

News from our Compensation and Benefits Group

RiskMetrics Group Introduces CGQ Successor: Governance Risk Indicators (“GRId”)

This Alert was originally issued in March 2010 and was then updated June 2, 2010 to reflect updates released by RMG.

Introduction

Recently, RiskMetrics Group (“RMG”)¹ announced its new corporate governance rating product, Governance Risk Indicators (to be known as GRId). GRId is the successor to RMG’s Corporate Governance Quotient rankings or “CGQ rankings” and it is intended to help shareholders and investors identify and measure investment risk. GRId will evaluate companies on an absolute basis based on 63 variables in four categories of corporate governance.²

GRId scores will be posted on companies’ Yahoo!Finance profile pages, published in RMG Proxy Research Reports, and given to RMG’s institutional shareholder clients. However, GRId scores will not influence the vote recommendations contained in RMG’s Proxy Research Reports and thus might not influence institutional shareholders’ voting patterns. To better predict how institutional shareholders may vote on proxy proposals, companies should familiarize themselves with the RMG proxy voting guidelines and analyze the voting histories of their institutional shareholders vis-à-vis the RMG vote recommendations.³

As discussed more fully below, companies may take actions now to verify the accuracy of GRId variables before GRId scores are published.

Key Differences between CGQ Rankings and Governance Risk Indicators

The new GRId scores differ from the historical CGQ rankings in the following significant ways:

- ▶ **Relative versus absolute scoring:** CGQ rankings were expressed as relative percentiles comparing a company to its industry and index peer groups. For example, a company’s CGQ ranking may show that its corporate governance practices are better than 85% of the companies in the Russell 3000 Index and 90% of companies in the Pharmaceuticals and Biotechnology industry. GRId scores will be expressed as absolutes—low, medium or high “levels of concern”—based on the perceived level of risk in the categories of audit, board, shareholder rights and compensation. GRId scores are not relative and will not be expressed numerically.
- ▶ **Cumulative versus categorical scoring:** CGQ rankings were expressed as cumulative rankings based on all 65 data points. GRId scores will be expressed as “levels of concern” for each of the four categories and there will be no single cumulative score. A low level of concern indicates that a company’s practices meet or exceed standard market practices. A medium level of concern indicates that RMG believes that some practices appear not to be in line with market standards, including some emerging best practices, although

the disparities are not large enough to cause significant concern. A high level of concern indicates RMG’s conclusion that there is a meaningful variance between a company’s practices and market standards and that shareholders should further explore whether the company’s practices raise questions about long-term risk.

- ▶ **Alignment with RMG proxy vote recommendation guidelines:** CGQ rankings were not aligned with RMG’s proxy vote recommendation guidelines. The 63 variables underlying the GRId scores parallel RMG’s proxy voting guidelines;⁴ however, the GRId scores will not be used to change vote recommendations that are based on RMG’s proxy voting guidelines. For example, a high level of concern in the compensation category will not, by itself, change an otherwise positive

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vote recommendation on an equity plan proposal that otherwise satisfies RMG's proxy voting guidelines.

- ▶ **Transparency:** RMG published certain information about the 65 data points underlying CGQ rankings, but detailed information was not available without subscribing to one of RMG's services. For example, RMG publicized the fact that board size was one of the CGQ data points, but the size of the board that would lead to a higher or lower CGQ ranking was not made available except to paying subscribers to an RMG product or service. By contrast, the factors underlying the GRId scores are designed to be fully transparent, providing information about the precise weighting ascribed to each factor.⁵

For more information about the GRId variables and scoring methodology, including the normalization of raw scores and method of translation from numerical scores to levels of concern, refer to the appendix at the end of this document.

Timing of Implementation of Governance Risk Indicators

CGQ scores are scheduled to be frozen March 16, 2010 but should remain on Yahoo!Finance profile pages until the end

of June 2010. For companies with annual meetings in late March and beyond, GRId scores only (and not CGQ rankings) will appear in the RMG Proxy Research Reports issued for those meetings. For companies with annual meetings before late March, neither CGQ rankings nor GRId scores will appear in the RMG Proxy Research Reports—the GRId scores for these companies will be available by June 30, 2010 on Yahoo!Finance and for RMG's institutional shareholder clients.

