



RADFORD ALERT

Risk Metrics Group Updates Annual Proxy Voting Policies and Processes for 2010 for Key Compensation Matters

Proxy Advisory Group Lowers Key Burn Rate Targets for Technology and Life Sciences Sectors; Issues New Important Guidance on Executive Pay Practices

On November 19, 2009, proxy advisor Risk Metrics Group (RMG), formerly Institutional Shareholder Services, released its annual U.S. Corporate Governance Policy Update, which included significant changes in target equity burn rates for companies in the technology and life sciences sectors, as well as revisions to its methods for evaluating certain executive pay practices, and links between that pay and company performance. This Radford Alert provides a brief overview of RMG's policy changes, as well as details on the new equity burn rate targets.

Risk Metrics Group 2010 Changes

Changes in RMG 2010 policies are found in revised target equity burn rates and updated volatility and stock price assumptions, as well as new guidance on pay-for-performance and problematic pay practices. RMG also introduced its Executive Compensation Policy, which is a reorganization of its prior policies into three categories, including: Pay for Performance, Problematic Pay Practices and Board Communication and Responsiveness. The guidelines in this group of policies replace what were previously three separate policies for: Pay for Performance, Poor Pay Practices and Advisory Votes on Compensation (or Management Say on Pay – MSOP.)

2010 Gross Burn Rate Guidelines and Volatility/Stock Price Assumptions

Perhaps the most significant – and certainly most surprising – change in RMG policy is the downward revision of its target three-year average gross burn rates. As Figure 1 below shows, technology gross burn rates have declined nearly one full percentage point from 2009 levels. The rates dropped for pharmaceutical and life sciences companies as well, though not as dramatically.

Figure 1: RMG Three-Year Average Burn Rate Targets

	2009						2010					
	Russell 3000			Non-Russell 3000			Russell 3000			Non-Russell 3000		
	Mean	Standard Deviation	Mean + STDV	Mean	Standard Deviation	Mean + STDV	Mean	Standard Deviation	Mean + STDV	Mean	Standard Deviation	Mean + STDV
	Media	1.87%	1.38%	3.25%	3.16%	2.98%	6.13%	1.36%	0.93%	2.28%	2.14%	1.88%
Pharma/LSI	3.40%	2.36%	5.76%	4.98%	4.49%	9.46%	3.19%	1.97%	5.16%	4.52%	4.05%	8.58%
Software & Services	4.05%	2.72%	6.76%	5.57%	4.56%	10.12%	3.15%	2.32%	5.47%	4.32%	3.26%	7.58%
Tech HW & Equip	3.24%	2.29%	5.52%	3.54%	2.76%	6.30%	2.60%	2.18%	4.79%	3.32%	3.76%	7.08%
Semi/Semi Equip	3.69%	2.02%	5.72%	4.95%	2.84%	7.79%	2.94%	1.88%	4.82%	4.33%	2.98%	7.31%
Telecomm Svcs	2.16%	1.57%	3.74%	2.92%	3.00%	5.92%	1.30%	1.20%	2.50%	2.63%	2.45%	5.08%

Software/Services and Telecom Services companies will see the biggest point drops. The mean three-year rate for Software/Services will drop from 4.05% to 3.15%, and will fall from 2.16% to 1.30% for Telecom Services. RMG's reduction of acceptable gross burn rates will no doubt throw into question the ability of some companies to obtain additional shares for stock programs in 2010, which will exacerbate a situation already made tenuous by a preponderance of underwater options and cash constraints resulting from the recent market downturn.

Confirming its existing policy, RMG noted that if a company fails to meet the three-year average burn rate targets for its industry group, it may avoid a negative recommendation if it commits to a prospective three-year average burn rate (excluding stock options with reload features granted prior to 2004) equal to the higher of 2% of the company's common shares outstanding or the mean of its industry group. The company's first year burn rate may exceed its industry group, provided the prospective three-year average burn rate remains below the commitment level. Such a commitment would need to be publically disclosed in an 8-K or DEFA 14A filing, or in the summary plan description of the stock plan proposal filed in the DEFA 14A.

However, RMG also noted that such a commitment will not change its recommendation in those cases where it determines that the underlying equity plan creates other problematic pay practices.

