



## 708:Corporate Governance Practices: Investor Perspective

**Richard H. Koppes**  
*Co-Director of Executive Education Programs*  
Stanford University Law School

**Patrick S. McGurn**  
*Vice President & Special Counsel*  
Institutional Shareholder Services

**Broc Romanek**  
*General Counsel*  
Executive Press

**Howard D. Sherman**  
*Chief Operating Officer*  
GovernanceMetrics International

## Faculty Biographies

### Richard H. Koppes

Richard H. Koppes is the former deputy executive officer and general counsel of the California Public Employees' Retirement System, the largest public pension fund in the United States. He is currently of counsel to the international law firm of Jones Day, serves as codirector of the executive education programs at Stanford Law School, and does private consulting for corporations. As second in command at CalPERS, Mr. Koppes was responsible for all legal advice to the system (including its fiduciary obligations), direction of the fund's corporate governance programs, and oversight of all internal auditing matters and public affairs activities. In that role, he became nationally recognized as a leading expert in corporate governance and shareholder rights issues facing most corporations and institutional investors today.

Among his numerous activities, Mr. Koppes taught corporate governance as a consulting professor of law at Stanford Law School, served as a member of the New York Stock Exchange board of governors' legal advisory committee, and is a member of the American Society of Corporate Secretaries, the advisory board of the National Association of Corporate Directors, the Blue Ribbon Commissions on Board Evaluations and Shareholder/Director Communications of the NACD, the American Law Institute, and the International Bar Association, where he serves as vice chairman of the corporate counsel committee of the Section On Business Law.

In addition, Mr. Koppes is a member of the board of directors of Apria Healthcare Group Inc., ICN Pharmaceuticals, Inc., and Peregrine Systems, Inc. He is the founder, past president, and current administrative officer of the National Association of Public Pension Attorneys and serves on the board of directors of the Investor Responsibility Research Center in Washington, DC.

Mr. Koppes received his BA from Loyola Marymount University and his JD from UCLA School of Law.

### Patrick S. McGurn

Patrick S. McGurn is senior vice president & special counsel at Institutional Shareholder Services. ISS is the world's leading provider of proxy voting services and corporate governance research. ISS serves more than 1,000 institutional investor and corporate clients. ISS recommends votes on ballot issues for more than 20,000 shareholder meetings in 80 markets around the globe each year. ISS's corporate governance quotient is the industry-standard benchmark for ranking governance practices at U.S. public companies.

Prior to joining ISS, Mr. McGurn was director of the corporate governance service at the IRRC, a not-for-profit firm that provides governance research to investors. He also served as a private attorney, a congressional staff member, and a department head at the Republican National Committee. Mr. McGurn serves on the advisory board of the National Association of Corporate Directors and was a member of the NACD's 2001 Blue Ribbon Commission on Board Evaluations.

Mr. McGurn is frequently cited by business publications such as *The Wall Street Journal*, *The New York Times*, and *Business Week*. He has appeared on *ABC World News Tonight*, Bloomberg TV, BBC

Radio, *CBS Evening News*, CNBC, CNN, *Marketplace*, *NBC Nightly News*, *Nightly Business Report*, National Public Radio, Tech TV, and ABC's *This Week*.

He is a graduate of Duke University and the Georgetown University Law Center.

### **Broc Romanek**

Broc Romanek is general counsel of Executive Press and editor of *TheCorporateCounsel.net*, *AccountingDisclosure.com* and *GreatGovernance.com*. In addition, he serves as editor of the *Corporate Governance Advisor* and managing editor for the *M&A Lawyer*. He is the coauthor of the "Shareholder Proposal Handbook" and "Mergers and Acquisitions."

Before his time at Executive Press, Mr. Romanek served as assistant general counsel at a Fortune 50 company, was in the office of chief counsel of the SEC's Division of Corporation Finance, acted as counselor to former SEC Commissioner Unger, and was in private practice. He also founded and served as editor of RR Donnelley's *RealCorporateLawyer.com*.

Mr. Romanek is chair of ACCA's Corporate & Securities Law Committee. In addition, he is a member of the board for the American Society of Corporate Secretaries, as well as serves as president for the Mid-Atlantic Chapter and sits on the society's securities and education committees.

