

### **RMG Finalizes 2010 Executive Pay Policy**

**December 23, 2009**

A prior Morgan Lewis LawFlash addressed the proposed changes by RiskMetrics Group (RMG) (formerly Institutional Shareholder Services, or ISS) to its proxy advisory policies to be in effect for the 2010 proxy season.<sup>1</sup> On November 19, 2009, RMG released its final 2010 policy. This LawFlash discusses the changes from RMG's 2009 policy applicable to U.S. markets. As noted in the prior LawFlash, many of the RMG policies are applicable with respect to pay practices effective in 2009.

#### **Problematic Pay Practices**

Under its 2009 policy, RMG could recommend an “against” or “withhold” vote on the re-election of compensation committee members, a company's chief executive officer, or the entire board if the company maintains “poor compensation practices,” which were characterized by features such as excise tax gross-ups in connection with a change in control, excessive change-in-control payouts without a job loss, or substantial diminution in duties and walk-away rights.

For 2010, a management “say on pay” (MSOP) proposal will be the primary vehicle for RMG to communicate its view on a company's pay practices if such a proposal is on the ballot. RMG will evaluate an MSOP by focusing on pay for performance (i.e., CEO compensation), pay practices, and board responsiveness and communication on compensation issues. RMG acknowledges that because the pay practices adopted by individual companies will vary depending on a company's industry or unique situation, each company will be reviewed on a case-by-case basis.

If RMG determines that a company maintains problematic pay practices, RMG may recommend an “against” vote on MSOP proposals, an “against” vote on equity-based incentive plan proposals, and/or an “against/withhold” vote on compensation committee members (or against the full board if all directors are deemed responsible). Under current law, MSOP is not generally mandatory, but may become so in 2011.

RMG's new policy, and its accompanying FAQs, also identify certain practices that RMG considers particularly problematic and that carry the greatest weight as “problematic pay practices” in an evaluation, including the following:

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1. The November 17, 2009 Morgan Lewis LawFlash, “RiskMetrics Group Releases Proposed Changes to Proxy Advisory Policies for 2010 Proxy Season,” is available online at [http://www.morganlewis.com/pubs/EB\\_RiskMetricsProxyPolicies\\_LF\\_17nov09.pdf](http://www.morganlewis.com/pubs/EB_RiskMetricsProxyPolicies_LF_17nov09.pdf).

- Multiyear guarantees for salary increases, nonperformance-based bonuses, and equity compensation
- Crediting additional years of unworked service in pension calculations that results in significant additional benefits without providing sufficient justification, or including long-term equity awards in the pension calculation
- Providing excessive or overly generous perquisites, such as perquisites for former and/or retired executives or extraordinary relocation benefits (including home buyouts) for current executives
- Tax reimbursements related to excessive perquisites or other payments
- Dividends or dividend equivalents paid on unvested performance shares or units
- Excessive change-in-control benefits, such as payments exceeding three times salary and target bonus
- Change-in-control payments without job loss or substantial diminution in duty (“single trigger” payments)
- New or materially amended agreements providing for “modified single trigger” benefits, under which an executive may voluntarily leave for any reason (and without “good reason”) during a “window” period in connection with a change in control and still receive severance benefits
- New or materially amended agreements providing for excise tax gross-ups in connection with a change in control
- Executives using company stock in hedging activities such as “cashless” collars, forward sales, equity swaps, or similar arrangements
- Repricing or replacing underwater stock options or stock appreciation rights without shareholder approval (even if otherwise permissible under the company’s equity plan and applicable exchange rules)

Under its evaluation of “problematic pay practices,” the new RMG policy also includes an analysis of pay practices that may encourage inappropriate risk taking, as illustrated by practices such as guaranteed bonuses, the use of single performance metrics for short- and long-term plans, high severance packages or high pay opportunities relative to industry peers, excessively large annual equity grants, and disproportionate supplemental pension levels. However, RMG will consider clawback provisions, stock ownership and holding guidelines, and other factors that may mitigate the impact of the potentially risky incentives.

On December 16, 2009, the Securities and Exchange Commission adopted final amendments to the proxy disclosure rules to be in effect for definitive proxy statements mailed on or after February 28, 2010 (the Amended Proxy Disclosure Rules). Among other requirements, the Amended Proxy Disclosure Rules require a discussion in the proxy statement of a company’s compensation policies or practices as they relate to risk management if the company’s compensation policies or practices for employees create risks that are likely to have a material adverse effect on the company.<sup>2</sup>

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2. For more information regarding the Amended Proxy Disclosure Rules, please see the following Morgan Lewis LawFlash: [http://www.morganlewis.com/pubs/EBLF\\_SECFinalGuidanceOnExecCompDisclosure\\_21dec09.pdf](http://www.morganlewis.com/pubs/EBLF_SECFinalGuidanceOnExecCompDisclosure_21dec09.pdf)

## **Pay for Long-Term Performance Alignment**

Under the 2009 policy, RMG could recommend an “against” vote on an MSOP proposal (also referred to in the 2009 policy and corresponding FAQs as “management-proposed advisory votes on compensation”) and on an equity plan proposal and/or a “withhold” vote on compensation committee members if (i) a pay-for-performance disconnect existed between a company’s CEO and the company’s stock performance, (ii) more than half of the CEO’s pay increase was equity-based, and (iii) the CEO was a participant in the equity proposal. A pay-for-performance disconnect was deemed to exist if a company’s one- and three-year total shareholder returns were in the bottom half of its industry group, and its CEO (with at least two years’ tenure) had an increase in total direct compensation from the prior year. If RMG identified a pay-for-performance disconnect, it examined the company’s Compensation Discussion & Analysis to analyze whether the increase to the CEO’s total direct compensation was attributable to non-performance-based equity compensation.