What to Do Now

We recommend taking the following actions:

- ▶ **GRId data verification:** We recommend using RMG's free data verification site to verify the accuracy of the data underlying each of the 63 GRId factors.⁶ The data verification site shows the data underlying each factor and gives companies the opportunity to submit data correction requests in the event that there are any errors. Data should be verified as soon as possible so that any errors can be corrected before the GRId scores are published in RMG's Proxy Research Reports. If changes are made to any relevant corporate governance practices in the future, we recommend using

the data verification site to update the RMG database.⁷

- ▶ **Review and analyze corporate governance practices:** Although we generally do not recommend making any changes to corporate governance practices solely to increase GRId scores, we do recommend using the GRId factors as one reference point in evaluating corporate governance practices, especially when companies are evaluating corporate governance practices that may impact perceived investment risk.

If you have questions about this Alert, the RMG Governance Risk Indicators (GRId) or any RMG guidelines, please contact one of the Cooley attorneys listed above. ■

NOTES

- 1 In January 2007, RMG acquired Institutional Shareholder Services ("ISS"). ISS continues to operate as a segment of RMG.
- 2 More information about GRId can be found at: www.riskmetrics.com/grid-info. GRId is a global product, tailored to each specific financial market. This Alert focuses only on the GRId product as applied to U.S. companies.
- 3 Cooley LLP has access to the RMG proxy voting guidelines and voting analytic tools to help our clients through this process.
- 4 The GRId variables will be updated annually in accordance with the annual updates to RMG's proxy voting guidelines.
- 5 The RMG technical document with detailed information on the new methodology underlying GRId can be found at: www.riskmetrics.com/sites/default/files/GRId_Tech_Doc.pdf.
- 6 Companies can use the same log-in and password for the GRId data verification site that they used for the CGQ data verification site. If you do not have a log-in and password to RMG's data verification site, you can obtain one by e-mailing support-corporate@riskmetrics.com or by calling (301) 556-0570.
- 7 We also recommend reviewing the updates to RMG's proxy voting guidelines each year and undertaking the data verification process in connection with each annual update to RMG's proxy voting guidelines. Note that updates to RMG's guidelines are typically issued each November.

APPENDIX

GRId Categories and Scoring Methodology

Each of the GRId categories is comprised of subcategories and within each subcategory there are a number of variables expressed as questions.⁸ Each answer is given a score that can range from -5 to 5 (with 0 representing a neutral score),⁹ and the variables are weighted to reflect market nuances. The weighting of each of the 63 variables is described below.

Audit Category Weighting

Within the audit category, the subcategories are audit fees (representing 21.25% of the audit score), controversies (representing 57.50% of the audit score) and other issues (representing 21.25% of the audit score). The individual audit variables are weighted as follows:

VARIABLE	VARIABLE WEIGHTING FOR CATEGORY
AUDIT FEES	
Non-Audit fees represent what percentage of total fees?	21.25%
CONTROVERSIES	
Did the auditor issue an adverse opinion in the past year?	21.25%
Has the company restated financials for any period within the past two years?	10.00%
Has the company made late financial disclosure filings in the past two years?	5.00%
Has a securities regulator taken enforcement action against the company in the past two years?	21.25%
OTHER ISSUES	
Has the company disclosed any material weaknesses in its internal controls in the past two years?	21.25%
	100%

⁸ For greater detail on what is meant by each question and the scoring methodology applied to each specific variable, see the RMG technical document.

⁹ For example, for the variable in the Board category that is based on whether any directors attended less than 75% of the board meetings without a valid excuse, a score of 5 applies to companies where no directors attended less than 75% of board meetings without a valid excuse and a score of -5 applies to companies where one or more directors attended less than 75% of board meetings without a valid excuse or where there is no disclosure to make a determination.