He received his BBA from the University of Michigan and JD from the University of Maryland.

### **Howard D. Sherman**

Howard D. Sherman is chief operating officer of GovernanceMetrics International (GMI). GMI is the only independent corporate governance research and ratings agency focusing exclusively on corporate accountability issues on a global scale. He is responsible for GMI's research, technical, product development, and client support operations. Mr. Sherman also participates in business and policy development at GMI and serves as the company's primary contact for rated companies.

He is the former president and CEO of Thomson Financial Investor Relations and Institutional Shareholder Services (ISS), the proxy advisory firm. He has worked in the corporate governance field since 1986, when he joined the Investor Responsibility Research Center (IRRC) as a senior analyst.

He has published numerous articles and op-ed pieces on corporate governance in publications such as the *Wall Street Journal*, *Pensions and Investments* and *Directors and Boards* magazine. He is coauthor of *Structural Imbalances in Japanese Corporate Governance* with Bruce Babcock and coauthor of *Conflicts of Interest in the Proxy Voting System* with James Heard.

Mr. Sherman holds a BA from George Washington University and an MBA from the Wharton School.

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### **Good Corporate Governance: The Road Back**

Richard H. Koppes is Of Counsel at Jones, Day, Reavis & Pogue and a Director of Apria Healthcare Group, Inc. and ICN Pharmaceuticals, Inc. Mr. Koppes formerly was General Counsel of CalPERS.

Recently, a well-known corporate attorney told me: “Ten years ago we used to worry about entrenching management; now, today Rich, we worry about incarcerating management!” Not a day goes by that you can’t find “corporate governance” in print in the world’s financial papers, or rolling off the lips of business television network anchors. There is unprecedented public interest in the subject of corporate governance. Discussions are no longer limited to business circles, lawyers, regulators and financial experts. A wide range of participants now take part in the debate.

Now, I can tell you that corporate governance always existed. It is nothing new. And it certainly is not a buzz phrase. In my 16 years involved with this issue – first as General Counsel of the California Public Employees’ Retirement System for 10 years, and then the last six years as a corporate director and advisor to companies, I have talked about corporate governance until I have been blue in the face. In fact, I have been tempted to say: “I told you so! I was right – corporate governance is important!”

### **Why is there a Corporate Governance Buzz?**

So why is there so much conversation being devoted to corporate governance? Why is it on the minds and lips of so many Americans today? Because frankly, too many in corporate America lost sight of its importance. I hope to provide you some insight and possibly suggest a new path for America’s corporate owners, on how we as a financial community might recover some of our lost steam and lost confidence by finding our road back through good corporate governance.

Now the last decade was certainly a breathtaking time for American business. Many things happened during the 1990s. The Internet was widely adopted at lightning speed. With it came a proliferation of companies that had dazzling promise, but no business model for making money. But their stock prices soared to unbelievable levels.

It was a time when cycles were banished. The focus on the quarterly performance of companies, a hallmark of American capitalism, was transformed. Companies were expected to make each quarter better than the last, or they would be punished with a sharp fall in their stock price. If the company missed the consensus forecast by a few pennies, stock analysts and the business media treated them with punishing results.

The whole system depended on rising stock prices. Boards shifted the weight of executive compensation toward option packages. At last, it seemed, one of the holy grails of

shareholder value was to be achieved – management's incentives were now said to be aligned with the interests of shareholders.

But not quite. Unlike shareholders, executives suffered no out-of-pocket penalties when the company's stock price went down. Stock options that fell out of the money were repriced or swapped. Generous severance packages were negotiated going into the job, – and out of it! Overcompensated for success, CEOs decided they should not be penalized for failure. They lived beyond the norms of the nation – in effect, they became our new “royal” class.

An army of professionals enabled them. Conflicts of interest became a way of life among professionals who once took pride in the honesty and integrity of their work. Accountants, who were trusted to watch the books, cooked them instead. Analysts who were supposed to guide and protect investors, cheered companies on and used investors to engorge themselves and their firms. And boards of directors - who should have been overseeing and monitoring management - spent far too much time on enabling and compensating management.

