant proportion of top executives' pay; if the grants are made subsequent to the "performance" year, disclosures in the Grants of Plan-Based Awards Table may distort the pay-for-performance link.

Some investors believe that equity awards can incentivize and retain executives' for past and future performance; therefore, adjustments for such timing issues may not be relevant. Nevertheless, RMG may consider the timing of equity awards made early in the fiscal year if complete disclosure and discussion is made in the proxy statement. If the company makes equity grants early in each year, based on the prior year's performance, shareholders should not be required to search for the information in Form 4s and compute the adjusted total compensation for the top executives in order to make a year-over-year comparison. Instead, companies should provide information about grants made in relation to the most recently completed fiscal year in the proxy statement for the shareholder meeting that follows that fiscal year (aligned with other compensation reported for that year). Many companies provide an alternate summary compensation table that takes into account of the recent equity awards made in the current fiscal year. The number of options or stock award with the relevant exercise price or grant price should be disclosed in the proxy statement. The term of the options should be provided as well. In order for RMG to compute the adjusted total compensation and include it for purposes of our narrative discussion and analysis, companies need to make transparent and complete disclosure in the proxy statement; RMG will not search for the companies' Form 4 filings to make such adjustments but will rely on the specific grant disclosures found in the proxy statement.