

## Preparing for the 2010 Proxy Season: RiskMetrics Updates Voting Policies

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RiskMetrics Group, an influential proxy advisory service, recently issued updates on its proxy voting policies applicable to meetings of US companies held after February 1, 2010. The updates explain the basis for new or additional factors RMG evaluates in providing voting recommendations to its clients with respect to elections and proposals. The updates this year appear to be fairly modest. However, many of RMG's policies continue to be vague, and the unknown as always lies in RMG's discretionary application of its standards.

This year has seen a sharp uptick in controversies aired at shareholder meetings, as evidenced by:

- a threefold increase in the number of individual directors who received less than majority support,
- more shareholder proposals receiving majority support, and
- more companies being willing to amend practices in response to those voting results.

RMG's proxy voting recommendations reinforce and often catalyze shareholder concerns. With the elimination of broker discretionary voting in 2010 (discussed [here](#)) and the likely prospect of an increased number of close elections, RMG's recommendations will continue to have a meaningful impact on voting results in the upcoming season. We summarize below certain key RMG policies and updates.

### Executive Compensation

*Management Say on Pay Proposals.* The most significant change is RMG's statement that management say on pay proposals, if available, will be the primary way for RMG to communicate its views on pay practices, rather than negative recommendation against the entire compensation committee. RMG is clearly trying to encourage companies to adopt say on pay by offering a pass, at least in the first round, for compensation committee members. RMG says that it continues to evaluate management say on pay proposals on a case-by-case basis, with the additional consideration of a "pay for performance" factor examining the alignment of the CEO's total direct compensation and total shareholder return over a period of at least five years.

*Problematic Pay Practices.* Given that only a handful of non-TARP companies will have management say on pay proposals on their ballots in 2010, recommendations against compensation committee members or equity-based plan proposals will for most companies continue to be the RMG weapon of choice. Unfortunately, as companies have discovered in the past, the vagueness of the published list of problematic pay practices, combined with RMG's interpretive discretion, make it difficult to predict with confidence whether any pay practice, or combination of practices, will cause RMG's thumb to point down. The list, which RMG has indicated is not exhaustive, has not changed materially, but it is worth including in its entirety to refresh your recollection:

- multi-year guarantees for salary increases, non-performance based bonuses and equity compensation;
- including additional years of unworked service that result in significant additional benefits, without sufficient justification, or including long-term equity awards in the pension calculation;
- perquisites for former and/or retired executives, and extraordinary relocation benefits (including home buyouts) for current executives;

- change in control payments exceeding three times base salary and target bonus; single trigger change in control payments; new or materially amended agreements that provide for “modified single triggers” (under which an executive may voluntarily leave for any reason and still receive change in control severance); new or materially amended agreements that provide for an excise tax gross-up;
- tax reimbursements related to executive perquisites or other payments such as personal use of corporate aircraft, executive life insurance, bonus, and other perks;
- 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; or
- repricing or replacing of underwater stock options/stock appreciation rights without prior shareholder approval (including cash buyouts and voluntary surrender/subsequent re-grant of underwater options).

*Potential Incentives for Excessive Risk Taking.* The impact of compensation practices on corporate risk profiles is a fashionable issue this year, and RMG has not been left behind. Practices identified by RMG in this regard include:

- 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; or
- mega annual equity grants that provide unlimited upside with no downside risk.

Some of these factors contradict each other, calling into question the coherence of the whole exercise. Guaranteed bonuses might, for example, be seen as making executives less inclined to “swing for the fences” and thereby might be seen as *reducing* risk in the short term. But one suspects that this list is just another RMG catalog of “things we don’t like” rather than a thoughtful attempt to link risk to compensation. In any case RMG notes that rigorous clawback provisions and robust stock ownership and holding guidelines may mitigate the impact of risky incentives.

## Director Elections

*Director Independence.* RMG continues to ignore the standards of the listing exchanges and instead to employ its own classifications, with the result that otherwise independent directors may be branded as “insiders” or “affiliated outsiders”. Changes in director classifications for 2010 include:

- The materiality test for transactional relationships, which to date has been applied consistently regardless of listing, will now be bifurcated, reflecting the different standards of the NYSE and Nasdaq. The NYSE test is the greater of \$1 million or 2% of the recipient’s gross annual revenues, while the Nasdaq test is the greater of \$200,000 or 5% of the recipient’s gross annual revenues. In this area, at least, RMG is simplifying life for NYSE-listed companies, who in prior years have had to be conscious of two different standards.
- Related person transactions involving directors will be examined on a case-by-case basis for materiality if the director (or an immediate family member) is a partner in, a controlling shareholder, or an executive officer of, an organization that has the transactional relationship with the company. Going forward, no other transactional relationships involving a director will be considered material. Although not mentioned in the RMG policy statement, RMG analyzes a

company's disclosure of both related person transactions (Item 404 of Regulation S-K) as well as findings of director independence (Item 407 of Regulation S-K) for this purpose.