But then, the economy flattened out. Business was not so great. The name of the game now was just to keep the game going. That's when some mixture of temptation, pressure, greed, ego, arrogance and fear came into play, leading some managers into gray areas – or worse. A number of people (and at times last spring/summer it seemed like way too many people) simply crossed the line, possibly even Martha Stewart.

What followed were shock waves and allegations of illegal and tawdry corporate behavior that hit shareholders hard and devastated employees. Scandals jolted both the broader public – now cynical about markets and worried about retirement portfolios – and foreigners, who no longer could look to U.S. stocks as a secure redoubt. Coast to coast, business people talked about the economic malaise.

The thud you heard wasn't just Enron, Tyco, WorldCom, *et al* stocks hitting the earth and skidding to pennies on a share, it was the sound of the end of an era. Today, our environment is not the same. It's a whole new world. The losses alone from the companies whose names you see on the screen to my pension fund alone, CalPERS, was well over One Billion Dollars!

### **Who's to Blame?**

So who's at fault? To a degree, we may all be. Many of us got caught up in the quest for immediate shareholder value and higher returns that guaranteed the security – and heft – of our retirement packages. But for the most part, Corporate America bears a great deal of the blame. Why? Because for too long, too many dismissed, or treated lightly, the importance of good corporate governance.

Leading institutional investors like CalPERS, TIAA-CREF, Barclays and other large investors have well-defined guidelines and principles that spell-out - what constitutes in their view - good corporate governance. Over the last decade, they have advocated these views in the media, and in face-to-face meetings with boards and corporate management. Their hope was that Corporate America would understand that a good corporate governance system is crucial to providing the necessary checks and balances to avoid such disasters like Enron. Institutional

investors made board independence, accountability and transparency the cornerstones of their campaigns. Unfortunately, in too many cases, Corporate America didn't listen.

For example, 26 shareholder proposals to repeal classified boards submitted by shareholders during the 2002 proxy season received majority votes – and another 31 proposals asking companies to redeem their poison pills or to allow shareholders to vote on them did the same. In fact, the average level of support for these proposals was more than 65 percent.

Nearly half of the 195 shareholder proposals tracked by the Investor Responsibility Research Center received majority votes in 2002. Overwhelmingly, these shareholder votes were “ignored” by corporate boards! It is an understatement to say that shareholders are fed up and demanding change!

### **The Necessary Reforms**

Now I will admit, there is one silver lining in all this economic malaise and shareholder discontent. Enron, WorldCom, Tyco et al certainly helped to create what I like to call the “perfect storm” of last summer. The perfect storm that sent lawmakers and regulators tripping over each other to clean up our financial markets.

And several positive reforms emerged from that:

- **1<sup>st</sup>** – The SEC required the top leaders of the largest U.S. companies to take responsibility for the accuracy of their company's financial statements. They had to affirm that they had looked carefully at them, and to certify to the SEC that no irregularities existed. The day when top executives such as Jeffrey Skilling and Bernie Ebbers could plead ignorance of accounting principles were over.
- **2<sup>nd</sup>** – In late July, President Bush signed the Sarbanes-Oxley Act of 2002 (overwhelmingly passed by a bi-partisan Congressional vote), which includes an overhaul of existing accounting and corporate governance laws. A key provision creates a regulatory board to oversee the accounting industry and punish corrupt auditors. It increases penalties for mail, wire, and pension fraud and adds new criminal penalties for corporate financial fraud and obstruction of justice involving shredding documents. It also expands on the SEC's action by requiring all publicly traded companies to swear to their financial statements.
- **And lastly**, the New York Stock Exchange and Nasdaq propose measures to strengthen corporate accountability and restore investor confidence. These sweeping sets of proposals will hold listed companies to a much higher standard of corporate governance with a focus on giving boards greater independence and investors greater say in the governance of companies.

These are all good moves. I'm hopeful that these reforms will have a lasting impact on the culture of corporate America and will help restore investor confidence. They are a tremendous step forward toward greater accountability and the road back to improved corporate governance.

## Beyond Reforms

But more needs to be done. Companies are going to have to work to restore credibility. Achieving this will require a complete transformation in corporate relationships and accountability. Boards need to voluntarily adopt comprehensive and vigorous corporate governance guidelines and begin to take steps to more fully address the reforms that have only been outlined by the SEC, NYSE, Nasdaq and Congress.

