

# MORROW & CO., LLC

## Proxy Update

January, 2010

### **RiskMetrics 2010 Corporate Governance Policy Updates In Depth Review**

As we move into the 2010 Annual Meeting season, we wanted to provide you with a detailed review of the changes to the RiskMetrics Group (“RMG”) policies that may have an impact on the voting at your Annual Meeting. While the most extensive changes to these policies come in the area of executive compensation, RMG has also modified their views on director elections, poison pills, share authorizations, and social and environmental issues.

In summary,

- Many of the changes codify current practices.
- RMG is encouraging additional disclosure in proxy statements, especially on compensation, board practices, and capital stock increases.
- The policy changes allow for more qualitative judgment, provide greater latitude in applying policies, and increase the opportunities for a withhold or against recommendation.
- Some of the policy changes are to some extent prescriptive in the areas of diversity, management proposals on calling special meetings and management say on pay proposals.

In light of these policy changes, we want to reemphasize the importance of reviewing director nominees and other agenda items, well in advance of your proxy mailing.

#### **Executive Compensation**

RMG has revised and reorganized its policies on executive compensation into a single holistic “Executive Compensation Evaluation” policy. The new executive compensation evaluation policy is a combination of RMG’s existing pay for performance, poor pay practices, and management say on pay (“MSOP”) guidelines. Although the basis of the “Executive Compensation Evaluation policy” remains the same from previous years, there are several noteworthy modifications and additions.

## Pay for Performance

RMG considers Pay for Performance to be a “critical” factor in evaluating MSOP, director elections, and equity plan proposals.

RMG’s current policy looks at one and three year total shareholder return (“TSR”) and the most recent year-over-year CEO pay changes. For 2010, RMG has added a new factor to its pay for performance evaluation that will review the alignment of the CEO’s total direct compensation (“TDC”) with TSR over a period of at least five years. RMG has made this change in an effort to allow shareholders to better assess the alignment between CEO pay and stock performance.

If a company’s one and three year TSR are in the bottom half of its industry group, RMG will analyze the CD&A to determine if various pay elements reinforce proper alignment with performance. Recent year-over-year increases in CEO pay remain a key factor, but now RMG will emphasize the long term (at least five year) trend in CEO compensation relative to performance. RMG will also look at the mix of performance-based compensation relative to total compensation. In that regard, RMG encourages companies to provide “complete disclosure of the performance measures and goals”. As a result of this guideline modification, a CEO may actually receive less compensation year over year but still violate their pay for performance guideline.

Should RMG determine misalignment between CEO pay and company performance under this new measure, RMG will recommend a vote against an MSOP proposal and/or recommend withhold or against the election of directors (generally the compensation committee members). Should a large portion of CEO pay misalignment be attributable to equity awards, RMG will generally recommend a vote against an equity compensation plan on the agenda.

## Management Say on Pay (“MSOP”) Proposals

In what appears to be an effort to encourage companies to submit MSOP proposals to a shareholder vote, RMG intends to use its vote recommendations with respect to these proposals as the primary avenue of communication to address what it views as problematic pay practices. The use of an MSOP proposal *may* shield compensation committee members from a withhold or against recommendation if the company has problematic pay practices. Previously, RMG would generally recommend a withhold or against vote on compensation committee members up for election. Now, for companies that include MSOP proposals on their annual meeting agenda, RMG may only recommend an against vote on the MSOP, thus sparing the compensation committee members from a negative recommendation.

For companies with problematic pay practices under the new Executive Compensation Evaluation policy, RMG’s general course of action will now be to recommend:

- Against MSOP proposals at such companies;
- Withhold or against with respect to the election of compensation committee members, or the entire board (when deemed appropriate) in egregious situations or when the board has failed to respond to concerns raised in prior MSOP evaluations; and
- Against equity based incentive plan proposals if excessive non-performance based equity awards are deemed to be the primary reason for pay for performance misalignment.

