# The 2009 Proxy Season: RiskMetrics Group's Voting Policy Updates and an Examination of Upcoming Trends

DAVIS POLK & WARDWELL

December 9, 2008

## Introduction

RiskMetrics Group ("RMG"), the influential proxy advisory firm formerly known as ISS Governance Services, recently released its U.S. Corporate Governance Policy Update for 2009. The Policy Update is effective for annual meetings of U.S. public companies occurring on or after February 1, 2009.

* * * * *

## Emerging Trends for the 2009 Proxy Season

Corporate activism seemed relegated to the sidelines in 2008 as compared to recent years. The financial crisis, beginning with the Bear Stearns implosion in March, largely overshadowed disputes over governance and compensation. Activist hedge funds, a growing presence a year ago, are today in many cases fighting for their own survival in the face of investor redemption notices. Final voting results in 2008 for many key proposals were relatively flat compared to the prior year, including such notables as "say on pay."

But the 2009 Policy Update is a useful reminder that the activists have not gone away. The 2009 season has barely begun, but here are some trends to look for:

» ***Smaller companies as targets***: Activists have typically been elephant hunters, but there are indications that they are now looking beyond the traditional group of major companies, and into the next tier of corporate issuers. For example, in 2008 proponents submitted approximately 75 say on pay proposals, while proponents have indicated that over 100 companies could expect such proposals this year.

» ***More governance practices under attack***: Having made substantial progress in forcing board declassifications, poison pill expirations and majority vote standards, proponents are focusing on the handful of remaining defensive measures. Activists are seeking the right to call special meetings, and to amend bylaws by simple majority votes. These changes would permit a group of shareholders to call snap meetings for the purpose of ousting the board or making other changes, and could turn what has been an annual preparation exercise into a constant vigil.

» ***Reloading stock programs***: Declining stock prices mean that more companies may need to seek shareholder approval of new or amended equity plans earlier than they had previously expected, as more shares may need to be issued to employees to deliver the same compensating value. Some companies are also considering exchange programs for underwater options.

» ***Spreading the TARP***: The Troubled Asset Relief Program ("TARP") not only limits certain executive compensation elements for participating companies, but also requires compensation committees to determine whether their executive compensation programs motivate inappropriate and unnecessary risk taking. While only a relative handful of public companies may be TARP participants, we think that other companies should consider examining the risk incentives that may be built into their own executive compensation programs.

» ***Predicting the SEC's Agenda***: The SEC has had a difficult year, and with the arrival of a new administration we can anticipate changes in leadership and possibly the agency's scope and mandate. These changes may have unpredictable impacts on the Commission's substantial agenda of uncompleted initiatives, including proxy access, broker discretionary votes in the election of directors, beneficial ownership disclosure and the continuing evolution of executive compensation disclosure.

Below we summarize each of the RMG policy updates. We begin with the corporate governance provisions and cover executive compensation matters beginning on page 4, and social responsibility issues beginning on page 5.

# Corporate Governance

**Policies for "Withhold" or "Against" Recommendations**

*Director Attendance of Less than 75% of Board and Committee Meetings*

RMG has traditionally issued recommendations to "withhold" votes or vote "against" directors who failed to attend at least 75% of board and committee meetings, and such a recommendation has led to at least one instance of a director failing to receive a majority of the votes at a company with majority vote standards and a director resignation policy. RMG has recognized the powerful influence of its vote recommendation for these particular situations, and has revised its policy to allow for companies to disclose to RMG (without also requiring public disclosure) the reasons for a director's absence at meetings. RMG will then evaluate the issue on a case-by-case basis, taking into account: (a) the degree to which the absences were due to an unavoidable conflict; (b) the pattern of absenteeism; and (c) other extraordinary circumstances underlying the director's absence. We encourage companies that identify this issue to contact RMG early to provide an explanation. In addition, RMG will continue to exempt from its policy director absences due to circumstances of illness, service to the nation, work on behalf of the company and, new for the 2009 Policy Update, funeral obligations.

*Poor Accounting Practices Affecting Votes for Audit Committee Members*

RMG has expanded its definition of "poor accounting practices" which could cause it to recommend votes to "withhold" or vote "against" audit committee members, to include the issuance of an adverse opinion by the auditors on the company's financial statements. RMG will make voting recommendations on a case-by-case basis for audit committee members, and possibly the entire board, if additional accounting practices exist that may raise serious concerns, including fraud, misapplication of GAAP and material weaknesses.

*Company's Performance and Absence of Oversight*

RMG will recommend votes to "withhold" or vote "against" director nominees if it believes that the board lacks accountability and oversight, coupled with sustained poor performance by the company relative to its peers. RMG has revised its definition of poor performance, which it now measures as one-year and three-year total shareholder returns ("TSR") in the bottom half of a company's four-digit GICS industry group. Its assessment of poor accountability and oversight evaluates several factors, including governance provisions that it considers problematic such as classified boards, dual class structure and the existence of non-shareholder approved poison pills.