- RMG has explained its characterization of its \$10,000 de minimis threshold for professional services that are advisory in nature. They consider advisory services to generally involve access to sensitive company information or to strategic decision-making, and typically with a commission- or fee-based payment structure.

*"Egregious Actions"*. RMG has broadened its policy on actions that may result in negative recommendations to include: (a) material failures of governance, stewardship, or fiduciary responsibilities at the company; (b) failure to replace management as appropriate; or (c) egregious actions related to the director(s)' service on other boards that raise substantial doubt about his or her ability to effectively oversee management and serve the best interests of shareholders at any company. No real news here, as these are all matters that RMG would presumably have considered in any case.

*Continuing Issues*. RMG continues its policy of issuing negative recommendations against individual directors or the entire board according to a lengthy list of factors. The most common reasons for RMG's recommending against individual directors include poor attendance, overboarding, and "insiders" or "affiliated outside" directors serving on independent committees. Recommendations against entire boards are more commonly grounded in (a) failure to act on a shareholder proposal that received approval by a majority of shares outstanding the prior year or majority of votes cast for the previous two consecutive years; (b) failure to address the underlying issue that caused a director to receive more than 50% withhold/against votes; or (c) adoption of poison pills without shareholder approval or ratification as further described below.

### Poison Pills

*Seeking shareholder approval*. RMG has made slight modifications to its underlying policy that it will make negative recommendations against boards if:

- the board adopts a poison pill with a term of more than 12 months, or renews any existing pill, without shareholder approval; or
- the board makes a material, adverse change to an existing pill without shareholder approval.

RMG will now examine the adoption of new pills with terms of 12-months or less on a case-by-case basis.

*Net Operating Loss (NOL) Protective Amendments and Poison Pills*. Reflecting the current profitability environment, some 41 companies have reportedly adopted NOL protective amendments or pills to date in 2009, compared to 12 in all of 2008. These pills are intended to preserve NOLs against the impact of section 382 of the Internal Revenue Code, under which in some circumstances even small changes in shareholder composition may be cumulatively viewed as part of a change in control that can severely limit the future use of a company's NOLs.

RMG's views on these pills are somewhat less dogmatic than with respect to conventional poison pills. Factors that RMG says it will employ in making its voting recommendation when companies seek shareholder approval or ratification of these types of amendments or pills include (a) the ownership threshold; (b) value of the NOLs; (c) shareholder protective mechanisms (sunset provision or commitment to cause expiration of the protective amendment upon exhaustion or expiration of the NOL); and (d) the company's existing governance structure including: board independence, existing takeover defenses, track record of responsiveness to shareholders, and any other problematic governance concerns.

### Other Significant Governance Proposals

*Shareholder Ability to Call Special Meetings or Act by Written Consent*. Over 30 shareholder proposals to give 10% or more shareholders the ability to call special meetings received majority support in the 2009 proxy season, and many have been repropoed for 2010. Some companies are responding to these

proposals, or the threat of them, with management proposals that would give shareholders more limited rights to call special meetings or to act by written consent. RMG says that it will take the following factors into account in considering any proposals that appear to restrict these rights of shareholders, including: (a) shareholders' current right to call special meetings or act by written consent; (b) minimum ownership threshold necessary to call special meetings (10% preferred) or consent threshold; (c) the inclusion of exclusionary or prohibitive language; (d) investor ownership structure; and (e) shareholder support of and management's response to previous shareholder proposals.

*Common Stock Authorization.* RMG will continue to recommend voting on a case-by-case basis on proposals to increase the number of shares of common stock authorized for issuance but will emphasize attention on the disclosure of specific reasons for the proposed increase. RMG has also expanded the recommended analysis to take into account (a) the company's use of existing shares during the last three years; (b) one- and three-year total shareholder return; and (c) the board's governance structure and practices.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact

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