Companies need to create a culture of compliance and ethics. I should emphasize that a market economy requires a structure of formal rules – a law of contracts, bankruptcy statues, a code of shareholder rights – to name a few. But rules can't substitute for character. In virtually all transactions, whether with customers or with colleagues, we rely on the word of those with whom we do business. If we could not do so, goods and services could not be exchanged efficiently.

Companies should be run by people with high ethical standards. People with these standards arguably do not need detailed rules to act in the long-term interests of shareholders and, presumably, themselves. Regrettably, human beings come as we are – some with enviable standards, but others who continually seek to cut corners. Boards and management that place a high standard on ethics and compliance will, in my opinion, succeed. And I guarantee that their shareholders will be loyal.

Finally, boards must say no to outlandish executive requests for millions of dollars in options, unjustified bonuses, personal loans and retirement packages. Period. The bottom line is that companies must treat good corporate governance as an important corporate strategy and communicate that to their shareholders.

## Duties of Investors

Now I also want to add here that the duty for reform doesn't just fall totally on Corporate America. Institutional investors can't be left off the hook for sharing some of the blame and a degree of responsibility to correct the problem. Now, you may find that to be an odd statement coming from a veteran institutional investor activist like myself. And institutional investors – some of them – have been remarkably responsible and set a fine example. Some have been quite vocal and active, even resorting to legal action and running their own board candidates to enforce good corporate governance. But in my opinion, they need to do a lot more – and not just a few, but a whole lot of them!

Long-term institutional investors – all of them – need to act, and react, as real owners; quickly, professional and in concert (where appropriate) with each other. Personal opinions, political agendas and conflicts of interest must be put aside. The focus must remain on the interests of the shareholders – the employees, individual investors, and beneficiaries.

Fortunately, the legal framework is already in place to force institutional investors to deal with these issues. Under the Employee Retirement Income Security Act and similar state laws, pension fund trustees – public and private – must administer the assets “for the exclusive benefit of plan participants.” With this mandate, there is no excuse for any institutional investor to watch the corporate governance debate from the sidelines. As New York's Attorney General,

Elliott Spitzer recently said to the Council of Institutional Investors: “You have a fiduciary obligation to get in companies’ faces before I do!”

The road back to good corporate governance will not be easy because so much has changed in the last decade. As a result, in the next decade, we will have to learn to live with what I call the perfect corporate governance triangle – the legal paradigm of three equal sides, represented by the board, shareholders and management.

Unfortunately, for many decades, this triangle was out of balance – way out of balance! Management, and to some degree, boards (if they weren’t totally owned by management) were in the driver’s seat. We now have a triangle that is more equally weighted, with a balance between these three corporate power centers of shareholders, management and the board.

So what lies ahead for these three power centers in the corporate governance triangle? Let me close with 12 questions or areas to ponder:

1. Will the Public Company Accounting Oversight Board work to clean up the accounting profession? (It surely needs to!)
2. How empowered and independent will audit committees become? Will they become the “super” committee of the board? Or will the corporate governance committee become the “super” committee?
3. Will boards rotate audit firms; not just audit partners every five, seven or ten years?
4. Will expensing stock options become the norm of American business?
5. Will boards say “no” more often to CEOs in executive pay, severance retirement packages, unjustified bonuses and even in acquisitions and mergers?
6. Will boards separate the positions of Chair and CEO or at least accept the role of lead director (or whatever you want to call this independent leadership position)?
7. Will boards opt for executive sessions at every board meeting?
8. Will directors run annually or continue to have staggered terms?
9. How will we deal with the growing concern of who is on the board and how they get there?
10. Will more boards treat being a director as a job, not just a honor, and deal head-on with issues such as limits on the number of directorships, terms of directors, director education and board and director self-evaluation?
11. How will the various corporate governance grades and ratings by Institutional Shareholder Services, Governance Metrics Inc., ValueLine, The Corporate Library, S&P or Moody’s be handled by companies and boards? How seriously will institutional investors treat these ratings?



12. And lastly, (but not completely, as this is certainly not an exhaustive list), how will companies institutionalize the concerns for good corporate governance? Will they name a corporate governance officer? Adopt meaningful corporate governance guidelines and possibly a corporate governance strategy?

