Corporate Governance Quotient

CGQ Best Practices Manual

Revised November, 2008

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RiskMetrics Group, Inc is the world's leading provider of proxy voting and corporate governance data services. RMG's proprietary rating system, Corporate Governance Quotient (CGQ®), ranks the corporate governance performance of more than 7,500 companies worldwide, including the following indexes: S&P 500, S&P 600, S&P 400, Russell 3000, MSCI's EAFE (Europe, Asia and Far East) and the S&P/TSX Composite (Canada), FTSE All-World Developed, and FTSE All-Share. Considered to be the world's leading corporate governance rating solution, RMG's CGQ is designed on the premise that good corporate governance ultimately results in increased shareholder value.

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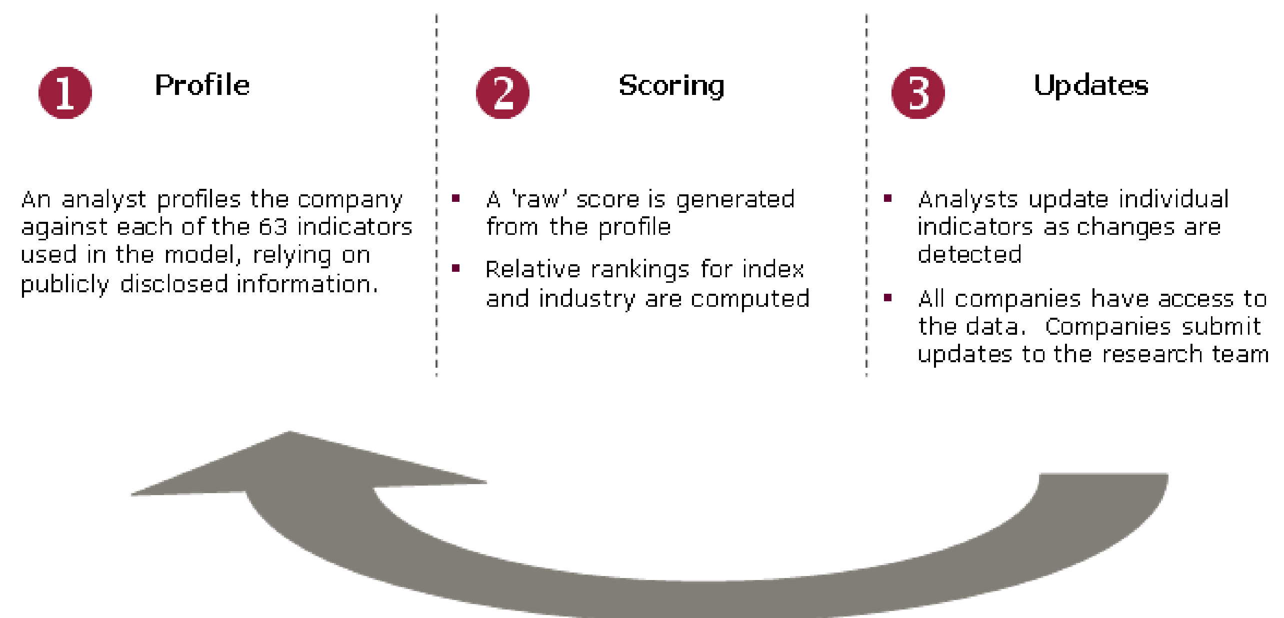
About CGQ

Background
Today, more than ever, investors are concerned about the quality of corporate governance and how it might affect portfolio performance. This widespread view that 'governance matters' necessitates the creation of metrics that allow investment managers to quickly and accurately identify the relative performance of companies vis a vis their governance structures.

The Corporate Governance Quotient is a rating tool that assists institutional investors in evaluating the quality of corporate boards and their corporate governance practices. The Corporate Governance Quotient rates 5,600 U.S. companies and 2,200 non-U.S. companies.

Methodology
Companies undergo regular top-to-bottom reviews. We also post ad-hoc updates to one or a few datapoints as information becomes available. Source data is derived from public disclosure documents, press releases, and corporate websites, then reviewed and verified by ISS' corporate governance analysts.



Calculating the CGQ – US companies
To generate a CGQ for each company, ISS analysts use public available documents and Web site disclosure to gather data on 63 different issues in the following four broad rating categories: 1) board of directors, 2) audit, 3) antitakeover, and 4)

compensation/ownership. Based on this information and a scoring system developed by an external advisory panel and ISS, the next step is to calculate a CGQ for each company. While each variable is evaluated at on a standalone basis, some variables are also looked at in combination under the premise that corporate governance is improved by the presence of selected combinations of favorable governance provisions.

Each company's CGQ is compared with other companies in the same index and industry group.

- All scores are relative (percentile basis)
  - CGQ index score: compare to Relevant Market Index including: S&P 500, Mid-Cap 400, Small-Cap 600, Russell 3000, and CGQ Universe (remaining companies covered by CGQ but outside the Russell 3000). Note that when CGQ refers to a "Russell 3000" CGQ score, it is referring to Russell 3000 companies MINUS the three S&P Indices).
  - CGQ industry score: compare to industry peer group based on the S&P "GICS" (Global Industry Classification System) of 24 industry groups.

INDEX RANKING	INDUSTRY RANKING
98.8%	100.0%

DIS outperformed 98.8% of the companies in the S&P 500, and 100.0% of the companies in the Media group.

CGQ Subscores provide a measure of a company's governance in a particular governance area by ranking companies into quintiles relative to a relevant index and industry group.
Subscores are calculated for four categories:

- Board
- Takeover Defenses
- Executive and Director Compensation and Ownership
- Audit

Subscores are expressed from 1-5

- 5 indicates company is in the top quintile in a governance area.
- 1 indicates company is in the bottom quintile in a governance area.

CGQ Data Collection – US Companies

- Data collected from SEC EDGAR filings (i.e. Proxy Statement, 10K, 8K, Guidelines…), Press Releases and Company web sites.
- ISS re-profiles companies every 120 days, or at least 3 times per year. Should issuers provide comments about the CGQ data to ISS in between profiles, ISS will review the comments, fact check each requested data point change, correct/update the profile as necessary and check the remaining CGQ data points not addressed by the issuers.

- ISS provides all companies with a unique account number, password and hyperlink to review the CGQ data collected for the company.
- ISS emails Issuers when a change is made to its' CGQ data and request the company verify the information changed. The email will contain the account number/password and hyperlink to the corporate web site to facilitate the process by which the company may verify that changes were made.
- All changes to an Issuers CGQ data are date stamped based on when the review took place and the clock re-started such that the company will be re-profiled in another 120 days, or sooner if the company requests changes before that date.
- All requests for updates are acted upon within one business day, worst-case scenario two business days.

CGQ Ratings Criteria

The Corporate Governance Quotient comprises 61 variables divided into eight core topics. Each core topic and the variables associated with it are discussed below. In addition to looking at each variable in isolation, combinations of variables are also considered as discussed at the end of the document under "combination variables."

The CGQ rating factors for U.S. companies are listed by rating category below. Note that some of the ratings factors are also looked at in combination under the premise that corporate governance is enhanced when selected combinations of these criteria are adopted.

Board

1. Board composition
2. Nominating committee composition
3. Compensation committee composition
4. Governance committee
5. Board structure
6. Board size
7. Changes in board size
8. Cumulative voting
9. Boards served on – CEO
10. Boards served on – Other than CEO
11. Former CEOs on the board
12. Chairman/CEO separation
13. Governance guidelines
14. Response to shareholder proposals
15. Board attendance
16. Board vacancies
17. Related-party transactions -- CEO
18. Related-party transactions – Other than CEO
19. Majority Voting
20. ISS Recommendation of Withhold Votes

Audit

21. Audit committee
22. Audit fees
23. Auditor ratification
24. Financial experts
25. Financial Restatements
26. Options Backdating

Charter/Bylaws

27. Poison pill adoption
28. Poison pill – shareholder approval
29. Poison pill – TIDE provision
30. Poison pill – sunset provision
31. Poison pill – qualified offer clause
32. Poison pill – trigger
33. Vote requirements – charter/bylaw amendments
34. Vote requirements – mergers
35. Written consent
36. Special meetings
37. Bylaw amendments
38. Capital structure – dual class
39. Capital structure – blank check preferred

State of Incorporation

40. State of incorporation antitakeover provisions
41. Control share acquisition
42. Control share cashout
43. Freezeout
44. Fair price
45. Stakeholder law
46. State endorsement of poison pills

Ownership

47. Director stock ownership
48. Executive stock ownership guidelines
49. Director stock ownership guidelines
50. Officer and director stock ownership levels
51. Mandatory holding period for stock options
52. Mandatory holding period for restricted stock

Executive and Director Compensation

53. Cost of option plans
54. Option repricing permitted
55. Shareholder approval of option plans
56. Compensation committee interlocks
57. Director compensation
58. Option burn rate
59. Performance-based compensation
60. Option expensing

Progressive Practices

61. Board performance reviews
62. Individual director performance reviews

63. Meetings of outside directors
64. CEO succession plan
65. Board can hire outside advisors
66. Directors resign upon job changes

Director Education

67. Directors participating in director education programs

Board Issues

1) **Board Composition** – an evaluation of the independence of the board members.

