

## RISKMETRICS 2008 POLICY SUMMARY

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RiskMetrics, formally known as Institutional Shareholder Services or ISS, is the leading proxy advisory firm in the world. The firm provides recommendations to the vast majority of institutional investors, and their recommendations can have an enormous impact on a shareholder vote. Although official numbers are not known, The Altman Group estimates the RiskMetrics recommendation can, on average, influence the vote between 20 – 25 percent. Corporate issuers must understand how RiskMetrics analyzes proxy issues.

Each year RiskMetrics releases updates to its proxy voting guidelines for the upcoming proxy season. To assist our clients and partners, The Altman Group has summarized the 2008 RiskMetrics policy updates. This report will break down the policy changes into three broad categories: board related, compensation related, and audit related. These updated guidelines will affect companies with meeting dates on or after February 1, 2008. This is a summary document not intended to be used as the formal RiskMetrics policy. If readers have any questions about these policies we encourage them to contact their representative at The Altman Group.

### **BOARD RELATED ISSUES**

RiskMetrics is adding two more instances (and modifying another) where it may recommend a vote to withhold or a vote against directors. This update will force companies to consider more governance criteria that may result in a large withhold or against vote.

#### **Issues Involving Classified Boards**

##### **Impact on Issuers: Negative**

If RiskMetrics feels that a director, who is not up for election due to the company's classified board

structure, is responsible for a "problematic" governance issue it may recommend a vote to withhold or vote against any or all of the nominees who are up for election. RiskMetrics could also potentially recommend against the re-election of the "offending" director the next time he or she is up for election. An exception for new nominees will be made.

RiskMetrics has never supported classified board structures. Under the new policy, continuing directors will no longer be able to avoid being targeted by the fact that they are not up for election. This update gives RiskMetrics the ability to continue voting against directors after the first year the problem arises. Although RiskMetrics does not define the universe of possible problematic issues, one can infer it means issues like options backdating, lack of pay for performance, and adoption/renewal of poison pills (among others).

Issuers need to be aware that a withhold or against vote could now have a three year horizon, whereas in the past the company would generally not have any concerns beyond one year.

#### **Adoption of Poison Pill without Shareholder Approval prior to IPO**

##### **Impact on Issuers: Neutral**

RiskMetrics will recommend a vote against all incumbent directors at companies that (1) adopt or renew a pill without shareholder approval, (2) do not publicly commit to putting the pill to a shareholder vote within 12 months of adoption, (3) reneges on a commitment to put the pill to a vote, and (4) has not yet received a withhold recommendation on this issue.

The only change in RiskMetrics' policy reflected in the above is that it now encompasses newly public companies, which had been exempted before. These companies must commit to putting any pill



up to a vote within 12 months of the IPO.

Companies going public have to review a slew of governance issues and this policy update just adds one more.

### **Performance Test for Directors**

#### **Impact on Issuers: Positive**

In 2007, RiskMetrics adopted a performance test which sought to find the worst performers in each industry group using certain financial metrics over a five year period. If a company failed this performance test, RiskMetrics would recommend a withhold vote against director nominees. This policy only applied to companies in the Russell 3000 Index.

RiskMetrics is essentially scrapping this policy and saying it will include the director performance test in its overall evaluation of the board. The impact of this change will be minimal as only a handful of companies failed this test in 2007.

### **Cumulative voting**

#### **Impact on Issuers: Slightly Negative**

Under the new guidelines, RiskMetrics will vote for proposals to provide for cumulative voting unless:

the company has proxy access to allow shareholders to nominate directors

AND

the company has adopted majority voting with a director resignation policy and a carve-out for contested situations.

In the past, an issuer had to meet a list of ten governance principles before RiskMetrics would vote against proposals to provide for cumulative voting. These ten principles are being replaced with proxy access and majority voting. Most proposals that provide for cumulative voting are presented as shareholder proposals, and RiskMetrics has supported the majority of these proposals. According to data on its Voting Analytics system, RiskMetrics supported 38 of 48 – 79 percent – of cumulative voting proposals since January 2006.

Expect to see RiskMetrics continue to support most shareholder proposals to provide for cumulative voting. Although many companies have adopted majority voting, very few have adopted proxy access or a similar structure.

### **Shareholder Proposal: Separate Chairman and CEO**

#### **Impact on Issuers: Slightly Negative**

Currently, RiskMetrics will vote for shareholder proposals seeking an independent chairman unless the company has a “counterbalancing governance structure” in place. This structure includes a lead independent director (with very specific disclosed duties), two-thirds independent board, independent committees, governance guidelines, positive performance compared to peers, and lack of any “problematic” governance issues.