**RMG Classification of Directors**

RMG continues to have separate and more stringent standards than the listing exchanges or SEC rules for determining when a director may be considered independent. A director with relationships that RMG believes cause that director to be classified as either an "inside director" or an "affiliated outside director" is not considered independent, which at times will affect RMG's voting recommendation for such a director. For example, RMG will recommend votes to "withhold" or votes "against" nominees it classifies as "affiliated outside directors" if they sit on the audit, compensation or nominating committees.

*Former CEOs of Special Purpose Acquisition Corporations (SPACs)*

RMG will generally classify former CEOs of a SPAC serving on the board of an acquired company to be independent unless the director has operating ties to the firm or other conflicting relationships such as related person transactions.

*Directors Who Are Parties to Voting Agreements*

RMG will continue to classify directors who are parties to voting agreements as "affiliated outside directors," but makes an exception for dissident directors who are parties to voting agreements pursuant to a settlement arrangement, subject to an examination of the terms of the agreement.

**Shareholder Proposals on Governance Issues**

*Proposals Seeking Independent Chair (Separate Chair/CEO)*

RMG made slight modifications to its recommendation on voting for shareholder proposals requiring that the chairman's position be filled by an independent director, including eliminating the need for certain disclosures from last year's policy update. RMG will continue to generally recommend a vote "for" the proposal unless the company has: (a) designated a lead director elected by independent board members with specified duties, including those listed in the 2009 Policy Update; (b) a board composed of two-thirds independent directors; (c) all independent key committees; (d) established governance guidelines; and (e) no problematic governance or management issues such as egregious compensation practices, multiple related person transactions or corporate or management scandals. In addition, and perhaps the most difficult criteria in the current market environment, the company must not have performed in the bottom half of its four-digit GICS industry group measured as one- and three-year TSRs, unless there has been a change in the Chairman/CEO position during that time.

*Proposals on Poison Pills*

In addition to requiring particular attributes for making voting recommendations regarding management proposals to ratify a poison pill, which RMG determines on a case-by-case basis, the 2009 Policy Update now requires a company to fully explain the rationale for adopting the pill.

RMG has added a new provision related to management proposals to adopt a poison pill for the stated purpose of preserving a company's net operating losses ("NOLs"), recognizing the difference with traditional poison pills. RMG will consider: the trigger, the value of the NOLs, the term, shareholder protection mechanisms and other applicable factors.

*Proposals Seeking Establishment of Board Committees*

In response to proposals last year seeking the establishment of a compliance committee to monitor lending practices at several homebuilders, and requesting that companies establish board committees on sustainability and human rights, RMG will now recommend a vote "against" a shareholder proposal to establish a new standing board committee, depending in part on the existing oversight mechanism and disclosure regarding the issue in question.

*Proposals Seeking Advance Notice Requirements*

RMG makes voting recommendations on advance notice proposals on a case-by-case basis, and has revised its determination of a reasonably broad window period for shareholders to submit proposals or nominations to be no more than 60 days before the meeting, with at least a 30-day period before the deadline for submissions. RMG generally supports efforts by companies seeking full disclosure of a proponent's economic and voting positions so long as it deems the requirements to be "reasonable" and aimed at providing shareholders with sufficient information.

**M&A and Capital Structures**

*SPACS M&A*

RMG has determined that its recommendations on SPAC mergers and acquisitions will be on a case-by-case basis, taking into account valuation, market reaction, deal timing, negotiations and process, conflicts of interest, voting agreements and governance.

*Capital Structure*

RMG's 2009 Policy Update provides a more comprehensive approach when determining whether or not a proposed increase in authorized capital is warranted. RMG will make recommendations for voting on proposals to increase the number of shares of common or preferred stock authorized for issuance on a case-by-case basis, eliminating previously specified caps, taking into account: (a) reasons for the increase; (b) the dilutive impact as determined through its model; (c) the board's governance structure and practices; and (d) risks to shareholders of not approving the request.

# Executive Compensation

**Policies for "Withhold" or "Against" Recommendations**

*Pay for Performance Disconnect*

RMG has updated its policy to adopt a relative approach to determining a "pay for performance disconnect," which is one factor that may cause RMG to recommend a vote "against" an equity compensation plan and/or a "withhold" vote or vote "against" compensation committee members. The "disconnect" is now defined as an increase in a CEO's total compensation while the company's one- and three-year TSRs are in the bottom half of its industry group, depending upon the company's CD&A discussion of the reasons for the increase in compensation. Total compensation includes all of the compensation disclosed in a company's "Summary Compensation Table," with the grant date full value of stock awards and options substituted for the stock and option award amounts disclosed in the Table.