Governance Standard
The current minimum standard is that at least a majority of the directors on the board should be independent. ISS evaluates the independence of directors based on the ISS definition of "independence," not the stock exchanges' definitions of "independence".

Directors with ties to management may be less willing and able to effectively evaluate and scrutinize company strategy and performance. Furthermore, boards without adequate independence from management may have inherent conflicts of interest. Three categories of directors are utilized: inside directors, affiliated directors, and independent directors.

Inside Director

- Employee of the company
- Officer of the company if he is among the five most highly compensated individuals
- Beneficial ownership of more than 50% of the company's voting power (this may be aggregated if voting power is distributed among more than one member of a defined group; e.g. members of a family beneficially own less than 50% individually, but combined own more than 50%)

Affiliated Director

- Former employee of company or its affiliates
- Relative of current employee of company or its affiliates
- Provides professional services to company or its affiliates or to its officers*
- Has any transactional relationship with company or its affiliates*
- Interlocking relationships as defined by the SEC involving members of the Board of Directors or its Compensation and Stock Option Committee
- Founder of company but not currently an employee
- Employed by a significant customer or supplier*
- Employed by a foundation or university that received grants or endowments from the company or its affiliates*

*If significant enough to be disclosed in the proxy statement

Independent Director

- No connection to company other than board seat. Even if a director has served on the board for over 10 years, he is still considered to be

independent - however, ISS' analysis will make note of independent and affiliated directors who have served on the board for over ten years.

2) **Nominating Committee Composition** – an evaluation of the independence of the members of the nominating committee.

Governance Standard
This key committee of the board should be composed solely of independent directors.

Three categories of directors are utilized: inside directors, affiliated directors, and independent directors. See rating variable 1, board composition for definitions of director independence.

The nominating committee is responsible for identifying and approving nominees for vacant positions on the board of directors.

3) **Compensation Committee Composition** – an evaluation of the independence of the members of the compensation committee.

Governance Standard
This key committee of the board should be composed solely of independent directors.

Three categories of directors are utilized: inside directors, affiliated directors, and independent directors. See rating variable 1, board composition for definitions of director independence.

The compensation committee makes recommendations and sets guidelines for the compensation of executives of the company.

4) **Governance Committee** – a review of whether the board has created a governance committee, or whether the functions of the governance committee are handled by another board committee, and if the company discloses the number of times the governance committee meets.

Governance Standard
The functions of a governance committee should be handled by a committee of the board, typically the nominating committee or the governance committee.

The governance committee ensures that company has the appropriate checks and balances to avoid many of the pitfalls of doing business today. A company's self interest necessitates good governance.

5) **Board Structure** – an evaluation of whether the board is annually elected or classified.

Governance Standard
Directors should be accountable to shareholders on an annual basis.

A company that has a classified, or staggered, board is one in which directors are typically divided into three classes, with each class serving three-year terms; each class's reelection occurs in different years. In contrast, all directors of an annually elected board serve one-year terms and the entire board stands for election each year.

Classifying the board makes it more difficult to change control of a company through a proxy contest involving election of directors. Because only a minority of directors is elected each year, a dissident will be unable to win control of the board in a single election and would need two years to gain control of the company unless there are vacancies in the other classes.

For example, a company that has 15 directors and a classified board would structure its board in three classes of five directors each. Directors would hold overlapping three-year terms. Each year, shareholders would elect only five of the 15 directors. Anyone trying to change control of the company through a proxy contest would need two years to gain majority control of the board and three years to gain full control.

In their proxy statements, companies often argue that classifying the board will assure continuity among directors and stability of the board as an institution. As a practical matter, however, continuity generally may be achieved without classifying the board. The only real motive for board classification is to make it more difficult to change control of the board. A classified board can (1) delay a takeover desired by shareholders but opposed by management, and (2) prevent bidders from even approaching a target company if they do not want to wait more than a year to gain majority control. Shareholders lose in both cases, and management has less incentive to keep shares fully valued if the directors' board seats are secure. Although shareholders need some form of protection from hostile takeover attempts, and boards need tools and leverage in order to negotiate effectively with potential acquirers, a classified board tips the balance of power too much toward incumbent management at the price of potentially ignoring shareholder interests.

6) **Board Size** – an evaluation of the number of directors serving on the board.

Governance Standard
Generally, boards should not have fewer than 6 members or more than 15 members. A board of between 9 and 12 board members is considered ideal.

Boards that become too large may find it difficult to effectively conduct the business of the board. On the other hand, boards that are too small may not have the depth of skill sets necessary to fulfill its responsibilities.

7) **Changes in Board Size** – an evaluation of whether management must seek shareholder approval prior to changing the size of the board.

Governance Standard
Shareholders should have the right to vote on changes to expand or contract the size of the board.

Proposals to allow management to increase or decrease the size of the board at its own discretion are often used by companies as a takeover defense. Because directors are the shareholders' agents, and votes on directors are the most fundamental shareholder right, the corporate governance system should allow shareholders the same rights given to management: to expand the scope of the board, or to contract it, if they wish.

Shareholders should support management proposals to fix the size of the board at a specific number of directors, thus preventing management from increasing board size in the face of a proxy contest without shareholder approval. By increasing the size of the board, management can make it more difficult for dissidents to gain control. Fixing the size of the board also prevents a reduction in the board size as a means to oust independent directors or those who cause friction within an otherwise homogenous board. Finally, fixing the board size prevents management from increasing the number of directors in order to dilute the effects of cumulative voting.

8**) Cumulative Voting** – a review of whether shareholders have cumulative voting rights.

Governance Standard
Shareholders should have the right to cumulate their votes for directors.

Cumulative voting permits a shareholder to amass (cumulate) all his or her votes for directors and apportion these votes among one, a few, or all of the directors on a multi-candidate slate. For example, consider a company with a ten-member board and 500 shares outstanding. The total number of votes that may be cast is 10 x 500, or 5,000. In this case, a shareholder with 51 shares (10.2 percent of the outstanding shares) would be guaranteed one board seat because all votes may be cast for one candidate. This provision facilitates the election of minority representatives to the board and can be particularly significant in proxy contests where dissident candidates are seeking election to the board.

The power of cumulative voting is diluted at companies with classified boards. Because only one-third (in the case of a board divided into three classes) of the directors stand for election at any one time, it takes three times as many votes for a shareholder's choice for director to be guaranteed a board seat. In the example above, 151 shares (30.1 percent of the outstanding shares) would be required to guarantee a board seat if the company had a three-class board.

Additionally, some companies use "contingent" cumulative voting charter and bylaw amendments in connection with classified board proposals. These proposals provide that standard voting will be used in director elections until an investor's ownership surpasses a certain threshold (for example, 20 percent), at which point all shareholders other than the controlling shareholder may cumulate their votes for directors.

The purpose of this type of proposal is to strengthen the antitakeover impact of a classified board. Classified boards alone make it difficult for a would-be acquirer to gain control of the board, but adding a cumulative voting requirement once the would-be acquirer holds a substantial block of stock further delays his or her ability to control the board. The reason cumulative voting is not permitted until there is a majority shareholder is to prevent holders of smaller blocks (ten percent, for example) from electing their own candidates.

Cumulative voting is a corporate governance tool that shareholders can use to protect their interests. It is a means of giving shareholders access and influence over director elections. Supporters of cumulative voting argue that it ensures that holders of a significant number of shares may win board representation.

9) **Boards Served on by the CEO** – a review of the number of other public company boards on which the CEO serves.

