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# CORPORATE ALERT

## RISKMETRICS 2009 CORPORATE GOVERNANCE POLICY UPDATES MAY AFFECT EXECUTIVE COMPENSATION DECISIONS

RiskMetrics Group (formerly ISS), a leading proxy advisory firm, recently released its 2009 U.S. Corporate Governance Policy updates, providing guidelines and recommendations for voting during the 2009 proxy season. The 2009 policy updates cover a variety of matters for companies to consider, particularly in connection with executive compensation. This client alert highlights a few of the policy updates relating to executive compensation of which companies should be aware as they make executive compensation decisions going forward.

**Poor Pay Practices.** The RiskMetrics governance policy provides that RiskMetrics may recommend that investors withhold votes on, or vote against, compensation committee members, the CEO and, potentially, the whole board of directors if a company has poor pay practices. In its updates for the 2009 proxy season, RiskMetrics has added several new items that it considers to be poor pay practices.

- **Tax Gross-Ups.** "Gross-ups" to cover excise taxes owed by executives for severance and/or change-in-control payments have been added to the list of items that RiskMetrics considers to be poor pay practices. This updated policy applies only to new or materially amended gross-ups and does not apply to existing gross-ups. Approximately two-thirds of S&P 500 companies offer gross-ups. According to a survey of 2008 proxy statements conducted by RiskMetrics, the average golden parachute payment for companies offering gross-ups (excluding the cost of gross-ups) was approximately 38 percent more than the average golden parachute at companies that did not offer tax gross-ups. A poll conducted by RiskMetrics found that 76 percent of institutional investors consider gross-ups to be "problematic."

- **Other Poor Pay Practices.** In addition to excise tax gross-ups, the 2009 policy updates added the following to the list of items that RiskMetrics considers to be poor pay practices—
  - tax reimbursement arrangements for any executive perquisites or other payments;
  - payments of dividends or dividend equivalents on unearned performance awards
  - modified "single-trigger" change-in-control provisions, which allow change-in-control payments upon voluntary resignations following a change in control
  - broad change-in-control definitions in individual contracts or equity plans that could result in payments to executives without an actual change in control.

**Best Pay Practices.** In addition to its updated list of poor pay practices, RiskMetrics has also updated its list of examples of best pay practices. The updates include policies regarding employment and severance agreements, change-in-control payments, supplemental executive retirement plans, deferred compensation, disclosure practices and responsible use of company stock.

**Repricing Options and Resetting Performance Goals.** The volatile stock market has deflated stock prices, and many companies are finding themselves with stock options that are now underwater. Prior to making any decisions to reprice stock options or reset the goals of performance plans, companies should note that RiskMetrics will not consider market deterioration, in and of itself, an acceptable reason for a company to reprice underwater stock options or reset performance goals. RiskMetrics believes there should be a strong relationship between executive compensation and company performance.

**Pay for Performance.** RiskMetrics will generally recommend that investors vote against plans and/or withhold votes from compensation committee members if—

- there is a pay for performance disconnect between the CEO's pay and the company's stock performance,
- over half of the pay increase is equity based, and
- the CEO is a participant of the equity proposal.

In its 2009 policy updates, RiskMetrics revised its definition of a "pay for performance disconnect." Its prior policy provided that there was a disconnect if the CEO's total compensation was increased while the company's one-year and three-year shareholder returns were both negative. Under the updated policy and in recognition of the broad impact of the financial crisis on the overall stock market, RiskMetrics will consider there to be a pay for performance disconnect if the CEO's total compensation is increased while the company's one-year and three-year shareholder returns are in the bottom half of its industry group.

**Compensation Peer Groups.** The 2009 policy updates revise the way in which RiskMetrics will create compensation peer groups. Company size will now be a key determinant when constructing peer groups, with RiskMetrics using size parameters ranging from 0.5 to two times the company's size. Size will be measured using revenue, assets for financial services companies or market capitalization, as appropriate. Under the updated policy, CEO pay peer groups may have a minimum of eight companies, rather than 12. Furthermore, for extremely large companies, RiskMetrics may now use wider industry sectors or a market index to construct appropriate peer groups. In its reports, RiskMetrics will display the comparison of CEO pay under both its peer group methodology and the peer group selected by the company. The updated peer group methodology will be released in 2009, and the report comparing the RiskMetrics peer group to the company's peer group will be released at a later date.

**Other Compensation Policy Updates.** RiskMetrics has made the following other updates to its policy regarding executive compensation—

- Due to extreme market volatility, RiskMetrics will now use 400-day stock volatility (rather than 200-day stock volatility) with respect to calculations under its Shareholder Value Transfer and burn rate policies. In addition, RiskMetrics has updated its burn rate percentages.

- RiskMetrics may now support shareholder proposals for "clawbacks" of incentive pay if existing company policies do not meet the guidelines prescribed by the U.S. Treasury under the Emergency Economic Stabilization Act of 2008.

- RiskMetrics will add to its list of factors whether a company has a liberal definition of "change in control" when making its case-by-case evaluation of company equity-based compensation plans.

- RiskMetrics will now recommend voting against Section 162(m)-related plans if the compensation committee does not consist entirely of independent outsiders (based on the RiskMetrics definition of "independence").

Executive compensation is a particularly controversial issue in the current economic climate and will likely be a hot button for shareholder activism during the upcoming proxy season. In light of these developments, companies may wish to consider the new RiskMetrics policy updates when crafting executive compensation packages.

## CONTACT INFORMATION

If you have any questions regarding this alert, please contact–

N. Kathleen Friday ........................kfriday@akingump.com........................ 214.969.2827 ............................Dallas