Board Structure Category Weighting

Within the board structure category, the subcategories are board composition (representing 25% of the board structure score), committee composition (representing 15% of the board structure score) and board practices (representing 60% of the board structure score). The individual board structure variables are weighted as follows:

VARIABLE	VARIABLE WEIGHTING FOR CATEGORY
BOARD COMPOSITION	
What is the independent director composition of the board?	15.00% ¹⁰
What is the qualification (classification) of the Chairman of the Board?	10.00%
NOMINATING COMMITTEE COMPOSITION	
What is the independent status of the nominating committee members?	5.00%
COMPENSATION COMMITTEE COMPOSITION	
What is the independent status of the compensation committee members?	5.00%
AUDIT COMMITTEE COMPOSITION	
What is the independent status of the audit committee members?	5.00%
BOARD PRACTICES	
Does the CEO serve on an excessive number of public company boards?	8.95%
Do non-executives serve on an excessive number of public company boards?	9.95%
Did any directors attend less than 75% of the board meetings without a valid excuse?	4.28%
Does the company disclose board/governance guidelines?	3.98%
Did outside directors meet without management present?	3.98%
How many directors received withhold/against votes of 50% or greater at the last annual meeting?	9.95%
What percent of the directors were involved in material related party transactions?	6.97%
Do the directors with related party transactions sit on key board committees?	1.99%
Does the company have a majority vote standard in uncontested elections?	9.95%
	100%

¹⁰ The weighting for this variable applies only if the score for this variable is neutral or positive. If the score is negative, the weighting for this variable will be 18.75% and the weighting for the variable based on the qualification of the Chairman of the Board will instead be 6.25%.

Shareholder Rights Category Weighting

Within the shareholder rights category, the subcategories are “one share one vote” (representing 10% of the shareholder rights score), use of takeover defenses (representing 50% of the shareholder rights score), voting issues (representing 17% of the shareholder rights score) and voting formalities (representing 23% of the shareholder rights score). The individual shareholder rights variables are weighted as follows:

VARIABLE	VARIABLE WEIGHTING FOR CATEGORY
ONE SHARE ONE VOTE	
Does the company have classes of stock with different voting rights?	5.00%
Are there any directors on the board who are not up for election by all classes of common shareholders?	5.00%
USE OF TAKEOVER DEFENSES	
Are all directors elected annually?	16.67% ¹¹
Does the company have a poison pill (shareholder rights plan) that was not approved by shareholders?	16.67%
<i>What is the trigger threshold for the poison pill?</i>	4.82%
<i>Does the poison pill have a sunset provision?</i>	1.32%
<i>Does the poison pill have a TIDE provision?</i>	1.32%
<i>Does the poison pill have a qualified offer clause?</i>	2.85%
Is the board authorized to issue blank check preferred stock?	6.36%
VOTING ISSUES	
Does the company require a super-majority vote to approve amendments to the charter and/or bylaws?	6.80%
Does the company require a super-majority vote to approve mergers/business combinations?	6.80%
When does the shareholder rights plan expire?	3.40%
VOTING FORMALITIES	
What is the percentage of share capital needed to convene a special meeting?	4.60%
Can shareholders act by written consent?	2.30%
Has the board failed to implement a shareholder resolution supported by a majority vote?	16.10%
	100%

¹¹ The variable weightings in the “Use of Takeover Defenses” subcategory assume that the company *does* have a poison pill that was not approved by its shareholders. If the company does not have a poison pill that was not approved by its shareholders, then the weightings of the other variables in this subcategory will increase as follows: 20.99% for “Are all directors elected annually?”; 20.99% for “Does the company have a poison pill (shareholder rights plan) that was not approved by shareholders?” and 8.01% for “Is the board authorized to issue blank check preferred stock?”