No one has the crystal ball that will tell us the answers to these questions. Only time will tell whether Corporate America and institutional investors will take responsibility for their mistakes and clean up their acts. If nothing else, I hope the perfect corporate governance storm of this year created by corporate America's scandals will jostle us all awake and make us remember that corporate governance is defined as the relationship among a wide variety of participants in determining the direction and performance of companies – with the primary participants being the board of directors, management, and shareholders. In its best form, corporate governance is the perfect triangle. Many people forgot this internal truism. It's time to relearn it.

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# Beyond the Rules: A Commitment to Corporate Governance

By **Siri S. Marshall** and **Richard H. Koppes**

No corporation in America wants bad governance. Most companies play by the rules, but rules alone do not ensure good governance—they cannot guarantee thoughtful, diligent board oversight.

Exemplary corporate governance requires an active and ongoing commitment on the part of the company and board members. It can only be built over time and, while based on rules and policies, is ultimately shaped and refined through practices honed to meet the needs of the particular company.

General Mills is one company that has demonstrated this long-term commitment to corporate governance, and has consistently received recognition for its practices. In 1994, California Public Employees' Retirement System (CalPERS) awarded an "A" grade for the company's governance guidelines. Its board of directors has been included among *Business Week's* 25 Best Boards. For the company's 2002 proxy statement, Institutional Shareholder Services (ISS) assigned a corporate governance quotient (CGQ) rating in the top quartile of S&P 500 companies, a ranking that continues today.

For General Mills, a \$10.8 billion global consumer foods company, a commitment to good corporate governance has long been viewed as a sound way to grow the business and deliver long-term value for the shareholders. General Mills has taken to heart the most basic tenet of exemplary corporate governance: an active, independent, strategy-guiding board of directors.

Independent outside directors have made up a majority of the company's board since 1962. All of the company's acting committees—audit, compensation, corporate governance, finance, and public responsibility—have comprised only independent directors for 16 years.

In addition, the board adopted its first corporate governance guidelines in 1980 and has disclosed them publicly in the company's proxy statements since 1999.

These ideas and other good governance practices of General Mills may not be unique. But they have been applied thoughtfully and consistently over time and reassessed regularly. They reflect an active board commitment to effective governance and, as such, have withstood the tests of time and been ahead of most regulatory requirements.

## Board Independence and "Surround Sound"

New rules from the New York Stock Exchange (NYSE), when approved by the Securities and Exchange Commission, will require corporate boards of listed companies to have at least a majority of independent directors. In addition, their audit, compensation, and nominating or corporate governance committees will have to comprise entirely independent directors.

At General Mills, an independent board has been the norm for decades. Underlying this practice is the fundamental belief that the best ideas come from open minds and diverse perspectives. General Mills refers to this as "surround sound," and the concept is simple: a 360-degree approach, with diverse, experienced, multifaceted, and independent directors bringing a full range of perspectives to help the company set strategies, assess options, and make the best decisions.

The process starts with the selection of board members. The governance committee sets a list of criteria for identifying candidates to ensure that a "surround sound" of perspectives comes together in the boardroom

**Director Summary:** General Mills has long upheld exemplary standards of corporate boards that will now become mandatory for listed companies. Its majority-independent board is based on a "surround sound" philosophy of encouraging a variety of viewpoints and backgrounds.

## Of course, it is not enough just to have engaged, independent directors. Directors also require the right information from management.

and employs an outside search firm that reports directly to the committee.

Is there a global viewpoint? One from finance? Public policy? Is there a board member with retail experience? Do board members offer ethnically and geographically diverse points of view? Technology know-how? As the company's needs evolve and board composition changes, the committee revises the criteria.

**Setting the agenda.** Of course, it is not enough just to have engaged, independent directors. Directors also require the right information from management. This begins with setting the agendas for board and committee meetings. Directors regularly offer input into the agendas, both formally and informally. They specify informational needs and issues they want to address. Committee chairs oversee the formulation of committee agendas. This open process seeks to ensure that no issue of importance is missed either at the board or committee level.

**Timely information.** Another requirement for optimizing director input is scheduling sufficient time for board discussion. The objective is to send information in advance so that directors begin meetings already grounded. Management presentations are limited and focused on critical issues, so more time can be scheduled for director questions and discussion. Again, the General Mills concept of surround sound, with probing perspectives and insights from directors, is the goal.