With respect to other dilution-related issues, RMG also elaborated on its policy for determining when it will apply its overhang carve-out policy. RMG will view favorably carve-outs from overhang in cases where there the company has sustained positive stock performance and there is a high overhang cost attributable to in-the-money-options in excess of six years, so long as the dilution associated with the new request is reasonable and otherwise conforms to sound compensation policies. RMG acknowledged that recent market upheaval may factor into its determination of 'sustained stock performance.'

RMG advised companies to present sufficient detail for it to determine the portion represented by sustained in-the-money options. It suggested companies provide tranches with grant dates, option exercise prices and vesting schedules. It defined high overhang cost as a situation where the sum of outstanding option and stock awards exceeds or is close to the company's cap. Outstanding options and stock awards should represent 75%-100% of the total overhang. When determining the carve-out allowance, RMG will also evaluate what it calls the concentration ratio, or percent of equity grants allocated to executives, as compared to the rest of the employee population. It considers ratios above 50:50 to be potentially "concerning." Although we have seen this exception used rarely, it would appear that the "concentration ratio test" is a further restriction reducing the benefits of this exception.

With respect to stock price volatility and stock price assumptions, RMG will revert back to their original 200-day volatility and 200-day average stock price for shareholder value transfer and burn rate policy calculations, beginning with the December 1, 2009 quarterly download. This will replace the temporary 400-day volatility and 90-day stock price assumption used in the most recent three quarters. In making the change, RMG noted that the extraordinary volatility experienced in the market during the past year had diminished.

Pay-for-Performance Policy

The key change in RMG's pay-for-performance policy is the inclusion of a five-year window for evaluating the alignment between CEO total direct compensation (TDC) and total shareholder return (TSR). This is an important change given stock market performance over the past year or two.

RMG will continue to monitor Russell 3000 companies that have one-year and three-year TSR performance below the median of their industry group. The evaluation will include analysis of the year-over-year and long-term changes in CEO TDC. However, RMG clarified in its 2010 policy statement that pay changes will not be the sole determinate of unfavorable recommendations. RMG will consider the direction and magnitude of the pay change, the rationale of the pay change with respect to pay mix (performance vs non-performance based vehicles), and the long-term (at least 5 years) alignment of CEO TDC with TSR.

In cases where RMG determines there is a pay-for-performance disconnect, it may recommend votes against an MSOP proposal and/or compensation committee members. If more than half of the TDC increase comes from non-performance-based equity, RMG may recommend against any stock plan in which the CEO participates. These recommendations may be mitigated in those cases where the company renews its commitment to pay-for-performance. RMG further provided guidance on how companies can “recommit,” and stipulated that such commitments must be made in a public filing (8-K or DEF 14A).

Problematic Pay

Within the Problematic Pay Practices, RMG detailed the executive compensation practices that will most influence an adverse recommendation (see Figure 2). This is not a comprehensive list of practices RMG deems most concerning; rather these are the practices that it weights most heavily.

Figure 2: RMG’s Problem Pay Practices

Issue	Problematic Pay Practice Defined
Egregious employment contracts	<ul style="list-style-type: none"> Contracts that guarantee multi-year salary increases, non-performance based bonuses and equity
Overly generous CEO new hire compensation	<ul style="list-style-type: none"> Excessive “make whole” provisions lacking sufficient rationale Any of the problematic pay practices listed in the policy
Outsized bonus payouts lacking performance link or disclosure	<ul style="list-style-type: none"> Includes changes to performance metrics without adequate explanation and link to performance
Egregious pension/supplemental executive retirement plan payouts	<ul style="list-style-type: none"> Inclusion of additional years of service not worked that result in significant benefits Inclusion of performance-based equity awards in pension calculation
Excessive perquisites	<ul style="list-style-type: none"> Such as lifetime benefits, car allowances, personal use corporate aircraft for former and/or retired executives Extraordinary relocation benefits
Excessive severance and/or change in control (CIC) provisions	<ul style="list-style-type: none"> CIC payments in excess of 3x base and bonus CIC payments without job loss or substantial reduction of job duties (single-trigger) 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 CIC severance; and Excise tax gross-up (including modified gross-ups)
Tax reimbursements	<ul style="list-style-type: none"> Payment of income taxes on certain executive perks or other payments, including personal use of corporate aircraft, life insurance, bonus, excise tax gross-up
Dividends or dividend equivalents paid on unvested performance shares or units	
Executives using company stock to hedge (“cashless” collars, forward sales, equity swaps, etc)	
Repricing or replacing underwater stock options/stock appreciation rights without prior shareholder approval (including cash buyouts)	

RMG will also recommend a withhold/against vote, on a case-by-case basis, for other types of “excessive” or “egregious” pay practices. Severance and/or CIC contracts that include payments after termination for performance failure, and those that provide for payment without an actual CIC will be viewed as concerning. Additionally, personal use of corporate aircraft, personal security systems, car allowances and executive life insurance will be similarly assessed.

