

To: Our Clients and Friends

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## RiskMetrics Introduces Governance Risk Indicators (“GRId”), a New Tool to Measure Corporate Governance

On March 10, 2010, RiskMetrics Group, formerly known as Institutional Shareholder Services or ISS, published its new scoring system to measure corporate governance practices, which it has named “Governance Risk Indicators,” or GRId. In the 188-page publication, Risk Metrics sets forth the questions, scoring and weighting methodology for GRId, including breakdowns by market. The GRId publication is available [here](#), with a breakdown of questions applicable to companies in each market set forth in Appendix B of the release. RiskMetrics indicates that the methodology for assessing risk is aligned with its benchmark voting policy.

Earlier this year, Risk Metrics introduced GRId as a new tool intended to allow investors to assess the level of corporate governance risk of companies. RiskMetrics indicated it expects to publish GRId ratings beginning March 17, 2010 with its former Corporate Governance Quotient (“CGQ”) ratings eliminated by the end of June. Companies should expect to be contacted by RiskMetrics once their data is ready for review.

The Governance Risk Indicators will be based on an evaluation of a company’s compliance with a series of “best practices”, with an individual company’s score based on its own practices instead of its relative performance against peers. The relative weightings of the underlying criteria will vary depending on the relevant global market.

### GRId Methodology Generally

GRId will measure risk in four corporate governance areas. The measures will be expressed as three different levels of “concern”: low, medium and high (color coded blue, yellow and red). The governance areas are:

- Audit,
- Board Structure,

- Shareholder Rights, and
- Compensation.

Scores will be based on answers to a series of between 59 and 95 questions (63 for U.S. companies) across the four areas. Each area will be divided into subsections, with questions in each subsection. Answers will be converted into numerical values based on a grading system determined by RiskMetrics with the results converted into overall scores and levels of concern (e.g., low, medium and high) in each of the four areas. The closer a company’s actual practice is to the “highest” level as determined by RiskMetrics, the higher the score.

Generally, GRId’s scoring for a question will be based on a scale of “-5” to “5” with “0” a neutral score. According to RiskMetrics, a neutral score suggests the Company meets, but does not necessarily exceed, the local governance standard on the issue. Scores are then normalized on a 100 point scale (e.g., 0 to 100).

RiskMetrics’ GRId publication provides the following table regarding how score ranges translate into concern levels for each of the four areas. See the GRId publication at page 16.

Concern Level - Market	Scoring Range			
	Audit	Board	Shareholder Rights	Compensation/ Remuneration
High - U.S.	0-75	0-55	0-35	0-55
Medium - U.S.	75-90	55-70	35-60	55-70
Low - U.S.	90-100	70-100	60-100	70-100
High - Canada	0-75	0-55	0-50	0-45
Medium - Canada	75-90	55-85	50-75	45-65
Low - Canada	90-100	85-100	75-100	65-100
High - Europe	0-75	0-60	0-55	0-55
Medium - Europe	75-90	60-80	55-80	55-75
Low - Europe	90-100	80-100	80-100	75-100

RiskMetrics explains the three levels of concern as follows (page 15 of the technical release):

- A “low” concern level will generally suggest that the relevant practices are well in line with, or exceed, standard market practices as encapsulated by ISS’ benchmark voting policy; there may be exceptions, but not significant ones.
- A “medium” concern level typically will suggest that some practices appear not to be in line with market standards, including some emerging best practices, though incongruities are not large enough to cause significant concern.
- A “high” concern suggests a meaningful variance between a company’s practices and market standards, and that investors should explore further whether the company’s practices raise questions about long-term risk.

According to RiskMetrics, companies will be provided a limited amount of time, through a data verification tool, to correct any errors upon which the scores are based. Additionally, investors will be able to “drill down” to the underlying data.

RiskMetrics indicates that the questions are based on the same principles underlying RiskMetrics’ benchmark voting policy. However, the GRId ratings will not serve as the basis for RiskMetrics proxy voting recommendations. The methodology is expected to be updated annually in conjunction with a review of the voting policy.