### The Practice of Governance

General Mills has instituted other practices over the years that also help to ensure sound governance:

- All General Mills directors have a stake in the company to ensure that their interests are aligned with those of shareholders. The board has established guidelines that independent directors should own at least \$250,000 in company stock. Directors also may elect to receive all board remuneration in stock and stock-based compensation.
- While most S&P 500 companies maintain classified boards, General Mills gives stockholders an annual opportunity to elect all directors and has done so from the beginning. A classified structure may be appropriate for some companies, but General Mills believes that an annual election gives the board the right balance between accountability and stability.
- To ensure a regular infusion of fresh ideas, the board requires that members serve no more than 15 years and must retire at age 70. Setting a term policy allows General Mills to achieve the desired long-term view for directors, who in turn can broaden their knowledge over a defined period of time.
- Since 1994, the board has conducted regular formal written evaluations of its corporate governance practices, under the leadership of the governance committee. The full board then approves the recommended changes.
- For many years, the independent, outside directors of General Mills have met formally, at least once a year, without management. The chair of the compensation committee has led these sessions, ensuring that outside directors can raise and freely discuss issues outside the presence of management.
- One outcome of last year's board self-evaluation was the decision to provide outside directors the opportunity to meet in executive session at every board meeting. New NYSE rules will soon require all listed companies to adopt a similar practice: regular executive sessions for outside directors.

Again none of these practices are unique in themselves. But the General Mills board has critiqued and refined them over the years to make them effective tools for ensuring comprehensive, dynamic, and insightful input from the board.

As General Mills practices illustrate, the heart of good corporate governance lies with the company's desire and commitment to be guided by an active, independent, and broadly experienced board of directors. ■

**Siri Marshall** is senior vice president, corporate affairs, and general counsel of General Mills. She is on the board of Jafra Cosmetics International, Snack Ventures Europe, and the American Arbitration Association, and is a former director of NovaCare, Inc. She may be reached at [Siri.Marshall@genmills.com](mailto:Siri.Marshall@genmills.com).

**Richard Koppes** is of counsel to Jones Day law firm and a private consultant to corporations. He is former general counsel of the California Public Employees' Retirement System. He is on the board of Apria Healthcare Group and ICN Pharmaceuticals, and may be reached at [RKoppes@jonesday.com](mailto:RKoppes@jonesday.com).

## Using CGQ to Rate Governance in the Post- Enron Market

Patrick S. McGurn  
Special Counsel  
Institutional Shareholder Services  
301-556-0402;  
patrick.mcgurn@issproxy.com  
For more info visit [www.isscgq.com](http://www.isscgq.com)

## Governance Matters!

- Poor Governance = R I S K
- Ratings Agencies
  - Standard & Poor's *Corporate Governance Score*
  - Ken Bertsch Joins Moody's Credit Analysis
- Sell Side
  - Pru's Mike Mayo on Banks
  - Morgan Stanley's Leah Modigliani
- Media
  - *Forbes* (5/12/03): "Spineless Boards"
  - *Corporate Secretary* (April/May): "Top 10 Most Improved"

## What is CGQ?

- Corporate Governance Quotient
  - A Tool for Assessing Governance & Risk
    - Two Years in Development (Went Live: June 2002)
  - CGQ's for Full U.S. Universe (5,400+) in 2003
    - New! Real-Time Updates (Review Cycles: 120 Days)
  - Look to Top Right Hand Corner (Drivers, See Page 2)
  - Scores Relative: Percentile: Zero (Low) to 100 (High)
  - #1 Compare to Relevant Market Index
    - S&P 500, Mid-Cap 400, Small-Cap 600, Rest of Russell 3K, Remainder of Full Coverage Universe
  - #2 Compare to Industry Peer Group
    - 23 Standard S&P Groups (see [isscgq.com](http://isscgq.com))