Compensation Category Weighting

Within the compensation category, the subcategories are executive short term, including performance (representing 3% of the compensation score); executive long term, including equity remuneration, equity performance, equity dilution, equity timing and equity pricing (representing 32% of the compensation score); and other remuneration, including stock ownership, termination and pay practices (representing 65% of the compensation score). The individual compensation variables are weighted as follows:

VARIABLE	VARIABLE WEIGHTING FOR CATEGORY
EXECUTIVE SHORT TERM	
Performance	
Does the company disclose the performance measures, hurdle rates, and target payout thresholds for the short-term cash incentive plan that generated the awards reported?	3.00%
EXECUTIVE LONG TERM	
Equity Performance	
Does the company disclose a performance measure for stock options plans (for executives)?	1.60%
Does the company disclose a performance measure for restricted share plans (for executives)?	1.60%
Does the company disclose the performance measures, hurdle rates and target payout thresholds for executives' long-term cash plans?	1.60%
Does the company disclose a performance measure for other long term plans (for executives)?	1.60%
Equity Dilution	
Does at least one of the new and/or amended plans for the last three years permit share recycling for options/SARS?	1.60%
Does the company grant equity awards at an excessive rate, according to RMG policy?	4.80%
Equity Timing	
What are the minimum vesting periods mandated in the plan documents for executives' stock options or SARS in the equity plans adopted/amended in the last 3 years?	2.40%
What are the minimum vesting periods mandated in the plan documents, adopted/amended in the last three years, for executives' restricted stock?	2.40%
What is the holding period for stock options (for executives)?	2.40%
What is the holding period for restricted shares (for executives)?	2.40%
Equity Pricing	
Does one or more of the company's equity plans approved or amended in the past three years permit option/ SAR repricing and cash buyouts?	4.80%
Has the company repriced options or exchanged them for shares, options or cash without shareholder approval in the last three years?	4.80%
OTHER	
Stock Ownership	
If a new or amended broad-based plan is proposed, then what is the expected duration of shares?	2.44%
Is the CEO subject to stock ownership guidelines?	2.44%
Are directors subject to stock ownership guidelines?	2.44%
Do all directors with more than one year of service own stock?	2.44%

CONTINUED

Compensation Category Weighting *CONTINUED*

VARIABLE	VARIABLE WEIGHTING FOR CATEGORY
Termination	
What's the trigger under the change-in-control agreements?	22.75%
Pay Practices	
Did the company disclose a claw back provision?	3.25%
Are any of the NEOs eligible for multi-year guaranteed bonuses?	3.25%
Do any of the NEOs receive tax gross-ups on their perks other than relocation and other broad-based benefits?	3.25%
What is the multiple of salary plus bonus in the change-in-control agreements for NEOs excluding the CEO?	3.25%
What is the multiple of salary plus bonus in the severance agreements for the CEO upon a change-in-control?	3.25%
Does the company provide excise tax gross-ups for change-in-control payments?	3.25%
What is the length of the employment agreement with the CEO?	3.25%
Are executives given credit toward pension for years not worked?	3.25%
In the last fiscal year, did the company grant premium priced options of at least 125% of market price that need to be maintained for at least 30 consecutive days?	3.25%
Has the company voluntarily adopted a management 'say on pay' advisory vote resolution for the most recent annual meeting or committed to a resolution going forward?	3.25%
	100%

GRId Normalization and Translation

The weighted scores are summed for each category and compared against a minimum and maximum for each applicable category. The minimum and maximum weighted scores for each category are as follows:

CATEGORY	MINIMUM	MAXIMUM
Audit	-5.00	0.00
Board	-5.00	3.56
Shareholder Rights	-4.83	2.58
Compensation	-4.07	3.69

For each category, the weighted and summed scores are then normalized on a scale of 0-100 on a straight line interpolation. The normalized scores are then translated into levels of concern based on the following:

CATEGORY	HIGH	MEDIUM	LOW
Audit	0-75 ¹²	75-90	90-100
Board	0-55	55-70	70-100
Shareholder Rights	0-35	35-60	60-100
Compensation	0-55	55-70	70-100

¹² It is unclear whether a normalized score that falls exactly on a threshold would go into the higher or lower level of concern. For example, it is unclear whether a normalized score of exactly 75 in the audit category would go into the high or medium concern level.