Similarly, RMG will recommend withhold/against votes, on a case-by-case basis where it finds internal pay inequities, as defined by the difference in pay between the CEO and the next highest paid named executive officer (NEO). And, it will also look for policies that allow for voluntary surrender of underwater options by NEOs if the shares are returned to the equity plan.

In addition to the above, RMG will evaluate company policies and practices for the following:

- > 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
- > Mega annual equity grants that provide unlimited upside with no downside risk

RMG said that it will also look for compensation policies that mitigate against the potential risks created by problematic pay, including clawbacks and significant stock ownership guidelines/holding practices.

Other Issues

Underwater Exchange Guidance

RMG also provided guidance for companies considering an underwater exchange. RMG considers underwater exchanges a “last resort” incentive tool, and said that only “deep underwater” options should be included in an exchange program. Its guideline for the threshold exercise price of eligible options is the higher of the 52-week trading high or 50 percent above the current stock price. However, RMG conceded that this rule of thumb will be considered within the context of the timing of the request, the company’s trading history and current trading price. RMG also advised that companies should communicate which levels of employees will participate in any exchange program.

Compensation Policies and Company Risk

Reflecting fallout from the financial crises of 2008-09, and the belief among many that compensation at many financial institutions precipitated adverse risk-taking that led to the debacle, RMG added a guideline for assessing the extent to which company compensation policies promote excessive risk. The addition of this guideline follows an SEC proposal that companies add such evaluations to their Compensation Discussion & Analysis filings.

Linking Executive Pay to Environmental and Social Issues

RMG changed its recommendation policy from case-by-case to against on proposals that would link executive compensation to environmental and/or social issues, such as downsizing, customer/employee satisfaction, community involvement, human rights, environmental performance, etc). RMG noted that a lack of standards against which to measure performance makes the determination of effectiveness problematic.

Conclusion

In keeping with its history, Risk Metrics has further sought to reduce dilution and tighten controls on executive compensation practices with the release of its 2010 Governance Policy Update. It has also taken up the cause for increasing analysis and disclosure of the influence company compensation practices have on encouraging adverse risk-taking. We believe companies should, in response, review their dilution rates and executive pay practices against these new policy definitions. As always, we will follow this update with further policy changes from Risk Metrics and other proxy advisory services as well as related regulatory changes from the Securities Exchange Commission. We also encourage you to review the policies directly with your working team. The RMG 2010 policies can be found at <http://www.riskmetrics.com/policy>.

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Linda E. Amuso is a highly recognized thought-leader and an expert in the field of executive and employee compensation design for the technology and life sciences industries. For 20 years, Linda has worked directly with senior management and Board of Directors on developing and implementing executive and equity compensation strategies, effectively linking performance management strategies to salary systems, and designing annual/long-term incentive plans. Since joining Radford in 2005, Linda has been instrumental in building Radford's consulting practice and expanding Radford's services globally.

In 1993, Linda co-founded iQuantic, Inc. (acquired by Buck Consultants in 2001), and was a key contributor in building the organization into a national compensation consulting business. She also led the expansion of iQuantic's business into the life sciences industry, offering consulting and survey support. At Buck Consultants, Linda held a number of leadership positions including Western Region Compensation Practice Leader, National Leader for the Biotechnology Sector and Northern California Market Leader.

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Edward J. Speidel has nearly 20 years of experience in executive and equity compensation, corporate governance and employee benefits consulting. His clientele consists of companies of varying size and complexity, in a wide array of industries. He maintains a strong focus on the high technology communities, with emphasis in e-commerce, semiconductors, software, and life sciences firms.

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Prior to joining Radford, Ram was an assistant vice president in the executive compensation practice of Aon Consulting. Prior to Aon, Ram worked in the corporate governance industry for more than six years, including four years at the prominent proxy advisory firm, Institutional Shareholder Services (ISS). While at ISS, he led the US research group charged with analyzing all public US companies and making proxy recommendations to institutional investors.

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About Radford

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