Since the beginning of 2006 RiskMetrics has made recommendations on 98 shareholder proposals to separate the roles of chairman and CEO. They supported the proposal in 57 instances (58 percent).

In addition to the current governance structure, RiskMetrics has adopted two additional criteria that a company must meet if ISS is to vote against the shareholder proposal, namely:

- the company publicly discloses a comparison of the duties of its independent director and its chairman; and,

the company publicly discloses a sufficient explanation of why it chooses not to give the position of chairman to the independent lead director, and instead to combine the chairman and CEO positions.

RiskMetrics does not elaborate on the parameters around the additional disclosure, as it will probably make the determination if the disclosure is adequate on a company-by-company basis. Issuers will have some discretion on this disclosure, although the more detail provided, the more likely RiskMetrics will support management.



## COMPENSATION RELATED ISSUES

### Shareholder Value Transfer

#### Impact on Issuers: Positive

Shareholder Value Transfer (SVT) is one of the main drivers in RiskMetrics' recommendations on equity incentive plans. They use a proprietary binominal model to calculate how much wealth is being transferred from the company to the award holder as awards are exercised and vest. RiskMetrics is adjusting its SVT model to account for well-performing companies with a high overhang due to in-the-money options. Essentially, in-the-money outstanding options in excess of six years may receive a carve-out as long as any new share request is reasonable and the company has positive compensation practices. RiskMetrics will review the following criteria when considering whether to carve-out options:

- **Positive Stock Performance:** five-year total shareholder return (TSR), year over year performance, and peer performance
- **Overhang Disclosure:** Companies will need additional disclosure in their public filings, which are necessary for RiskMetrics to run its SVT model. Companies will really need to break down their overhang into several buckets.
- **Dilution:** RiskMetrics will review the expected duration of the new share request: any duration greater than five years will be considered excessive. This duration will be calculated using a formula based on burn rate and the total awards available for grant.

**Compensation Practices:** Repricing provisions, ratio of grants to top executives, and practices outlined in poor pay practices policy.

This is a positive development for corporations that have performed well; and as a result, options are held for a longer period of time. The Altman Group has used a similar strategy when talking directly to institutional shareholders in solicitation campaigns and is pleased that RiskMetrics has adopted this progressive policy update. Many large institutions consider these in-the-money options while calculating dilution. Given the influence that RiskMetrics has, this is a welcome policy change.

However, issuers should be aware that RiskMetrics may ultimately modify this policy update. Although nothing specific has been revealed, sources close to the issue say RiskMetrics may issue a policy clarification on this policy update in mid-January 2008.

### Advisory Votes on Executive Compensation – Management Proposals (Say on Pay)

#### Impact on Issuers: Neutral

RiskMetrics' 2008 policy includes guidelines on management proposals regarding say on pay – the advisory vote giving shareholders the ability to voice a “thumbs up or thumbs down” on the company's pay practices. Say on pay has been a “hot” governance topic in 2007 and will continue to be one in 2008. In the vast majority of cases, shareholders see say on pay in the form of a shareholder proposal, although so far two companies (AFLAC and Verizon) have committed to putting their executive pay to a shareholder vote. Given the pressure that advocates of say on pay are putting on companies, expect more companies to put their pay practices up for this vote. Thus the need for RiskMetrics to adopt a policy on management proposals related to say on pay.

Basically, RiskMetrics is going to review an issuer's overall pay practices on a case-by-case basis. On a global market basis, they will review issues such as pay-for-performance alignment with long-term shareholder value, lack of “pay-for-failure”, independent compensation committee, clear disclosure, and avoiding inappropriate pay to non-executive directors. For US based companies, RiskMetrics will rely heavily on the CD&A disclosure.

At this time, it is hard to see RiskMetrics being very critical of issuers that voluntarily submit their compensation practices to a shareholder vote. If it does take a hard line stance on this issue, RiskMetrics may alienate some companies who are considering putting pay to a vote. It is The Altman Group's opinion that RiskMetrics will only vote against a management say-on-pay proposal if an issuer has egregious pay practices and is way outside the norm in comparison to its peers.



## Poor Pay Practices

### Impact on Issuers: Negative

Currently, RiskMetrics has a policy which allows it to withhold or vote against board members and/or against a proposed equity plan if the company has what RiskMetrics deems to be “poor pay practices”. RiskMetrics currently lists 11 examples of poor pay practices including large employment contracts, excessive severance and change-in-control, and options backdating.