### **Problematic Pay Practices**

Below is a list of what RMG considers to be some of the problematic pay practices that are “particularly contrary to a performance-based pay philosophy” (this is not a new list, but worth repeating as you review your pay practices):

- Multi-year guarantees for salary increases, multi-year guarantees for non-performance based bonuses, and multi-year guarantees for equity compensation;
- Including additional years of un-worked 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; change-in-control payments without job loss or substantial diminution of duties (“single triggers”); new or materially amended agreements that provide for modified single triggers (under which an executive may voluntarily leave for any reason and still receive the change-in-control severance package); new or materially amended agreements that provide for an excise tax gross-up (including modified gross-ups);
- Tax Reimbursements related to executive perquisites or other payments such as personal use of corporate aircraft, executive life insurance, bonus, etc;
- 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).

## **Excessive Risk Taking**

RMG has added a new guideline related to compensation that looks to isolate compensation practices that could incentivize excessive risk taking. RMG's new assessment will consider the following:

- 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.

While most of these “risk-motivating” incentives are considered under general “Poor Pay Practices,” RMG's 2010 guidelines highlights these for special focus. Issuers should be familiar with RMG's broader list of poor pay practices and should be aware if their compensation practices run afoul of any of these practices.

## **Change in Volatility – Equity-Based and Other Incentive Plans**

RMG will revert to the 200-day volatility and 200-day moving average stock price for the Dec. 1, 2009 and subsequent quarterly data downloads in consideration of shareholder value transfer and burn rate policies. While the stock market has experienced volatile periods in the past and may in the future, volatility levels at the end of 2008 and early 2009 were unprecedented and caused RMG to use a 400-day volatility measurement and a 90-day average stock price for 2009.

## **Directors**

### **New Nominee**

In cases where RMG has recommended a withhold vote on nominees due to a problematic action, they have traditionally not recommended a withhold vote on a “new nominee” under the rationale that they should not be held accountable for actions taken before they joined the board. The “new nominee” definition has been refined to be “any current nominee who has not already been elected by shareholders and who joined the board after the problematic action in question transpired”. If it cannot be determined whether the new nominee joined the board before or after the action, the nominee will be considered “new” if he or she joined the board within the 12 months prior to the upcoming shareholder meeting.

## Egregious Actions

In an expansion of its policy on recommending a withhold vote on directors, committees or the entire board in cases of egregious actions, RMG will now include actions related to the director(s) service on other boards. Egregious actions that “raise substantial doubt about a director’s ability to serve as an effective monitor of management and in the best interests of shareholders” may result in a negative recommendation at any company where that director serves. With this change, you will need to be aware that a withhold recommendation may be possible even if a particular director meets all RMG guidelines at your company.

## Professional and Transactional Services

RMG has updated their evaluation of director independence as it relates to professional and transactional services:

- The materiality test for transactional relationships will now be bifurcated. Prior to this change, all companies were subject to the NASDAQ test of greater of \$200,000 or 5 percent of the recipient’s gross annual revenues. Under the new guidelines, companies that follow the NYSE/Amex listing standards will be subject to the NYSE test of the greater of \$1 million or 2 percent of the recipient’s gross annual revenues.

Companies that follow the NASDAQ listing standards will continue to be subject to the NASDAQ test described above. The NASDAQ test will also apply to companies that do not follow either of the exchanges’ listing standards with regard to related party transactions. The materiality test will apply if the director (or immediate family member) has the transactional relationship or if the director (or immediate family member) is a partner in, controlling shareholder, or executive officer of, an organization that has the transactional relationship.

- The \$10,000 de minimis threshold for professional services will be expanded to include organizations with which the director or members of their immediate family are affiliated.
- The characterization of professional services will be changed from “advisory in nature” to “advisory in nature, generally involve access to sensitive company information or to strategic decision-making, and typically having a commission or fee-based payment structure”.
  - Insurance services and marketing services will be considered professional services unless there is an explanation as to why they are not advisory.
  - Information technology (IT) services will be considered professional services unless they involve tech support.
  - Educational services will no longer be considered professional services.
  - Lobbying services, executive search services, property management and realtor services will now be considered professional services.