Governance Standard
In addition to serving on his own company's board, the CEO should not serve on more than two other boards of public companies.

The CEO who serves on multiple boards may find his time and attention taken from his primary responsibility of running his company. Serving on multiple boards can enhance a CEO's overall contribution due to increased experience and business contacts. However, some contend that it is impossible for a director to adequately represent shareholder interests if he cannot commit a significant amount of time to prepare for, travel to, and attend board and committee meetings, review company reports, and otherwise keep abreast of the company's operations and changes in the marketplace. One way for shareholders to monitor the CEO's number of commitments is to look at his service on other boards.

10) **Boards Served On by Directors Other than the CEO –** a review of whether the company has a policy limiting the number of other public company boards on which directors other than the CEO serve.

Governance Standard
Outside directorships should be limited to service on the boards of four or fewer public companies.

Board members serving on multiple boards may find their time and attention taken away from meeting the fiduciary obligations associated with board service. One way for shareholders to monitor the commitments of board members is to look at their service on other boards.

11) **Former CEOs** – a review of whether a retired CEO serves on the board of directors.

Governance Standard
Former CEOs should not serve on the board of directors.

As shareholder attention focuses more on the board of directors, it is natural that certain nominees, by virtue of having served as the CEO of the corporation, require close scrutiny. Retired CEOs bring with them knowledge of the company, personnel, and industry which is hard to match. On the other hand, those very advantages could limit the new CEO's efficacy or could force the retired CEO to be an ineffective director.

For most boards, the question of whether to nominate the outgoing CEO is left to the new CEO. If he wants the retired CEO to remain as a director, few directors would challenge that decision. If the new CEO decides against such nomination, the "dismissal" is handled diplomatically, generally by a board nominating committee. But the critical point is that the choice is up to the new CEO: he gets to choose the directors who presumably will oversee his actions.

One argument against retired CEOs remaining on the board is that they could dominate the board agenda and discussions. This relates to the fact that many, if not all, inside directors may owe their jobs to the retiring CEO and would be reluctant to contradict his views out of a sense of loyalty. The same can be said for non-executive directors who had been recruited by the retiring CEO.

12) **Chairman/CEO Separation** – a review of whether the positions of chairman and CEO are separated and the independence of the chairman

Governance Standard
The positions of chairman and CEO should be separated and the chairman should be an independent outsider.

The positions of chairman and CEO are two distinct jobs with different job responsibilities. The chairman is the leader of the board, which is responsible for selecting and replacing the CEO, setting executive pay, providing advice and counsel to top management, monitoring and evaluating managerial and company performance, and representing shareholder interests. By contrast, the CEO is responsible for managing the day-to-day operations of the company, acting as the company's spokesperson, and formulating strategy for the company, subject to the board's approval. Some believe that having the same person hold the positions of chairman and CEO calls into question whether the board can adequately oversee and evaluate the performance of senior officers (including the CEO) and the company.

13) **Governance (Board) Guidelines** – a review of whether the company has publicly disclosed a set of board guidelines and annually discloses them.

Governance Standard
Board guidelines should be published on the company Web site on an annual basis.

Board guidelines document policy standards on significant corporate governance issues facing the board including: director selection, orientation and evaluation; director compensation; director retirement; board planning and oversight functions; and board structure, board independence, and key committees of the board.

14) **Response to Shareholder Proposals** – an evaluation of how management has responded to shareholder proposals supported by a majority of shareholders.

Governance Standard
Management should take action on all shareholder proposals supported by a majority vote within 12 months of the shareholders' meeting.

Most shareholder proposals are submitted as prefatory proposals, or requests that are non-binding. Management may consider the outcome of the vote in determining what, if any, action is appropriate with respect to the proposal. In many instances, proposals receiving the support of a majority or a supermajority of shareholders have been ignored.

In response, shareholders have submitted binding bylaw amendments which must be acted upon if approved, or have mounted "just vote no" campaigns where shareholders withhold votes from director nominees.

15) **Board Attendance** – a review of director attendance at board meetings.

Governance Standard
Directors should attend at least 75% of board meetings.

Customarily, boards set schedules for routine board and committee meetings at least a year in advance. Anyone who accepts a nomination to serve as a director should be prepared to make attendance at scheduled meetings a top priority. Attendance information is summarized in every proxy statement where directors have attended less than 75 percent of board and committee meetings.

Directors should attend at least 75 percent of board and committee meetings to effectively carry out their fiduciary duties. Directors who fail to attend meetings are not able to adequately represent shareholder interests.

16) **Board Vacancies** – a review of how vacancies of the board are filled.

Governance Standard

Shareholders should be given an opportunity to vote on all directors selected to fill vacancies. In cases where the company has a classified board, a director filing a vacancy should stand for election along with the class of directors to be voted on at the next meeting of shareholders.

Shareholders are sometimes provided an opportunity to vote on how board vacancies are filled. In many instances, the proposal specifies that if a board vacancy exists, only the continuing directors may appoint new directors to fill the vacancies. This would further insulate the board by allowing directors to fill a vacancy of a board member removed by shareholders. In a takeover situation, the effect of these proposals is to limit the rights of acquirers to fill positions of directors who have been removed or who have resigned. Shareholders should be able to remove directors with or without cause by a majority vote and should also have the ability to nominate their own director candidates to fill vacancies as they arise.

17) **Related-Party Transactions Involving the CEO** – a review of "related-party transactions" as disclosed in the proxy statement.

Governance Standard

CEO's should not be the subject of transactions that create conflicts of interest as disclosed in the proxy statement.

Related parties are those with whom the client has a relationship that might destroy the self-interest of one of the parties (accounting is based on measurement of arm's length transactions). Related parties include affiliates of the client (direct or indirect control through ownership or otherwise), principal owners (more than 10% of the voting ownership), management (decision makers who control business policy) and members of their immediate families. Ordinary business transactions between management and the business such as compensation and expense accounts are excluded.

18) **Related-Party Transactions Involving Officers and Directors other than the CEO** – a review of related-party transactions disclosed in the proxy statement.

Governance Standard

Officers and directors should not be the subject of transactions that create conflicts of interest as disclosed in the proxy statement.

Related parties are those with whom the client has a relationship that might destroy the self-interest of one of the parties (accounting is based on measurement of arm's length transactions). Related parties include affiliates of the client (direct or indirect control through ownership or otherwise), principal owners (more than 10% of the voting ownership), management (decision makers who control business policy) and members of their

immediate families. Ordinary business transactions between management and the business such as compensation and expense accounts are excluded.

19) **Majority Voting**– a review of whether directors are elected by a majority or plurality of votes cast.

Governance Standard
Ideally a company will elect directors with an affirmative majority of votes cast, with a plurality standard for contested elections and a director resignation policy for directors not receiving a majority of votes cast in their favor.

The 2006 proxy season saw progress in the issue of director election reform. The majority vote election standard coupled with a post-election "director resignation policy" has emerged as the current state of the art: shareholders have a clear, legally significant vote, and the board retains the ability to address the situation of "holdover" directors to accommodate both shareholder concerns and the needs for stability and continuity of the board.

When there are more nominees than board seats, the use of a majority vote standard can act as an anti-takeover defense (e.g. although the dissident nominees may have received more shares cast, as long as the combination of withhold/against votes and the votes for the management nominees keep the dissident nominees under 50%, the management nominees will win, due to the holdover rules). This is clearly contradictory to the expressed will of the shareholders.

20) **ISS Recommendation of Withhold Votes Against Directors** – Has ISS issued a vote withhold recommendation against a director(s)?

Governance Standard
ISS has not recommended a withhold vote from any directors.

CGQ will now include a rating variable examining the existence of ISS withhold vote recommendations against directors. The possible rating answers to this issue are:

- ISS has recommended withholding votes for the entire board
- ISS has recommended a vote withhold for one or more directors serving on key committees
- ISS has recommended a vote withhold for one or more directors
- ISS has recommended a vote withhold for one or more directors, but the company has taken steps to address the reason for the withhold
- ISS has not recommended a vote withhold from any directors

It is possible a company will meet more than one of the above criteria; in such cases the more heavily penalized criteria will be assessed. This rating variable was added in order to better assess the quality and accountability of a company's directors.

The ISS proxy voting guidelines on this issue can be found starting on page nine at this url:
http://www.issproxy.com/pdf/2007USSummaryGuidelines.pdf .

