

## Preparing for RiskMetrics Group's New Governance Risk Indicators (GRId)

As we previously highlighted (*RiskMetrics' Governance Risk Indicators (GRId) – a New Governance Measurement for Proxy Voting Reports*), RMG is replacing its Corporate Governance Quotient (CGQ) scoring system with GRId. RMG has announced that all 6,400 U.S. public companies that it follows will begin receiving ratings on March 17<sup>th</sup>. CGQ scores will be frozen on that date and retired completely by the end of June. RMG has also released a 188 page technical document (*Governance Risk Indicators™ A New Measure of Governance-Related Risk*) providing background on the new system.

*An immediate action item, particularly for calendar-year companies and others with upcoming annual meetings, is to review and verify your GRId information.* You can contact RMG to correct any errors through RMG's free data verification site. Companies who have not previously obtained an RMG login may contact RMG at 301-556-0570 or by email at support-corporate@riskmetrics.com. Note that RMG generally only updates its database based on publicly available information, whether on websites or in SEC filings.

The RMG technical document attempts to achieve transparency as to how GRId works, although at 188 pages it does so only at the price of density. At a high level:

- GRId is a composite of four categories – audit, board, compensation and shareholder rights. Each category will be assigned a "concern" level of Low, Medium or High.
- There are 63 questions clustered in subsections contained within the four categories. We have created an Appendix attached to this memo with those questions for your reference. Each answer will be scored to increase, reduce or have no impact on the concern level.
- Each response is weighted and then summed to provide a score for each subsection, and the subsection scores are then weighted and summed to form the basis for the assigned concern level for that category. The weighting reflects RMG's view of the relative importance of the issue as well as its somewhat monolithic view of "best practices".

Examples:

- A company with a classified board would receive for that question a score of -5, while a company with annual elections would score 5 and one that is transitioning to annual elections would score 0. This question is weighted to comprise over 33% of the takeover defense subsection of the "Shareholder Rights" category.
- A company with an independent chairman would score 5, while having a lead director would score 0 and any other chairman structure would score -5. This question accounts for 40% of the board composition subsection of the "Board" category.

Your GRId profile will be included in ISS's voting recommendations and will also reside in online sources such as your Yahoo! Finance page. But although the GRId profile and the voting recommendations are broadly speaking based on the same policy considerations, there will not be a simple predictive relationship between the two. RMG says, for example, that a company whose compensation practices taken as a whole receive a "Low" concern might still receive a negative ISS voting recommendation as a result of particular pay practices, which could in turn jeopardize approval of an equity plan or even the survival of compensation committee members. It will thus continue to be important to look beyond the graphics and color-coding and to understand RMG's real hot button items.

It is at this point unclear how investors will use the GRId analysis. GRId is intended to allow investors to screen the companies in their portfolios so that "high concern" companies, or companies with specific types of practices, can be screened out quickly. As this may mean that a quick and ready database of,

for example, companies that do not have majority voting will be immediately available, it could add to the ability to target shareholder proposals easily in the future.

In the short term we suggest that companies review and if necessary correct the RMG data, identify any categories for which the GRId would indicate a High concern, and discuss the result with the board or the appropriate committee.

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If you have any questions regarding the matters covered in this publication, please contact either of the lawyers listed below or your regular Davis Polk contact.

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Appendix

GRId Questions for U.S. Companies

**Audit** (6 questions)

Non-Audit fees represent what percentage of total fees?

Did the auditor issue an adverse opinion in the past year?

Has the company restated financials for any period within the past two years?

Has the company made late financial disclosure filings in the past two years?

Has a securities regulator taken enforcement action against the company in the past two years?

Has the company disclosed any material weaknesses in its internal controls in the past two years?

**Board** (14 questions)

What is the independent director composition of the board?

What is the qualification of the Chairman of the Board?

What is the independent status of the nominating committee members?

What is the independent status of the compensation committee members?

What is the independent status of the audit committee members?

Does the CEO serve on an excessive number of outside boards?

Do non-executives serve on an excessive number of outside boards?

Did any directors attend less than 75% of the board meetings without a valid excuse?

Does the company disclose board/governance guidelines?

Did outside directors meet without management present?

How many directors received withhold/against votes of 50% or greater at the last annual meeting?

What percent of the directors were involved in material RPTs?

Do the directors with RPTs sit on key board committees?

Does the company have a majority vote standard in uncontested elections?

**Shareholder Rights** (15 questions)

Does the company have classes of stock with different voting rights?

Are there any directors on the board who are not up for election by all classes of common shareholders?

Are all directors elected annually?

Does the company have a poison pill (shareholder rights plan) that was not approved by shareholders?

What is the trigger threshold for the poison pill?

Does the poison pill have a sunset provision?

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Does the poison pill have a TIDE provision?

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Does the poison pill have a qualified offer clause?

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Is the board authorized to issue blank check preferred stock?

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Does the company require a super-majority vote to approve amendments to the charter and bylaws?

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Does the company require a super-majority vote to approve mergers/business combinations?

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When does the shareholder rights plan expire?

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What is the percentage of share capital needed to convene a special meeting?

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Can shareholders act by written consent?

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Has the board failed to implement a shareholder resolution supported by a majority vote?

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### **Compensation** (28 questions)

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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?

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Does the company disclose a performance measure for stock options plans (for executives)?

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Does the company disclose a performance measure for restricted share plans (for executives)?

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Does the company disclose the performance measures, hurdle rates and target payout thresholds for executives' long-term cash plans?

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Does the company disclose a performance measure for other long-term plans (for executives)?

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Does at least one of the new and/or amended plans for the last three years permit share recycling for options/SARS?

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Does the company grant equity awards at an excessive rate, according to RMG policy?

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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?

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What are the minimum vesting periods mandated in the plan documents, adopted/amended in the last three years, for executives' restricted stock?

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What is the holding period for stock options (for executives)?

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What is the holding period for restricted shares (for executives)?

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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?

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Has the company repriced options or exchanged them for shares, options or cash without shareholder approval in the last three years?

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If a new or amended broad-based plan is proposed, then what is the expected duration of shares?

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Is the CEO subject to stock ownership guidelines?

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Are directors subject to stock ownership guidelines?

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Do all directors with more than one year of service own stock?

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What's the trigger under the change-in-control agreements?

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Did the company disclose a claw back provision?

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Are any of the NEOs eligible for multi-year guaranteed bonuses?

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Do any of the NEOs receive tax gross-ups on their perks other than relocation and other broad-based benefits?

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What is the multiple of salary plus bonus in the change-in-control agreements for named executive officers excluding the CEO?

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What is the multiple of salary plus bonus in the severance agreements for the CEO upon a change-in-control?

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Does the company provide excise tax gross-ups for change-in-control payments?

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What is the length of the employment agreement with the CEO?

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Are executives given credit toward pension for years not worked?

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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?

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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?

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