- “Of Counsel” relationships will only be considered immaterial if the individual does not receive compensation in excess of \$10,000 per year or has retired from the law firm. This change codifies how RMG currently applies its policies, and places the burden on the company to disclose that no material financial tie exists.

### **Classification of Inside Directors**

There are two additional changes of note relative to the classification of inside directors:

- One of the criteria for inside directors will be changed from “Non-employee officer of the company if among the five most highly paid” to “Among the five most highly paid individuals”.
- Non-employee directors serving as officers due to statutory requirements will not be considered an insider unless they exceed the de minimis threshold of \$10,000 per year.

### **Poison Pills**

Currently RMG will recommend a withhold vote from all nominees (with the exception of “new nominees”) if the company adopted or renewed a poison pill without shareholder approval and there is no commitment to put the pill to a shareholder vote within twelve months. In the past, this withhold policy was only applied once, at the first meeting after the pill was put in place or renewed. (The one exception is when the pill has a dead-hand provision: in these cases RMG will continue to make the withhold recommendation each year until the dead-hand provision is removed).

RMG is now separating their withhold policy into two categories based on the term of the pill: long-term (more than twelve months) and short-term (twelve months or less).

In case of a long-term pill RMG will now review the pill and recommend a withhold vote every three years beginning with the first year the pill is adopted until the pill has expired or is redeemed. In cases where the board is classified, the review will be done on an annual instead of a three year basis. The result of this is that each director will receive an adverse recommendation at least once every three years.

Short-term pills will now be reviewed on a case-by-case basis taking into consideration: the rationale for the pill, the company’s governance structures and practices, and their track record of accountability to shareholders. It is of note that RMG has softened its stance with regard to short-term pills, calling them “less onerous” and acknowledging that in some cases they can be a “valuable tool”. RMG has indicated that for 2010 these new policies will only apply to companies that adopt or renew a pill after November 19, 2009. They further indicated that this policy might be applied retroactively after 2010.

## **NOL Poison Pills**

One of the topics arising out of the financial crisis was the concept of Net Operating Loss (NOL) protective amendments poison pills. Generally, companies are concerned that the significant tax benefit of an NOL asset may be lost upon the acquisition of 5 percent of a company's shares.

RMG will support NOL poison pills, as long as certain criteria are met. The most important criteria are:

- The ownership transfer threshold;
- The value of the NOL;
- The term of the pill;
- Shareholder protection mechanisms; and
- The company's current governance structure.

RMG recognizes that the tax benefits can be significant. However, their overriding concern is simply that any pill should be put to a shareholder vote. An NOL pill that is adopted without shareholder approval will cause RMG to recommend against directors.

## **Governance and Capital Issues**

### **Shareholder Ability to Call Special Meetings**

RMG has added specific factors that it looks for in proposals to provide shareholders with the right to call special meetings. The specific factors RMG will take into account include the minimum ownership threshold (they note that 10% is preferred), exclusionary or prohibitive language within the right, and management's response to previous shareholder proposals.

RMG has done this in response to what it considers overly restrictive, management-sponsored proposals to provide shareholders with the right to call special meetings. RMG points to procedural hurdles imposed by the management-sponsored proposals, such as high thresholds and advance notice restrictions, that it feels are tantamount to antitakeover devices.

RMG calls this a policy change, but it seems to be more of a prescriptive "how to" guide for companies considering a management-sponsored proposal on the call of a special meeting. RMG states that its new policy "encourages" companies to submit proposals that "provide a substantive right to shareholders." RMG seems to be providing fair warning that a proposal that does not meet its guidelines may receive an Against recommendation.