Audit

21) **Audit Committee Composition** – an evaluation of the independence of the members of the audit committee.

Governance Standard
This key committee of the board should be composed solely of independent directors.

Three categories of directors are utilized: inside directors, affiliated directors, and independent directors. See rating variable 1, board composition for definitions of director independence.

The audit committee reviews the adequacy and effectiveness of internal auditing, accounting, and financial controls of the company; reviews the audit performed by the company's independent auditors; and makes recommendations concerning the appointment of the independent auditor.

22) **Audit Fees** – an analysis of audit fees.

Governance Standard
Consulting fees (audit-related and other) should be less than audit fees.

Independence is fundamental to the reliability of the auditors' reports. Those reports would not be credible, and investors and creditors would have little confidence in them, if auditors were not independent in both fact and appearance. To be credible, the auditor's opinion must be passed on an objective and disinterested assessment of whether the financial statements are presented fairly in conformity with generally accepted accounting principals. As expressed by the Council of the American Institute of Certified Public Accountants in a statement adopted in 1947 "Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession's strength and its stature."

23) **Auditor Ratification** – a review of whether shareholders were permitted to ratify the selection of auditors.

Governance Standard
Shareholders should be permitted to ratify management's selection of auditors each year.

Companies are not legally required to allow shareholders to ratify the selection of auditors. Thus, in many cases, shareholders are not given an

opportunity to vote on ratification of an auditor. Such companies typically disclose in the proxy statement the name of the company auditor and that the board is responsible for selection of that firm.

However, in other cases, a company's bylaws will provide for a shareholder vote to ratify auditors. Even if not required, many companies seek shareholder ratification of auditors. Companies typically disclose the audit firm retained, and ask shareholders to approve selection of the audit firm. Occasionally companies also state in the proxy that if shareholders do not ratify the selection of auditors, the board will consider switching to a new auditor. A representative of the accounting firm is usually present at the annual meeting to answer questions.

Shareholders often view ratification of auditors as one of the most "routine" votes they cast. However, a vote for an auditor is confirmation that the auditor has reviewed the company's financial statements for compliance with generally accepted accounting principles.

24) **Financial Experts** – a review of the financial expert composition of the Audit Committee

Governance Standard
The entire Audit Committee should be comprised of Financial Experts.

Sarbanes-Oxley provides guidance on the presence of financial experts on a firm’s audit committee. This new rating issue analyzes the number of financial experts on the audit committee. One level of points is given if there are one or more financial experts, and the highest level of points is awarded if all of the audit committee members are financial experts.

ISS uses the SEC definition of financial expert:

- An understanding of financial statements and GAAP;
- An ability to assess the general application of those principles in connection with
the accounting for estimates, accruals, and reserves;
- Experience preparing, auditing, analyzing, or evaluating financial statements that
present a breadth and level of complexity of accounting issues that are generally
comparable to the breadth and complexity of issues that can reasonably be expected
to be raised by the registrant’s financial statements, or experience actively supervising
one or more persons engaged in such activities;
- An understanding of internal controls and procedures for financial reporting;
- An understanding of audit committee functions.

A person can acquire these attributes through:

- Education and experience as a principal financial officer, principal accounting officer,

controller, public accountant, or auditor or experience in one or more positions
that involve the performance of similar functions;

- Experience actively supervising a principal financial officer, principal accounting
officer, controller, public accountant, auditor, or person performing similar functions,
or experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial
statements; or
- Other relevant experience.

25) **Financial Restatements** – A review of whether or not the company has restated financial results for any period during the past 24 months

Governance Standard
The company should not have restated financials during any period during the past two years.

This rating issue simply examines whether or not the company restated financials for any period during the past 24 months. If the company restated financials, but took remedial action to correct the underlying reason for the restatement, some credit will be given to the company.

Following the lead of the GAO on this issue (please refer to the following url: http://www.gao.gov/new.items/d061053r.pdf?source=ra), CGQ will exclude financial statement restatements resulting from mergers and acquisitions, discontinued operations, stock splits, issuance of stock dividends, currency-related issues (for example, converting from Japanese yen to U.S. dollars), changes in business segment definitions, changes due to transfers of management, changes made for presentation purposes, general accounting changes under generally accepted accounting principles (GAAP), and litigation settlements. As a general rule, we also excluded restatements resulting from accounting policy changes.

CGQ will penalize companies for specified financial reporting fraud and accounting errors—previously referred to as accounting irregularities in the 2002 report—to include so-called "aggressive" accounting practices, intentional and unintentional misuse of
facts applied to financial statements, oversight or misinterpretation of accounting rules, fraud and computational errors.

26) **Options Backdating** – A review of whether or not the company has restated financial results due to "options backdating".

Governance Standard
The company has not restated financials due to options.

The *Wall Street Journal* provides a good background on the issue of options backdating. We paraphrase below:

Stock options give recipients a right to buy company stock at a set price, called the exercise price or strike price. The right usually doesn't vest for a year or more, but then it continues for several years. A key purpose of stock options is to give recipients an incentive to improve their employer's performance, including its stock price. If there is no stock gain, there is no profit on the options. Backdating them so they carry a lower price would run counter to this goal, by giving the recipient a paper gain right from the start.

Companies have a right to give executives lavish compensation if they choose to, but they can't mislead shareholders about it. Granting an option at a price below the current market value, while not illegal in itself, could result in false disclosure. That's because companies grant their options under a shareholder-approved "option plan" on file with the SEC. The plans typically say options will carry the stock price of the day the company awards them or the day before. If it turns out they carry some other price, the company could be in violation of its options plan, and potentially vulnerable to an allegation of securities fraud.

It could even face accounting issues. Options priced below the stock's fair market value when they're awarded bring the recipient an instant paper gain. Under accounting rules, that's equivalent to extra pay and thus is a cost to the company. A company that failed to include such a cost in its books may have overstated its profits, and might need to restate past financial results.

CGQ will only penalize a company in CGQ for backdating if it has admitted to backdating or if it has been the subject of a regulatory enforcement action. ISS will consider "options springloading" and "bullet dodging" to be the equivalent of backdating. Options springloading refers to the practice of timing an options grant to precede favorable news. Bullet dodging refers to the practice of delaying an options grant until after unfavorable news has been released.

Charter/Bylaws

27) **Poison Pill Adoption** – A review of whether or not the company has adopted a poison pill.

Governance Standard
The company should not have a poison pill in place.

Stock purchase rights plans or shareholder rights plans, otherwise known as poison pills, have enjoyed widespread adoption since their inception in 1983. Poison pills are the most prevalent takeover defense among S&P 500 companies. The vast majority of pills were instituted after November 1985, when the

Delaware Supreme Court upheld a company's right to adopt a poison pill without shareholder approval in *Moran v. Household International, Inc.*

Poison pills are corporate-sponsored financial devices that, when triggered by potential acquirers, do one or more of the following: (1) dilute the acquirer's equity holdings in the target company; (2) dilute the acquirer's voting interests in the target company; or (3) dilute the acquirer's equity holdings in the post-merger company. Generally, poison pills accomplish these tasks by issuing rights or warrants to shareholders that are essentially worthless unless triggered by a hostile acquisition attempt. The two most common poison pills in practice today are the flip-over plan and a variation of the flip-over plan that contains an ownership flip-in provision.

A flip-over plan distributes rights to shareholders to purchase discounted shares of the acquirer's holdings in the post-merger company (usually at 50 percent of fair market value). Such significant dilution to the equity holdings of the potential acquirer's stake makes the merger prohibitively expensive. However, the acquirer may still exercise control over the target firm without actually merging with it, simply by acquiring a majority position and controlling the election of directors and other matters submitted for shareholder approval. Although the inability to merge may result in operating inefficiencies, added regulatory costs, and licensing restrictions, a change in control could still be managed without triggering the poison pill.

The flip-in provision, which is a common part of many modern flip-over poison pills, penalizes the acquiring party even if it does not effect a merger with the target company. Originally designed to prevent the self-dealing transfer of a target's assets to the acquirer, the flip-in provision has been extended in many cases to cover simple ownership. Under a pill containing an ownership flip-in provision, shareholders of the target are given the right to purchase, at a discount, shares of their *own* company should the acquirer surpass a specified ownership threshold (usually between 20 percent and 50 percent of outstanding shares). The acquirer is excluded from this sale of discounted shares, and thus may see its equity position in the target shrink dramatically. When combined with the flip-over provision, the flip-in condition makes any type of hostile control share purchase very costly.