Under the 2010 policy, RMG has clarified how it will determine whether there is a pay-for-performance disconnect with respect to a particular company. First, the 2010 policy expands the length of time during which it will assess CEO pay vis-à-vis company performance to include an analysis over a period of five years. The 2010 policy also clarifies the factors RMG considers relevant for identifying a pay-for-performance disconnect. Though a recent year-over-year increase or decrease in pay remains an important factor, the revised policy places additional emphasis on the long-term trend of CEO total compensation relative to shareholder return and the mix of performance-based compensation relative to total compensation. Specifically, RMG will consider (i) whether the CEO’s pay has increased or decreased and the magnitude of the change, (ii) the reason for the change in pay with respect to the pay mix (i.e., performance- versus non-performance-based elements), and (iii) the alignment of the CEO’s total direct compensation with the company’s total shareholder return over a period of at least five years, with particular emphasis on the most recent three years.

## **Adoption or Renewal of Pills Not Approved by Shareholders**

The 2009 policy mandated a shareholder vote against all director nominees (other than new nominees) of a company with a shareholder rights plan, or “poison pill,” that has not been approved by the company’s shareholders and that has a term in excess of one year.

To encourage more companies to submit pills for shareholder approval with greater regularity, the 2010 policy provides the following:

- If a company adopts a pill with a term of more than one year, or renews any existing pill regardless of term length, in either case without shareholder approval, RMG will recommend a “withhold/against” vote on all director nominees, except new nominees, who will be considered on a case-by-case basis.<sup>3</sup>
- RMG will review companies that have adopted pills with terms in excess of one year and may recommend or continue to recommend a “withhold/against” vote on the entire board (except for new nominees) if the company continues to maintain the nonapproved pill. RMG

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3. Whether RMG will recommend a “withhold/against” vote with respect to a new director nominee will depend on a number of factors, including the date of the pill’s adoption relative to the next shareholder meeting (i.e., whether the company had time to put the pill on the ballot), the company’s rationale for adopting the pill, the company’s governance structure and practices, and the company’s history of accountability to its shareholders.

will conduct these reviews every three years if the company has an annually elected board and every year if the company has a classified board.

- If a company's board makes a material change to an existing pill that is adverse to shareholder interests, and such change is implemented without shareholder approval, RMG will recommend a "withhold/against" vote on the entire board.

## **Director Independence**

**Transactional relationship test.** One of the factors RMG currently uses to evaluate whether a director is an "independent outside director" is whether he or she has any "transactional relationship" with the company or its affiliates (other than investments in the company through a private placement). In making this determination under its 2009 policy, RMG applied a NASDAQ-based transactional relationship test to all companies, regardless of whether the company was in fact listed on NASDAQ. Under the NASDAQ test, a transactional relationship is deemed to exist if the company receives or makes (including through charitable contributions) annual payments exceeding the greater of \$200,000 or 5% of the recipient's gross annual revenues. Under the 2010 policy, companies listed on the New York Stock Exchange or American Stock Exchange will be subject to the New York Stock Exchange-based test. That test deems a transactional relationship to exist if the company receives or makes annual payments exceeding the greater of \$1 million or 2% of the recipient's gross annual revenues. RMG will continue to apply the NASDAQ-based test to companies not listed on the New York Stock Exchange or American Stock Exchange.

**Definition of professional services.** Another factor RMG uses to determine whether a director qualifies as an independent outside director is whether he or she (or his or her relative) provides professional services to the company, an affiliate of the company, or an officer of the company or a company affiliate in excess of \$10,000 per year. The 2010 policy clarifies that the \$10,000 *de minimis* threshold for professional services will be applied not only if the director (or an immediate family member) provides the professional service, but also if the director (or an immediate family member) is a partner in, a controlling shareholder of, or an employee of an organization providing the professional service. In addition, RMG has expanded the definition of "professional services" from services that are "advisory in nature" to include services that are "advisory in nature, generally involving access to sensitive company information or to strategic decision-making, and typically have a commission- or fee-based payment structure." The 2010 policy specifies that the definition will generally include insurance services, information technology services, marketing services, lobbying services, executive search services, and property management and realtor services.

Although the 2010 proxy advisory policies are effective for shareholder meetings held on or after February 1, 2010, the new policies and changes from the 2009 policies summarized above are, in effect, currently applicable as decisions regarding 2010 compensation are being made now.

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