Scores will be based on each company’s score relative to what RiskMetrics views as “best practice” in the relevant global market. RiskMetrics indicated that the variance across global markets will be based on its view of “local governance dynamics, with attention to the best practices in that market.”

### **GRId Scores and Questions for U.S. Companies**

GRId scores will be based on the answers to a series of questions in each of the four areas. Each area is further broken into multiple subsections with a series of questions in each subsection.

A total of 63 questions apply to U.S. companies. Unfortunately, RiskMetrics’ GRId publication covers 166 total questions with the scoring and weighting for each global market mixed together. Appendix B of RiskMetrics’ technical publication does list the questions by global market. We have prepared a summary of the questions and scoring system applicable to U.S. companies, which is available upon request.

A discussion of certain of the subsections, questions and weightings from those subsections that apply to U.S. companies is set forth below.

### **Audit**

The Audit area covers three subsections:

- Audit Fees (21.25% of the overall “Audit” score),
- Controversies (57.5%), and
- Other Issues (21.25%).

The questions in this area generally focus on whether non-audit fees exceed 50% of total fees, the existence of adverse opinions, restated or late financials, enforcement actions or material weaknesses in the last two years. Scoring generally ranges from -5 to 0, with little or no opportunity for positive scores. Given the relatively high thresholds for “low” risk (90%) and medium risk (75%), negative scores in any of these areas could result in a higher risk category.

### **Board Structure**

The Board Structure area covers three subsections:

- Board Composition (25%),

- Committee Composition (15%, spread evenly among nomination, compensation and audit committees independence questions), and
- Board Practices (60%).

If a majority of the Board is independent, the entire weighting for the Board Composition subsection depends on the qualification or classification of the chairman of the board. For example, companies that provide no information, or for which the chairman is an executive officer or is not independent may receive a “-5”, the lowest possible score. A separate lead director may result in a score of “0”. Given that this question accounts for 25% of the points applicable to the entire Board Structure area, companies with a score of “-5” may, depending on other answers, find it difficult to stay above the 70 score required to be “low” risk.

Some of the questions in the Board Practices subsection with greater weighting include the following (the percentages are of the weight of the particular question with respect to the Board Practices subsection, which, in turn, is worth 60% of the overall score in the Board Structure area:

- Does the company have a majority vote standard in uncontested elections? (16.58%)
- Do non-executives (presumed to mean non-employee directors) serve on an excessive number of outside boards (i.e., more than six other public companies)? (16.58%)
- How many directors received withhold/against votes of 50% or greater at the last annual meeting? (16.58%)
- Does the CEO serve on an excessive number of outside boards (i.e., more than two other public companies)? (14.92%)
- Did any directors attend less than 75% of the board meetings without a valid excuse? (7.14%)

## Shareholder Rights

The Shareholder Rights area covers four subsections:

- One Share One Vote (10%),
- Takeover Defenses (50%),
- Voting Issues (17%), and
- Voting Formalities (23%).

We note the emphasis on Takeover Defenses, which constitutes 50% of the score in the Shareholder Rights Area. Highly weighted questions in this subsection include the following:

- Whether all directors are elected annually determines 50% of the points in this subsection. Companies with a classified board structure will receive a score of “-5”, those with annual elections of all directors will receive a “5” and those transitioning to such an election cycle will receive a score of “0”.

- Does the company have a poison pill (shareholder rights plan) that was not approved by shareholders? Additional subquestions apply if a company has a poison pill. This question accounts for 33.3% of the score in the subsection.
- Is the board authorized to issue blank check preferred stock (12.72%)?

Other highly weighted questions in the Shareholder Rights area include the following:

- Questions relating to whether the company requires a super-majority vote to approve amendments to the charter and bylaws, or to approve mergers/business combinations. Each of these questions constitutes 40% of the score for the Voting Issues subsection.
- Has the board failed to implement a shareholder resolution supported by a majority vote? This question amounts to 70% of the points in the Voting Formalities Subsection.

## Compensation

The Compensation area covers three broad subsections for U.S. companies:

- Remuneration-Executive Short Term (3%, which focuses on whether a company discloses performance measures, hurdle rates, and target payout thresholds for short-term cash incentive plans),
- Remuneration-Executive Long Term/Equity (32%), and
- Remuneration-Other (65%).