## Can Issuers Review Their CGQ Scores?

- Issuer's Review
  - #1 NEW! Get CGQ Scores
    - Kevin McManus: [kevin.mcmanus@issproxy.com](mailto:kevin.mcmanus@issproxy.com)
  - #2 NEW! Year-Round Data Review
    - Audit & Augment On-line "24/7" Access
      - Must Include Written "Public" Document
  - Need Login and Password
    - Ted Seaton: [edward.seaton@issproxy.com](mailto:edward.seaton@issproxy.com)
    - A.J. Patterson: [ahaseem.patterson@issproxy.com](mailto:ahaseem.patterson@issproxy.com)

## What Issues Are Rated for the CGQ?

- Eight Core Topics for '03
  - **1) Audit/Auditor Independence**
  - 2) Board Structure & Composition
  - 3) Charter & Bylaw Provisions
  - 4) State of Incorporation
  - 5) Executive and Director Pay
  - 6) D&O Ownership
  - 7) Qualitative Factors
  - 8) Director Education
- 61 Sub Issues for '03 (See [isscgq.com](http://isscgq.com))
  - Partial Credit Given for Some Factors
  - Some Act In Combination

## #1 Audit/Auditor

- Audit Committee
- New for '03! Audit Fees (PUNCH)
  - Audit/Related/Tax Filing > Other Fees
- New for '03! Rotation/Term Limits
  - Audit Firm, Not Just Partners
- New for '03! Ratification
  - Annual Votes
- What's Possible for '04?
  - Financial Experts, Restatements

## #2 Board of Directors

- Independence (New ISS Definition)
  - > Percentage = Higher Score (LS=Listing Standards)
  - Panels--Compensation & Nominating/Governance (LS)
- Annual Elections (PUNCH)
- Leadership/Independent Chair (PUNCH)
  - Lead Director, Presiding Director? (LS-NYSE)
- Board/Governance Guidelines (NYSE)
- New for 2003!
  - Related Party Transactions, Overboarded Directors
- What's Possible for 2004?
  - Shareholder/Board Communications, Access

## #3 Charter & Bylaw Provisions

- Shareholder Rights Plans (Poison Pills)
  - Three-Year Independent Director Evaluation
- Vote Requirements (Supermajority)
  - Bylaws, Charter, Mergers
- Proxy Contest Defenses
  - Written Consent, Special Meetings, Amendment
- Capital Structure
  - Dual Class/Unequal Voting Rights

## #4 State of Incorporation

- Comparison of Shareholder Rights
  - Second Generation Statutes
    - Worst (PA, MD, OH, IN...)
    - Mid-Range (Delaware)
    - Best (No Statutes)
- Credit for Opting-Out

## #5 Executive & Director Compensation

- Option Plan Cost and Dilution
- Repricing Policy (NYSE/NASDAQ)
- SH Approval Requirement (NYSE/NASDAQ)
- Compensation Committee Interlocks
- Director Compensation
- Pensions for Non-Employee Directors
- New for 2003!
  - Option Expensing (PUNCH), Burn Rate, Loans
- What's Possible for 2004?
  - Holding Periods, Performance Pay (PUNCH), SERPs



## #6 D&O Ownership

- Director Ownership Levels
  - After 1 Year of Service
- Stock Ownership Guidelines
  - Executives
  - Directors
- Officer & Director Ownership
  - Percentage of Outstanding Shares

## #7 Qualitative Factors

- Progressive Practices
  - Board Evaluation Process **(LS)**
  - Directors Meet in Executive Session **(LS)**
  - CEO Succession Process **(LS)**
  - Independent Advisors **(LS)**
  - **What's Possible for 2004?**
    - # of Executive Sessions, Guidelines on Web

## #8 Director Education

- Take Your Directors to School
  - SRO Requirement in Light of Enron?
- Accredited Programs
  - See Programs on [isscgq.com](http://isscgq.com)
  - No Fee Charged for Inclusion!
  - Academic Institutions
  - Professional Groups Accredited Programs
  - Applies to All Boards Where They Serve

## Uses Of CGQ

- Proxy Voting
  - No Policies Tied To Ratings
    - But It's A Factor
- Screening (*Governance Analytics™*)
- Investing (See Pru's Sell Side Reports)
- A Four-Letter Word—R I S K
  - Scandal Companies' Scores: All Below 50
  - WSJ's SH Scorecard: Worst 3 Yr. TSR
    - 70% Below 50; 44% Below 25