As it relates to shareholder proposals on this subject, RMG will support shareholder proposals looking for a decrease in the percentage of shares needed to call a special meeting. (Most shareholder proposals ask for a 10% threshold.) As was the case last year, even if a company allows shareholders to call a special meeting at a higher level, they will not be insulated from shareholders proposals on the topic (nor would they be insulated from a recommendation that is adverse to the company).

### **Changes to Capital Structure**

RMG has added an additional narrative overlay in its analysis of increases in authorized common and preferred stock proposals. This change will afford RMG additional latitude to recommend against capital increase proposals. Conversely, companies will also have the opportunity to present their reasons for increases that exceed RMG's allowable cap.

Previous to 2009, RMG made a voting recommendation based on whether the requested increase was below RMG's allowable cap (as determined by their quantitative model). In 2009, RMG added a narrative overlay in its analysis to consider "problematic governance" issues.

In 2010, RMG will expand the narrative overlay to consider planned share usage (to the extent disclosed), one- and three-year TSR, and share usage during the last three years. In looking at past share usage, RMG will consider details of acquisitions, previous new share requests, and equity plans (including burn rate and repricings). This additional analysis provides RMG additional leeway to recommend against an increase even if the increase passes their quantitative tests.

For preferred stock issuances, RMG will continue to recommend FOR preferred shares that are "declawed" (stock that cannot be used as an anti-takeover defense), and AGAINST "blank check" preferred stock unless:

- the company commits not to use it for anti-takeover purposes without shareholder approval;
- the company already has existing authorized and outstanding shares of blank-check preferred (making an increase in shares moot): or
- the analyst at RMG determines that the risks of rejecting a specific proposal outweigh the risks of adopting it.

## **Social and Environmental Issues**

### **Greenhouse Gas Emissions (“GHG”)**

RMG’s policy with regards to shareholder proposals that call for the adoption of GHG reduction goals from products and operations is changing from “generally vote Against” to “Case-by-Case”. RMG will take into account the prescriptive nature of the request, whether the company’s level of disclosure is comparable to that of industry peers, whether the company has been subject to significant controversies, fines, penalties, or litigation associated with the company’s GHG emissions, and the feasibility of reducing GHG given the company’s products.

RMG is making this change to reflect a change in the proposals that have been submitted over the last few years, which ask that the company set “goals” for GHG reduction, rather than calling for reducing GHG emission by specific amounts or within specific time frames. The Case-by-Case approach will also allow RMG to take into account the company’s industry and whether the adoption of GHG reduction goals may not be possible without a product reformulation (in industries such as oil and coal, for example). This approach will likely result in additional FOR recommendations on these proposals in the future.

### **Board Diversity**

RMG has changed its policy with regards to shareholder proposals on board diversity. The key change is that RMG is now specifying that its definition of what constitutes diversity includes racial and gender diversity. RMG cites that in the past, companies may state that they seek diversity of backgrounds when evaluating director candidates, but the companies do not state whether their definition of diversity is limited to professional diversity, rather than racial and gender diversity. RMG will now look for that additional disclosure when making its recommendation.

RMG will also look for expanded disclosure of diversity within the company, not just at the board level as in the past.

In general, RMG will continue to recommend For reports on a company’s efforts to diversify the board, and case-by-case on proposals to increase the gender and racial minority representation on the board (taking into account how prescriptive the proposal is); unless the company provides the additional disclosure.

## **Conclusion**

Given the number and extent of the changes to RMG's policies for 2010, it is important that all companies review their director candidates and compensation policies for potential issues that may arise at the Annual Meeting. Many of these changes should also be reviewed through the lens of your particular voting requirements for directors (plurality or majority voting), since an adverse recommendation on directors could potentially result in a failed election. This is even more important as we enter 2010 with the loss of discretionary voting on directors.

Morrow & Co. would be pleased to review your proxy statement as early as possible, and provide you with appropriate guidance on how to address issues that may arise.

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