Other less common but restrictive poison pills include back-end rights plans and voting plans. Back-end rights plans give shareholders a redeemable right that can be exchanged for cash and securities worth more than the stock's then-current price. Typically, back-end prices exceed market prices by between eight percent and 92 percent on the date of issuance. Again, an acquirer is prohibited from participating in the exchange, which results in the acquirer suffering significant dilution to its equity holdings in the target company.

Voting plans issue preferred stock with superior voting rights to common shareholders in the event an acquirer surpasses a specific ownership threshold. Thus, even if an acquirer were to own far more than 50 percent of the target company, it would not be able to exercise control over its purchase. For instance, under one such voting plan adopted by ASARCO, Inc., the holder of 99 percent of the company's common stock would only have 16.5 percent of the company's total voting power.

Proponents of poison pills argue that, because pills force would-be acquirers to negotiate with the target company's board, they protect shareholders from coercive tactics such as two-tiered, back-end offers. Moreover, pills enhance shareholder value because such negotiations lead to higher premiums in the event of a purchase.

Opponents, on the other hand, believe poison pills lead to management entrenchment and discourage legitimate tender offers. Even if the premium paid to companies with poison pills is higher than that offered to unprotected firms, a company's chances of receiving a takeover offer in the first place might be reduced by the presence of a pill.

28) **Poison Pill – Shareholder Approval –** a review of whether shareholders have approved the adoption of a poison pill.

Governance Standard
Shareholders should be permitted to approve shareholder rights plans (i.e. poison pills).

Poison pills are unique among takeover defenses in that they may be approved by boards without shareholder approval. Enhancing this power is the fact that a number of states have passed poison pill endorsement legislation that removes courts from the position of challenging abusive pills. However, the degree that a rights plan may promote or diminish shareholder value clearly depends on circumstances specific to the individual company. Given their potential role in determining the future of a company, shareholders should have the right to vote on all new pills and any material changes to old pills. ISS advocates supporting proposals requesting boards to either submit their pills to a shareholder vote or redeem them.

29) **Poison Pill – TIDE Provision –** a review of whether the poison pill includes a TIDE provision.

Governance Standard
If a poison pill is adopted, it should include a Three Year Independent Director Evaluation (TIDE) provision.

Some firms have chosen to enhance their existing pills with a three-year independent director evaluation (TIDE) provision, under which a committee of directors who are not employees or affiliates of the company will review the pill at least every three years and decide on its continuation or revocation. This is often done as a preemptive strike against a shareholder pill proposal, however.

Although most firms resist shareholder attempts to eradicate pills, some companies have found pills difficult to remove. Sealed Air Corp., which inherited its rights plan from predecessor W.R. Grace & Co., tried in vain several times to remove its pill before finally generating sufficient voter

turnout to meet the 80-percent shareholder approval threshold. In the aftermath, CEO T.J. Dermot Dunphy remarked that rights plans "are designed like fishhooks—easy to get in, but tough to pull out of." Performance, on the other hand, "is the greatest defense against getting taken over."

30) **Poison Pill – Sunset Provision**

Governance Standard
If a poison pill is adopted, it should include a sunset provision

Because pills are often adopted without shareholder approval, shareholders should have the opportunity to ratify or reject them at least every two to three years. So-called "sunset" provisions permit shareholders to reaffirm or redeem a pill based on how the company's board has used it in the past, market conditions, or the firm's performance.

31) **Poison Pill – Qualified Offer Clause –**a review of whether the poison pill includes a qualified offer clause.

Governance Standard
If a poison pill is adopted, it should include a Qualified Offer Clause

To strike a balance of power, some activists have advocated pills with "chewable" attributes. Typically, these take the form of a qualifying offer clause requiring the pill to be redeemed, either automatically or by shareholder vote, if a bid is made for the company that meets certain criteria. Such criteria generally include premium pricing, full financing, and a grace period during which the board is accorded time to explore other options. Few companies voluntarily embed such progressive features in their rights plans.

32) **Poison Pill – Trigger Threshold –** a review of the "adverse person" ownership level that triggers the provisions of the poison pill.

Governance Standard
If a poison pill is adopted, the trigger threshold should be 20 percent or higher.

A growing number of companies are providing their boards with carte blanche authority to lower their flip-in thresholds to ten percent under specific circumstances, such as the determination that an individual is an "adverse person." This is a major shift from the late 1980s and early 1990s, when 20-percent triggers were de rigueur and ten-percent triggers were rare. Pills should not discourage potential bidders from accumulating a meaningful stake in the company or cause a large shareholder to inadvertently trigger the rights. Others advocate a fixed flip-in level of 20 percent or higher.

33) **Vote Requirements** – a review of the vote requirement to amend the charter/bylaws and to approve mergers or business combinations.

Governance Standard

A simple majority vote should be required to amend the charter/bylaws and to approve mergers or business combinations.

Supermajority shareholder vote requirements for charter or bylaw amendments are often the result of "lock-in" votes, which are the votes required to repeal new provisions to the charter. For instance, an amendment to classify a firm's board of directors may be accompanied by a lock-in provision requiring that a supermajority shareholder vote (usually between two-thirds and 80 percent) be necessary to declassify the board. Lock-in provisions typically accompany amendments that are harmful to shareholders. Very few companies require that all charter and bylaw amendments receive the support of a supermajority of voting shares.

Supermajority provisions violate the principle that a simple majority of voting shares should be all that is necessary to effect change regarding a company and its corporate governance provisions. Requiring more than this may permit managements to entrench themselves by blocking amendments that are in the best interests of shareholders.

That aside, supermajority provisions can have a future backlash on managements as well. Sealed Air Corp., for example, inherited an 80-percent lock-in from its predecessor company before merging with a unit of W.R. Grace & Co. After three attempts, including two adjournments of the 1999 annual meeting to solicit additional proxies, Sealed Air was finally able to garner the 80-percent approval threshold to repeal its classified board, reestablish written consent, and allow shareholders to amend the bylaws with a simple majority vote.

34) **Vote Requirements** – a review of the vote requirement to approve mergers or business combinations.

Governance Standard

A simple majority vote should be required to approve mergers or business combinations.

Shareholders should similarly oppose supermajority vote requirements to approve mergers and other business combinations. As a matter of principle, shareholder desires should be carried out with a majority vote of the disinterested shares. There are also practical reasons to oppose supermajority vote requirements. For example, irregularities in the proxy system (proxies that are never received by shareholders or that arrive too late for a vote, and proxies that are invalidated for bearing the wrong signatures) and the growing size of management and ESOP holdings, may make a supermajority requirement unreachable at times for purely technical reasons. The difficulty shareholders may experience in approving a merger beneficial to them contributes to the entrenchment of management.

35) **Written Consent** – a review of whether shareholders may act by written consent.

Governance Standard
Shareholders should be permitted to act by written consent.

Consent solicitations can be advantageous to both shareholders and management in that the process does not involve the expense of holding a physical meeting, and it is easier for shareholders who can simply respond to the proposal by mail. A consent solicitation is similar to a proxy solicitation: consents are mailed to shareholders for their vote and signature and delivered to management. The only procedural difference is that the consent process ends with delivery of the consents. If enough consents are returned, the subject of the consent is deemed ratified. In contrast, a proxy solicitation must end with a meeting because proxy cards merely authorize the indicated "proxy" to cast a vote at a shareholder meeting. A signed consent card is itself the final vote and, as such, does not require a vote by proxy at a shareholder meeting.

Many states require a unanimous shareholder vote for the subject of a consent solicitation to become effective. In other states, notably Delaware and California, consent subjects are considered ratified if the consent vote matches the ratification vote required at a shareholder meeting. For example, if simple majority approval is required to pass resolutions at a meeting, then a simple majority is also required to approve action by written consent.

Some argue that since shareholders do not have to provide advance notice to the SEC of their intention to take action by written consent, a consent solicitation aimed at replacing a board or other takeover-related measures can be inherently coercive because it does not allow shareholders enough time to properly evaluate their options. However, with their professional staff and experience with many change-of-control offers during the 1980s, institutional investors are more than able to evaluate a consent solicitation in the allotted time frame.