*Elements Considered Poor Pay Practices*

RMG has added several compensation elements to its existing lengthy list of what it considers "poor pay practices" and has clarified several existing elements, as follows:

» excessive severance/change in control arrangements now include: (a) payments for terminations in connection with performance failures; (b) any new or materially amended arrangements that include provisions for the payment of excise tax gross-ups and/or modified single-triggers; and (c) liberal change in control definitions;

» tax reimbursements of any executive perks or other payments;

» determinations of whether perks are "excessive" will follow guidelines of $110,000 for personal use of corporate aircraft and $100,000 for auto allowances; and

» payment of dividends or dividend equivalents on unearned performance awards.

While many of the new examples cited as "best pay practices" are as expected, RMG indicates that companies should adopt policies that prohibit executives from speculating in company stock, using the stock in hedging activities and prohibit or discourage the use of stock as collateral for margin loans. We advise that companies disclose in their CD&A if they have adopted such policies.

**Shareholder Proposals on "Clawbacks"/ Recoupment Policies and Holding Periods**

Influenced by TARP, RMG indicates that it may recommend a vote "for" shareholder proposals on "clawbacks" of incentive pay even if the company has an existing policy, if the company's corresponding policy does not meet the practices outlined in TARP. Similarly, evaluation of proposals seeking holding requirements for executives who receive stock-based incentives will be evaluated in light of events that call into question the risk–incentivizing behavior associated with certain incentives.

**"Resetting and Repricing" Under Existing Plans**

RMG will not view market deterioration alone as an acceptable reason for companies to re-price stock options or reset goals under performance plans.

**Equity Compensation Plan Evaluation**

RMG has made several changes in reviewing equity compensation plans for vote recommendations, including:

» in light of current market volatility, expanding the stock price volatility measure from 200 days to 400 days for determining a company's three-year average burn rate;

» evaluating the "disconnect" between CEO pay and performance where over 50% of the year-on-year increase is attributed to equity awards;

» viewing as a negative any plan that provides for the acceleration of vesting of equity awards even though an actual change in control may not occur, such as upon shareholder approval of a transaction or the announcement of a tender offer; and

» for a voting recommendation on a proposal introduced to enable the plan to comply with Section 162(m) of the Internal Revenue Code, RMG will recommend a vote "against" the proposal if the compensation committee does not fully consist of RMG's definition of independent outsiders.

**Compensation Peer Groups**

RMG has revised its methodology for constructing peer groups used to show in its voting report the pay of a company's CEO relative to its peers. It will evaluate the size of the company as a key determinant in constructing peer groups, with peers falling between 0.5 and 2 times the company's size. The minimum number of companies a peer group is required to contain has been decreased from 12 to 8, and, for very large companies, RMG may use wider industry sectors or a market index to create a peer group.

In addition, in a change that could produce some interesting results, the voting report will not only show a comparison of CEO pay under RMG's peer group methodology, but also against the peer group selected by the company.

# Corporate Responsibility Shareholder Proposals

*Consumer Issues*

RMG will generally recommend votes "against" proposals asking suppliers, genetic research companies, restaurants and food retail companies to voluntarily label genetically engineered ingredients in their products and/or eliminate such ingredients. In evaluating on a case-by-case basis proposals asking for a report on the feasibility of products containing genetically modified ingredients, RMG will no longer take into account any voluntary labeling initiatives undertaken or considered by the company.

In evaluating on a case-by-case basis proposals requesting that companies evaluate its pharmaceutical product pricing policies or their access to medicine policies, RMG will also consider the nature of a company's business, the potential for reputational and market risk exposure and the potential cost and scope of the requested report.

*Diversity Matters*

RMG has consolidated its various policies with respect to equal opportunity disclosure proposals, and will generally recommend votes "for" proposals requesting that a company disclose its diversity policies or initiatives, or a proposal requesting disclosure of a company's comprehensive workforce diversity data, including requests for Equal Employment Opportunity ("EEO") data, unless: (a) the company publicly discloses its comprehensive equal opportunity policies and initiatives and comprehensive workforce diversity data; and (b) has no recent significant EEO-related violations or litigation.

RMG has added gender identity to its existing recommendations related to proposals about sexual orientation and domestic partner benefits.

*Climate Change and the Environment*

RMG has amended the exceptions to its policy recommending votes "for" resolutions requesting that companies report on risks and liabilities related to concentrated area feeding operations, to include public disclosure of relevant company and supplier environmental performance data.

RMG has determined to recommend to vote "for" proposals requesting disclosure of energy efficiency policies unless: (a) the company complies with applicable energy efficiency regulations and laws and makes certain disclosures; and (b) the proponent requests adoption of specific energy efficiency goals within specific timelines.

*Compensation-Related Corporate Social Responsibility Issues*

RMG will recommend votes "against" proposals seeking to establish an explicit link between executive compensation and non-financial criteria and will evaluate proposals seeking related reports on a case-by-case basis.

*Labor and Human Rights Standards*

RMG will generally recommend votes "for" proposals requesting reports on company or company supplier labor and/or human rights standards and policies, unless such information is already publicly disclosed. RMG will now generally recommend a vote "against" a proposal to endorse or increase activity on the MacBride Principles.

* * * * *

If you have any questions regarding this memorandum, please call your Davis Polk contact.