

RiskMetrics Group Releases Proposed Changes to Proxy Advisory Policies for 2010 Proxy Season

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Recently, RiskMetrics Group (RMG) (formerly Institutional Shareholder Services, or ISS) released proposed changes to its proxy advisory policies to be in effect for the 2010 proxy season. The comment period on the proposed policies was open through November 11, 2009, and RMG anticipates releasing its final policy updates on November 20, 2009. The policy updates relate to RMG's proxy advisory policies in domestic and worldwide markets. This LawFlash discusses the following proposed proxy advisory policies applicable to U.S. markets.

Pay Riskiness

Under its overall executive compensation evaluation of its "problematic pay practices" policy, the new RMG proposal 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 aggressive clawback provisions, stock ownership, and holding guidelines, as well as other factors that may mitigate the impact of the potentially risky incentives.

RMG does not expect that this proposed policy will necessarily determine whether it will encourage a "for" or "against" recommendation on an election of directors. Rather, the proposed changes will allow for a more robust review of a company's pay programs.

Pay for Long-Term Performance Alignment

Under its current policy, RMG may recommend an "against" vote on an equity compensation plan or management "say on pay" proposal and a "withhold" vote on compensation committee members, if (i) a pay-for-performance disconnect exists between a company's CEO and the company's stock performance, (ii) more than half of the CEO's pay increase is equity-based, and (iii) the CEO is a participant of the equity proposal. A pay-for-performance disconnect exists if a company's one- and three-year total shareholder returns are in the bottom half of its industry group, and its CEO (with at least two years' tenure) has an increase in total direct compensation from the prior year. If RMG identifies a pay-for-performance disconnect, it will examine the company's Compensation Discussion &

Analysis to determine whether the increase in the CEO's total direct compensation is attributable to non-performance-based equity compensation.

Under the proposed revisions, RMG will lengthen the maximum time period during which it assesses CEO pay vis-à-vis company performance from three years to five years. In addition, under the proposed policy, RMG will identify a potential pay-for-performance disconnect not only in the event that the CEO of a company with shareholder returns in the bottom half of its industry group receives an increase in total direct compensation, but also in the event that the CEO's total direct compensation *remains unchanged* or only *marginally decreases* within the relevant period.

Adoption or Renewal of Non-Shareholder-Approved Pills

Currently, RMG policy mandates 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 more regularity, RMG is proposing the following changes:

- 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.¹
- Every three years, 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 should the company continue to maintain the nonapproved pill.
- If a company's board makes a material, adverse change to an existing pill 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 current policy, RMG applies a NASDAQ-based transactional relationship test to all companies, regardless of whether the company is in fact listed on NASDAQ.

Under the NASDAQ test, a transactional relationship will be deemed to exist if the company receives or makes (including through charitable contributions) annual payments exceeding \$200,000 or 5% of the recipient's gross annual revenues. Under the new RMG proposal, companies whose securities are listed on the New York Stock Exchange (NYSE) will be subject to the NYSE-based test. That test deems a transactional relationship to exist if the company receives or makes annual payments exceeding the

1. 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.

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.

Definition of professional services. RMG is also proposing to clarify its 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 of an affiliate of the company) in excess of \$10,000 per year. Currently, RMG characterizes professional services as being "advisory in nature." Under the new RMG proposal, the concept of professional services will be restated to cover 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."

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