Limitations on written consent are clearly contrary to shareholder interests. In terms of day-to-day governance, shareholders may lose an important right—the ability to remove directors or initiate a shareholder resolution without having to wait for the next scheduled meeting—if they are unable to act by written consent. Beneficial tender offers also may be precluded because of a bidder's inability to take action by written consent.

36) **Special Meetings** – a review of whether shareholders may call special meetings.

Governance Standard
Shareholders should be permitted to call special meetings.

Most state corporation statutes allow shareholders to call a special meeting when they want to take action on certain matters that arise between regularly scheduled annual meetings. Typically, this right applies only if a shareholder, or a group of shareholders, holds a specified percentage of the outstanding shares. (Ten percent is a common requirement.) The percentage of shareholder votes required to force the company to call the meeting depends on the state statute, as does the company's ability to limit or deny altogether shareholders' right to call a special meeting.

In terms of day-to-day governance, shareholders may lose an important right—the ability to remove directors or initiate a shareholder resolution without having to wait for the next scheduled meeting—if they are unable to act at a special meeting of their calling. Shareholders could also be powerless to respond to a beneficial offer if the bidder cannot call a special meeting. The inability to call a special meeting and the resulting insulation of management could result in corporate performance and shareholder returns suffering.

37) **Bylaw Amendments** – a review of whether management can amend the bylaws without shareholder approval.

Governance Standard
Management should not be permitted to amend the bylaws without shareholder approval.

Sometimes management is permitted to make changes to the company's bylaws without seeking shareholder approval. While many changes may be clerical in nature and inconsequential to shareholders, management's authority to unilaterally change the bylaws may result in changes considered unfavorable by shareholders.

38) **Capital Structure** – a review of the equity structure to determine if there is one class of common stock with one vote per share or if there is a dual-class capital structure. ISS reviews dual-class capital structures to determine if one class of shares has superior voting rights and is used as an entrenchment device by a controlling entity or whether both classes of stock are freely traded and available to any investor.

Governance Standard
Common stock entitled to one vote per share is viewed favorably.

Companies increase their supply of common stock for a variety of ordinary business purposes: raising new capital, funding stock compensation programs, business acquisitions, and implementation of stock splits or payment of stock dividends. When proposing an increase, companies will request a number of authorized shares that provide a cushion for unexpected financing needs or unanticipated opportunities. It would be impractical and costly for companies to continually seek shareholder approval of additional stock each time they needed to issue shares for ordinary business purposes.

One very effective way for a firm to thwart hostile takeovers is to concentrate its voting power in the hands of management or other insiders. The easiest way to do this is to issue to members of management common shares with voting rights superior to the common shares held by other shareholders, through either a dual-class exchange offer or dual-class recapitalization. Dual-class exchange offers involve a transfer of voting rights from one group of common shares (usually those held by regular shareholders or institutional investors) to another group of common shares (usually those held by management). Typically, a firm must offer a preferential dividend to its shareholders in a dual-class exchange offer in order to convince them to cede their voting power to management. A dual-class recapitalization also establishes two classes of common stock with unequal voting rights, but initially involves an equal distribution of preferential and inferior voting shares to current shareholders. For instance, a recapitalization may involve the exchange of a current common share for one-half of an inferior voting common share and one-half of a superior voting common share.

39) **Capital Structure** – a review of the equity structure to determine if blank check preferred stock has been authorized.

Governance Standard
Declawed preferred stock is viewed favorably.

Preferred stock is an equity security, but has certain features that liken it to debt instruments such as fixed dividend payments, seniority of claims to regular common stock, and, in many cases, no voting rights (except on matters that affect the seniority of preferred stock as a class). The terms of blank check preferred stock give a company's board the power to issue shares of preferred stock at its discretion, with voting, conversion, distribution, and other rights to be determined by the board at the time of issue.

Blank check preferred stock can be used for sound corporate purposes such as raising capital or making acquisitions. In these cases, "blank check" implies flexibility in meeting the company's broad finance needs. By not establishing the terms of preferred stock at the time the class of stock is created, companies maintain the flexibility to tailor their preferred stock offerings to prevailing market conditions.

In most instances, blank check preferred stock is used responsibly. Private placements of preferred stock are often used by companies that are experiencing a cash shortage and cannot afford to go through the months-long process of registering securities for sale through the SEC. Nevertheless, blank check preferred stock is also suited for use as an entrenchment device. A large number of companies, including many members of the S&P 500, obtained shareholder approval to issue blank check preferred stock amid a wave of hostile takeover activity in the mid-1980s. One powerful takeover defense at the time was the placement of large blocks of corporate securities, or blank check preferred stock, with friendly third parties—the white knight rescue. This practice was followed by a series of placements done before a tender offer was threatened—the white squire placement—either to a private

investor, a company's ESOP, another company, or an investment fund. Such a defense is particularly effective with the use of blank check preferred stock because the particular attributes of the shares (e.g., voting power, conversion rights, liquidation rights) are unspecified and they can be issued at the board's discretion. From the perspective of management, these placements not only preclude most takeover attempts, but also provide a pool of "patient capital" that helps managers focus on long-term planning. While there is a lot to be said for patient capital, these placements also can dilute existing shareholders' equity and voting positions.

Declawed Preferred Stock
Shareholders interested in protecting their voting positions in such situations devised a simple remedy. In 1990, the nation's largest private pension system, the Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), sponsored the first shareholder proposal (at Pfizer Inc.) asking that existing shareholders be allowed to vote on placements representing ten percent or more of existing equity. Other proposals have asked corporations to adopt a policy of seeking shareholder approval before placing blank check preferred stock (stock without predefined voting and dividend rights) with any person or group, except in cases when such placement of shares is for the purpose of raising capital or making acquisitions in the normal course of business.

Anti-takeover Provisions

40– 46 **Takeover Provisions applicable under State Law** – a review of state anti-takeover statutes and whether companies have opted out of the protection.

40) **Incorporation in a state with anti-takeover provisions**

Governance Standard
Incorporation in a state without anti-takeover provisions, or opting out of such protections is viewed favorably.

The ability of corporations to choose their legal domicile has led many states to compete for revenue from corporate fees and taxes by enacting management-friendly corporate codes. This competition has encouraged states to support a broad arsenal of antitakeover devices and wide latitude in restricting the rights of shareholders. *Delaware* has been the most successful in attracting businesses, as more than half of the S&P 500 companies are incorporated there. The fact that 20 percent of Delaware's public revenue is derived from incorporation fees and business taxes indicates that states benefit from formulating laws friendly to corporate management.

Not only do states favor antitakeover provisions as a means to entice corporations to their state, but they also offer a means for states to protect other constituencies like employees, suppliers, and creditors since takeovers can entail employee layoffs, plant closings, and moving corporate divisions to another locale. While this process is often necessary, and indeed may be desired by shareholders attempting to maximize their wealth, states have their own economic interests and agendas to consider.

Following are definitions for state anti-takeover statutes:

41) **Control Share Acquisition**
This statute can deny shares their voting rights when they contribute to ownership in excess of certain thresholds.

42) **Control Share Cash Out**
This statute gives dissident shareholders the right to "cash-out" of their position in a company at the expense of the shareholder who has taken a control position. When an investor crosses a preset threshold level, the remaining shareholders are given the right to sell their shares to the acquirer who must buy them at the highest acquiring price.

43) **Freezeout Provisions**
This provision forces investors who surpass a certain ownership threshold in a company to wait for a specified period of time before gaining control of the company. However, the potential acquirer must secure adequate financing before proceeding with the acquisition and, quite often, is subject to a fair price requirement once the freezeout period has expired.

44) **Fair Price Provisions**
Fair price provisions contain a requirement that board and shareholder approval be obtained for all takeover bids that do not meet predetermined fair price standards. Fair price provisions are designed to discourage two-tiered tender offers, which occur when a potential acquirer offers a price for the block of shares needed to gain control of the target company and subsequently offers a lower price for the remaining shares.

45) **Stakeholder Laws**
These provisions permit directors, when taking action, to weigh the interests of constituencies other than shareholders—including bondholders, employees, creditors, customers, suppliers, the surrounding community, and even society as a whole—in the process of corporate decision making.

46) **Poison Pill Endorsements**
This statute lends a seal of approval to the use of poison pills should they be challenged in court. Absent statutory endorsements, companies must rely on court precedents to legitimize poison pills.