The 2008 updated policy makes four additions and clarifications to the pay for performance policy:

- RiskMetrics may recommend withhold or against votes where cautionary language has previously been applied but poor pay practices have not been remedied.
- Example of poor pay practices expanded to include multi-year guaranteed salary increases and perks for former executives including car allowances and personal use of corporate jet, among others.
- A new category called “poor disclosure” has been added:
  - o Unclear disclosure of how the CEO is involved in the pay setting process;
  - o Retrospective performance targets and methods are not discussed;
  - o Methodology for benchmarking practices and/or peer group not disclosed.

The current guidelines are:

Annual Stock Price Volatility	Multiplier
>53%	1 full value award will count as 1.5 option shares
25% - 52%	1 full value award will count as 2.0 option shares
<25%	1 full value award will count as 4.0 option shares

Base salary will be used as a relative measure to determine if certain perks are excessive.

RiskMetrics adopted this policy for the 2006 proxy season and the policy has only been enforced a handful of times since that time. However, the policy now gives RiskMetrics more discretion to vote against a company’s director or plan outside of their standard policy. Companies should be aware of this policy, but not to the same extent as other RiskMetrics criteria including Shareholder Value Transfer, burn rate, pay for performance, and repricing of underwater options.

## Burn Rate Policy

### Impact on Issuers: Neutral

RiskMetrics will vote against executive compensation plans, regardless of SVT and pay for performance measures if the burn rate violates the guidelines they have established. RiskMetrics has made two slight changes to how it calculates a company’s burn rate figure. In addition, they have adjusted each industry group’s burn rate threshold for the 2008 season.

### *Stock Price Volatility*

In calculating the numerator of a company’s burn rate, options count as one share, while RiskMetrics uses a multiplier for full-value awards. So full-value awards, such as restricted stock and performance awards, will count as more than one towards a company’s burn rate. The multiplier depends on a company’s annual stock price volatility.

The new guidelines are:

Annual Stock Price Volatility	Multiplier
>54.6%	1 full value award will count as 1.5 option shares
36.1% or higher and less than 54.6%	1 full value award will count as 2.0 option shares
24.9% or higher and less than 36.1%	1 full value award will count as 2.5 option shares
16.5% or higher and less than 24.9%	1 full value award will count as 3.0 option shares
7.9% or higher and less than 16.5%	1 full value award will count as 3.5 option shares
<7.9%	1 full value award will count as 4.0 option shares

#### *Change in Denominator*

Currently, RiskMetrics uses common shares outstanding on fiscal year end date for the denominator in calculating the burn rate. Under the new policy, RiskMetrics will use weighted average common shares outstanding.

#### *Burn Rate Threshold Adjustment*

Every year RiskMetrics re-calculates its burn rate thresholds for each industry group. After two years of thresholds trending down, 2008 sees a slight increase in thresholds in many industry groups. For companies that are in the Russell 3000 Index, burn rate thresholds went up in 15 of 22 industry groups. For companies not in the Russell 3000 Index, burn rate thresholds went up in 13 of 22 industry groups. The burn rate thresholds went down for companies in the banking, real estate, and utility industries.

### **AUDIT RELATED ISSUES**

#### **Poor Accounting Practices**

#### **Impact on Issuers: Negative**

RiskMetrics will provide additional information and detail on companies deemed to have poor ac-

counting practices. This may include withhold or against vote on audit committee members and perhaps votes against the ratification of auditors.

RiskMetrics has a forensic accounting firm division which will be able to provide more data behind any vote recommendation. This is something ISS did not have prior to the RiskMetrics acquisition, so although it remains to be seen, RiskMetrics may start to vote against more audit related issues.

### **SUMMARY**

On balance, the 2008 RiskMetrics policy updates are fairly benign and should not have a tremendous impact on corporations. However, given the impact that RiskMetrics could have at a shareholder meeting, issuers should be aware of how these policies might impact them. Issuers should know their institutional shareholders. How many of these shareholders will follow the RiskMetrics recommendation? How many will at least review the analysis when making their own decision?

With the 2008 proxy season fast approaching, issuers need to start reviewing their proposals and how their shareholders might review them.

**About The Altman Group:** The Altman Group is one of the premier proxy solicitation corporate governance, shareholder identification, and bankruptcy services firms in the United States and winner of the 2006 TOPS Award as the Highest Rated Proxy Solicitation Firm.

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