Some of the more highly weighted questions in the Long Term/Equity subsection include the following:

- 20% of the score in this subsection relates to questions regarding whether the company discloses performance measures for stock option, restricted shares and other long-term plans.
- 20% of the score focuses on the level of dilution in stock plans, including whether the plans permit recycling of shares and whether the company grants equity awards at an excessive burn rate, as measured by ISS policy.
- 30% of the score relates to the minimum vesting or holding periods for stock options, SARS and restricted stock. The highest scores apply for vesting periods of five or more years and holding periods (post-vesting) until the end of employment.
- 30% of the score relates to whether the company has repriced options, exchanged them for shares, options or cash without shareholder approval in the last three years, or whether the company has equity plans that permit option/SAR repricing and cash buyouts.

The Remuneration-Other subsection covers 15 questions. The most highly weighted question, accounting for 35% of the score of the subsection, relates to the type of trigger under change-in-control agreements. A single triggers or “no information,” or “modified single trigger” (e.g., a window during which an executive can leave) in an agreement that was amended or entered into the last year, results in a score of “-5” and a double trigger or “no agreement” results in a score of “3”. A “modified single triggers” in an agreement that was not amended or entered into the last year results in a score of “-3” instead of “-5”.

The other questions in the subsection cover a variety of pay practices, including:

- Expected duration of shares under new stock plans;
- CEO and director stock ownership guidelines and director stock ownership;
- Disclosure of clawback provisions;
- NEO multi-year guaranteed bonuses or tax gross-ups on perks other than relocation and other broad-based benefits;
- The multiple of salary plus bonus in change-in-control agreements for NEOs (with the lowest scores where the multiple is greater than three);
- Whether the company provides excise tax gross-ups for change-in-control payments;
- Length of CEO employment agreements;
- Whether executives are given credit toward pension for years not worked;
- Whether the company recently granted premium priced options (125%) with a maintenance period of that price for at least 30 days;
- Voluntary adoption of a management “say on pay” advisory vote.

## **Transition**

RiskMetrics provided transition guidance in a set of FAQs for Corporate Issuers which are available [here](#). This guidance included the following:

- The initial Governance Risk Indicators will be published on proxy research reports beginning in the second half of March 2010, with high level indicators available on Yahoo! Finance.
- The ratings will initially cover companies in the U.S., Canada, U.K, France, Germany, Netherlands and Sweden. Japan and Australia will be added in the second half of 2010.
- CGQ scores will be frozen in the second half of March 2010 and retired completely in June 2010.
- Companies with March 2010 meetings will continue to have CGQ ratings published, but will have GRId ratings by June 30, 2010.
- Companies with meetings after March 2010 will have GRId ratings published in the second half of March 2010.
- Alerts are expected to be provided from RiskMetrics notifying a company that its data can be reviewed and verified.

## **Potential Implications**

- RiskMetrics’ stated goal is to “create the gold standard in governance research and ratings.” In the event its views gain broad acceptance, companies may face increased pressure to conform to these practices from proxy vote advisors, shareholder activists and others.

- The use of four “areas” instead of one overall CGQ score may place more emphasis on areas that received less attention under the CGQ system where a particular deficiency in one area (e.g., shareholder rights) may have only lowered the overall score slightly.
- Companies should consider utilizing the data verification tool to ensure accuracy of data. Corrections made in 2010 will need to be made promptly as RiskMetrics has indicated that there will be limited time to correct data in 2010.
- As a result of the publication of the GRId methodology, companies and their advisors can now understand the system and the effect of their corporate governance policies on scoring. Companies should be able to calculate or check their own scores and may find “low hanging fruit” to improve their overall scores.
- GRId scores should not drive decisions. Significant changes in corporate governance should only be made after careful consideration.

We would be happy to review and discuss your GRId profile as there often mistakes to be corrected and opportunities to improve scores. Moreover, as noted above, we have prepared a summary of the questions for U.S. companies and scoring methodology and weighting for each question. We are happy to provide this supplement upon request.

Additional information regarding GRId is available at <http://www.riskmetrics.com/grid-info>.

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