Shareholders are permitted to opt out of control share acquisition statutes, control share cash-out statutes, freezeout provisions, and fair price provisions.

Executive and Director Ownership

47) **Director Stock Ownership** – a review of stock ownership by directors.

Governance Standard
All Directors with more than one year of service should own stock.

Shareholders should insist that directors align their own interests with those of shareholders, for whom they act as a fiduciary, by requiring directors to own company stock. Some findings indicate that director ownership of company stock is associated with higher performance levels. According to compensation consultant Graef Crystal, a five-point increase in the aggregate stock ownership percentage among directors is associated with a 1.5 percentage point increase in annual shareholder returns.

Many believe that directors should be required to put their own funds at risk by purchasing stock in the company, as opposed to only owning stock through option or stock grants given as part of a director compensation package. Increasingly, companies are requiring directors to own a specified amount of stock in the company shortly after joining the board.

48-49) **Executive and Director Stock Ownership Guidelines**

Governance Standard
Executives and directors should be subject to stock ownership guidelines.

Stock ownership requirements for executives and directors enjoy support from both institutional investors and companies. A 1997 survey of institutional investors conducted for Russell Reynolds Associates found nine in ten investors believe that stock ownership and stock compensation serve to align the interests of directors with those of shareholders. In addition, the American Society of Corporate Secretaries' Current Board Practices: Second Study of more than 600 companies found that almost 31 percent of respondents already have stock ownership requirements (or soon will) and another 4.2 percent of the firms surveyed are "seriously considering" adopting them.

The appropriate amount of stock ownership for executives and directors and the timing of compliance with a stock ownership requirement are subject to debate. In an article published in Directors & Boards, Thomas Neff, president of Spencer Stuart, argues that companies should require directors joining a board to make a substantial personal investment in the company's stock and maintain it while serving on the board. Neff explains that a substantial investment is one that is large enough to have real meaning to the person involved. Experts also suggest that stock ownership may prevent fraud. According to Professor Charles Elson, a director of Sunbeam Corp., "The best way to avoid fraud is to have vigilant directors and compensate them with equity." Or, in the words of Warren Buffett, "Directors should eat their own cooking."

Taking an opposing view, Hoffer Kaback, president of investment firm Gloucester Capital Corp., argues that stock ownership does not align the interests of directors with those of shareholders. Kaback's primary concerns are that alignment may penalize a good director for the failings of his colleagues, may cause good directors to avoid serving on boards with financial troubles, and is an unwarranted intrusion on director's personal finances. Commenting on ownership requirements, Hoffer states, "One may wonder whether companies are adopting alignment because they believe in

its merits, or instead, as a defensive measure to avoid criticism for not having implemented it."

50) **Officer and Director Stock Ownership** – a review of aggregate ownership by officers and directors.

Governance Standard
Officers and directors should have a significant ownership position in their company's stock.

Stock ownership by officers and directors serves to align their interests with those of shareholders. John Core and David Larcker have found that increased levels of equity ownership among management results in statistically significant excess accounting returns and stock price returns. ISS reviews the aggregate ownership by directors and officers as a percentage of the total shares outstanding.

51-52) **Mandatory Holding Period for Stock Options and Restricted Stock** – a review of the holding periods and amounts held after the date of exercise.

Governance Standard
Officers and directors should hold a meaningful portion of the shares acquired after exercise.

This rating issue awards credit to companies that require their executives to retain a meaningful portion (50% of the original grant or 25% of the grant after taxes) of the shares acquired upon exercise of stock options for a specified period of time after exercise. Research points to superior financial performance when officer and director stock ownership falls within a certain range.

Executive and Director Compensation

53) **Cost of Option Plans** – an analysis of the cost of stock-based incentive plans.

Governance Standard
An option-pricing model is used to measure the cost of all *new* stock-based incentive plans. The cost is compared to an allowable cap that is based upon company-specific factors including industry, market capitalization, performance, and levels of cash compensation. The estimated plan cost is compared to the allowable cap.

Stock-based incentive plans are among the most economically significant issues upon which shareholders are entitled to vote. Approval of these plans may result in large transfers of shareholder equity out of the company to plan participants as awards vest and are exercised. The cost associated with such transfers must be measured if incentive plans are to be managed properly.

Decisions regarding the types of awards to be granted under a plan, the timing of grants, and the participants eligible to receive grants are ones best left to the plan administrator, typically the board compensation committee. Leaving such discretion in the hands of the board enables directors to structure the company's overall compensation program to provide incentives that meet the needs of individual plan participants and recognize a company's unique corporate culture.

Compensation plans are evaluated using a binomial option pricing model to estimate the cost of a company's stock-based incentive programs. The estimated plan cost is compared to an allowable cap.

Proposals to approve or amend stock-based incentive plans are evaluated in conjunction with all previously adopted plans to provide an overall snapshot of the company's compensation system. Therefore, shares reserved under a new plan or amendment are valued together with shares available for grant under all continuing plans and shares granted but unexercised. An integrated approach enables shareholders to evaluate a new request in conjunction with management's prior actions as well as costs to be incurred when awards are exercised.

After determining how much the plan will cost, ISS evaluates whether the cost is reasonable by comparing the cost to an allowable cap. The allowable cap is industry-specific, market cap based, and pegged to the average amount paid by companies performing in the top quartile of their peer groupings. Such a benchmark suggests that if the top performing companies in a given industry are able to attract and retain their employees for a given amount, most other companies in that industry should be able to compensate their employees within a similar budget.

54) **Option Repricing** – a review of whether the compensation plan documents expressly permit option repricing without prior shareholder approval.

Governance Standard
Plan documents should be written to expressively prohibit repricing without prior shareholder approval.

Option repricing occurs when companies adjust outstanding stock options to lower the exercise price—a relatively uncommon practice. Option replacing occurs when the company reduces the terms of exercise through cancellation and regrant, a practice that is far more common. Option replacements may be accomplished through option swaps or option regrants, as described below.

Under a classic option swap, for example, an executive holding a ten-year option to purchase 1,000 shares at $10 finds that three years after receiving the award, his shares have finally vested but his company's stock has fallen to $6. While the executive still has the right to exercise this award any time over the next seven years, some argue that the award no longer provides the recipient with the intended incentive value. As a result, the company may cancel the old option and grant a new one with an exercise price of $6. The

new "at-the-money" option may be fully vested and have a seven-year term remaining.

Other companies may use option regrants in such a situation whereby the original option is canceled and replaced with an entirely new grant. The typical new grant would have a ten-year term, new vesting restrictions, and today's lower exercise price. In the vast majority of cases, the number of shares canceled through an option swap or regrant flow back into the pool of reserved shares that may be issued. Thus, the net reduction in shares available for issue is not 2,000, but 1,000.

Companies have an enormous amount of latitude with respect to option repricing: plan terms are generally silent on this issue, shareholder approval is not required before repricing occurs, and disclosure is only provided after the fact, and only as it relates to the top executive officers and directors. While the SEC requires that all material terms of a compensation plan be disclosed when submitted to shareholders for approval, there is no specific requirement that a plan explain whether repricing is allowed without shareholder approval.

The SEC's compensation disclosure rules require companies that reprice stock options for the top five named executives to provide shareholders with a ten-year history detailing option repricing activity. The disclosure requirement extends to any replacement grant that is related to any prior or potential cancellation. Companies are also required to disclose the reason for repricing underwater stock options in the compensation committee report of the proxy statement.

Recent updates to NYSE and NASDAQ listing standards mandate that unless a company's option plans specifically permit repricing, option repricings may not be implemented without shareholder approval. Previously, plans that were silent on the issue of option repricing could be interpreted to permit repricing.

55) **Shareholder Approval of Option Plans** – a review of stock option plans adopted without shareholder approval.

Governance Standard
All stock-based incentive plans should be submitted to shareholders for approval.

Stock incentive plans are one of the most economically significant issues on which shareholders vote. Companies are now required to submit stock-based incentive plans for officers and directors to shareholders for review. However, many companies have plans that were adopted prior to the adoption of new shareholder approval requirements.

56**) Compensation Committee Interlocks** – a review of director interlocks along the members of the compensation committee of the board.

Governance Standard

No interlocking directors should serve on the Compensation Committee.

Compensation committee interlocks occur when the CEO of company A serves as a director on the compensation committee of company B, and the CEO of company B serves as a director on the compensation committee of company A. Objectivity may get lost amid the personal relationship shared by the interlocking directors, and shareholders interests may suffer.

57) **Director Compensation** – an analysis of director compensation.

Governance Standard
Directors should receive a portion of their compensation in the form of stock.

The board's legal charge of fulfilling its fiduciary obligations of loyalty and care is put to the ultimate test through the task of setting its own compensation. Directors themselves oversee the process for evaluating board performance and establishing pay packages for board members. Shareholders provide limited oversight of directors by electing individuals who are primarily selected by the board, or a board nominating committee, and by voting on stock-based plans for directors designed by the board compensation committee. Additionally, shareholders may submit and vote on their own resolutions seeking to limit or restructure director pay.

While the cost of compensating non-employee directors is small in absolute terms, relative to the cost of compensating executives, it is still a critical aspect of a company's overall corporate governance structure. Director compensation packages should be designed to provide value to directors for value received. Given that many directors are high-level executives whose personal income levels are generally high, cash compensation may hold little appeal. On the other hand, a compensation package must be designed to attract and retain competent directors who are willing to risk becoming a defendant in a lawsuit and suffer potentially adverse publicity if the company runs into financial difficulties or is mismanaged. Studies indicate that tying directors' compensation to the performance of the company generally serves shareholders better than providing directors with cash compensation. Stock-based incentives reinforce the directors' role of protecting and enhancing shareholder value. The stock-based component of director compensation should be large enough to ensure that when faced with a situation in which the interests of shareholders and management differ, the board will have a financial incentive to think as a shareholder.

58) **Option Burn Rate** – an analysis of the rate at which stock options are granted.

Governance Standard
Burn rates are considered excessive where average annual option grants exceed two percent of outstanding shares over the past three years OR exceed one standard deviation from the industry mena.

Shareholder approval of stock-based incentive plans may result in large transfers of shareholder equity out of the company to plan participants as

awards vest and are exercised. The cost associated with such transfers must be measured if incentive plans are to be managed properly.

59) **Performance-based Compensation** – a review of the performance criteria on which awards are granted.

Governance Standard
Awards should based upon transparent performance criteria.

This new rating issue awards points to companies that grant awards based on *disclosure* of specific performance criteria and disclosed hurdle rates. Companies that grant indexed options or awards that are not earned or vested unless specific performance objectives are met are also rewarded in this category. Not only should compensation be linked to performance, but the incentive payout thresholds should be disclosed as well.

60) **Option Expensing** – a review of whether companies have pro-actively adopted FAS 123.

Governance Standard
Companies are moving toward option expensing.

FAS 123, the current accounting rule for stock options, permits but does not require options to be expensed. Companies that opt not to expense options must provide extensive disclosure relating to option grants in the footnotes to the financial statements. Many shareholder advocates and investor groups believe movement toward option expensing serves to significantly enhance the transparency of the potential cost of stock options to shareholders. After January 1, 2003, the SEC will require all publicly-traded companies to expense options. This rating variable will be dropped from the next version of CGQ.

Progressive Practices

60-61) **Board Performance Reviews/Individual Director Performance Reviews**– a review of whether board performance evaluations and individual director performance reviews are regularly conducted.

Governance Standard
A policy of conducting annual board performance reviews should be disclosed.

Directors are responsible to act in the best interest of shareholders and to maximize shareholder value. This duty entails an ongoing evaluation of the CEO and senior management, analysis and approval of the company's strategic business plan, establishment of corporate policies, and a regular review of the financial and legal activities of the company. Directors must possess a thorough understanding of the company's business, its strategic plans, and the senior management responsible to carry out those plans.

Objective performance criteria that might also be considered are the director's current job status, attendance at board meetings, acceptance of additional directorships, and conflicts of interest. Key factors to consider with respect to a performance evaluation of individual directors include:

- How frequently and when are performance evaluations for individual directors completed?
- What criteria are used to assess each director's performance?
- How is the information obtained, organized, and communicated?
- How is the information utilized?

Individual director performance reviews should also be performed annually. Directors with staggered or classified boards should also have their performance reviewed on an annual basis. The full board, nominating committee, or other designated committee, should annually perform the reviews.

62**) Meetings of Outside Directors** – a review of whether outside directors meet without the CEO present and the number of times meetings were held.

Governance Standard
A policy specifying that directors should meet without the CEO should be disclosed.

Meetings held in the absence of management enable outside directors to discuss sensitive issues such as CEO performance and succession plans. Outside board members may establish a separate meeting schedule to discuss these issues or may set aside time before or after regularly scheduled board meetings. A process for sharing conclusions reached in these meetings may be established.

"All outside Directors should meet alone, at least once a year, coordinated by a lead Director," according to an article published in the Harvard Business Review by The Working Group on Corporate Governance, whose members include corporate representatives and shareholder activists. "The outside Directors should meet on their own no less than once a year. At that time they should evaluate the performance of the chief executive officer and such other matters as they consider appropriate, including the Board's performance and processes and the flow of information to and from the Board, management, and shareholders. Because working groups rarely function effectively without a leader, outside Directors should designate one of their members to organize and chair their separate meetings. This designation need not be formal, but the designated Director should be identified in advance."

63) **CEO Succession Plan** – a review of whether there is a board-approved CEO succession plan and that the policy is periodically evaluated.

Governance Standard
A board-approved CEO succession plan should be in place and evaluated by the directors periodically.

Boards should develop and maintain a CEO succession plan along with a program to develop promising senior managers. The succession plan should be reviewed on a regular basis to ensure that it is current and reflects the long-term goals of the company. Board members may find it useful to hire outside advisors to solicit input on appropriate successors.

64) **Outside Advisors Available to the Board –** a review of whether the board may hire its own advisors.

Governance Standard
A policy authorizing the board to hire its own advisors should be disclosed.

Strict reliance on management reports for information on corporate performance may skew directors' perceptions. Directors should develop a comprehensive corporate outlook by combining information from managers with that of outside consultants and equity analysts. It may also be prudent for directors to hire their own external counsel, the cost of which should be borne by the company.

The audit committee should have the authority to hire other advisors, such as accountants and attorneys, when needed. Similarly, the compensation committee of the board should routinely hire compensation consultants who report directly to the committee and have not been hired by management.

65) **Directors Resign Upon a Job Change –** a review of whether directors must offer to resign upon changing jobs.

Governance Standard
A policy requiring directors to resign upon a change in job status should be disclosed.

Companies invite individuals to become directors based in part on their experience, business contacts, and the prestige of their principal occupation. CEOs of major corporations are favorites among nominating committees. When a Director changes his principal employment, the issue arises of whether it is still desirable for that director to serve on the board. In addition to the potential for losing the prestige associated with a director's principal employment, some changes in employment may impact a director's ability to commit sufficient time to his director position.

A stated policy should indicate that if a director's position changes, that person should, as a matter of routine, submit a resignation. Maybe, by that time, the person will have established his competence or value to the company, and the continuation of the board position is no longer a relevant matter.

Director Education

66) **Director Education** – a review of whether board members have attended an "ISS accredited" director education program.

Governance Standard
All board members should participate in "ISS-endorsed" director education programs.

ISS has endorsed director education programs that seek to foster improved corporate governance practices. ISS receives no funds from the endorsed programs nor does ISS offer its own director education programs. Universities and associations submit their director education program course outlines and materials to ISS for review. If the program meets ISS' criteria for endorsement, companies with directors attending the program receive credit in CGQ.

A complete up-to-date list of providers and endorsement criteria is available at http://www.issproxy.com/governance/adep/index.jsp .

Combination Variables

Rating variables are also looked at in combination under the premises that corporate governance is enhanced when selected combinations of the variables are adopted.

1) **Board Composition and Ownership** – The board is controlled by independent outside directors and ownership by officers and directors is significant.

2) **Board Composition and Key Committee Structure** – The board is controlled by independent outside directors and the board committees (audit, nominating, and compensation) are composed solely of independent outsider directors.

3) **Proxy Contest Defenses** – No unequal voting rights, no classified board, no limit on the ability to call special meetings, and no ability to act by written consent.

4) **Key Committee Independence and Board Access to Advisors --** This issue is now treated as a separate combination factor. Previously, separate and additional credit was awarded under each committee independence question if the committees were independent and the board had access to its own advisors. Companies now receive credit if the Audit, Nominating and Compensation committees are fully independent *and* the board can hire outside advisors without management approval.