"Shareholder Access to the Ballot"  
Webcast Program - Wednesday, May 21, 2003

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Under pressure from investor groups, the SEC's Chairman has asked the Division of Corporation Finance to consider a wide-ranging overhaul of the proxy rules, particularly the ability of shareholders to nominate director candidates and a new shareholder proposal framework. This topic already has fostered quite a battle because if shareholders win the right to include alternative nominees on the ballot, the nature of election contests could change dramatically. This webcast offered viewpoints from both the corporate and investor perspectives in this controversial area. Join these experts:

**Panel:**

- \* **Andrew Brownstein**, Partner, Wachtell Lipton Rosen & Katz
- \* **Richard Ferlauto**, Director of Pension and Benefit Policy, AFSCME
- \* **Lawrence Hamermesh**, Professor, Widener University
- \* **Richard Koppes**, Of Counsel, Jones Day
- \* **Ted White**, Director of Corporate Governance, CalPERS
- \* **Beth Young**, Senior Research Analyst, TheCorporateLibrary.com and Corporate Governance Consultant

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**Broc Romanek, Editor, TheCorporateCounsel.net:** Welcome to another webcast program on TheCorporateCounsel.net. I'm very excited about today's program, "Shareholder Access to the Ballot." I think this is a very timely program, particularly since the SEC issued a press release a few weeks ago announcing that they were considering a broad initiative to reform the proxy rules, including the question whether of shareholders should be able to nominate directors more easily.

Let me go ahead and introduce our great panel. I believe we're going to get a variety of viewpoints during today's discussion, and I'm very excited about the quality of our panel. First we have Andy Brownstein, who's a partner at Wachtell Lipton up in New York City; Rich Ferlauto, the Director of Pension and Benefit Policy at AFSCME; Professor Larry Hamermesh from Widener University; Rich Koppes who's of counsel at Jones Day and a prominent member of the Stanford Director Education School staff; Ted White, Director of Corporate Governance at CalPERS; and Beth Young who's a senior research analyst at the TheCorporateLibrary.com who also serves as a free-lance corporate governance consultant.

This will be a true roundtable discussion, but we are going to kick it off with Andy Brownstein providing a brief background of why the SEC took the action that it did. Other panelists will also pitch in as to their views of why investors are putting pressure on the SEC on the access issue at this time. Andy?

### **Background of SEC's Request for Comments**

**Andy Brownstein, Partner, Wachtell Lipton Rosen & Katz:** Thanks, Broc, and thank you for having me on this program. As most of those in the audience are probably aware, shareholders as a matter of state law have the ability at any annual meeting to nominate a director for election, and most companies have bylaws establishing procedures to that effect. Shareholders also have the ability - under state and federal law - to solicit proxies for the candidate that they nominate. Under current rules, there are separate proxy statements and proxy cards - for candidates nominated by the Board and candidates nominated by shareholders and others.

From time to time over the years, really going back as early as the 1940s, there has been discussion of the question whether or not the shareholders ought to have the right to include their nominee in the company's proxy statement and have the name of that nominee listed on the company's proxy card.

This has been debated at the SEC, in Congress and among academics over the years, and the current system has remained. Earlier this year Rich's union, the AFSCME, a municipal employees union, submitted proposals to six companies for bylaws that would establish that stockholders representing three percent of the company's outstanding shares would have the right to have their nominee included in the company's proxy statement and on the company's proxy card.

In three cases, these were to be mandatory bylaws - and in another three they were precatory or advisory bylaws. At the time AFSCME filed those proposals under Rule 14a-8 they publicized the fact and put other institutional investors and the press and the public on notice of the campaign for this sort of bylaw. All six companies opposed inclusion of that bylaw in their proxy statement under the 14a-8 exclusionary rules and made a number of arguments seeking exclusion, including that they would result in proxy contests (which are governed under Rule 14a-12) that they were inconsistent with the proxy rules and that the bylaws violated state law.

The SEC staff ultimately determined that those bylaws were excludable under 14a-8(i)(8) that permits the exclusion of matters that can relate to election contests, relying on the precedent of its prior no-action positions in similar cases - although the AFSCME would debate the strength of the SEC precedent.

The SEC staff didn't address the other arguments against the bylaw that we'll probably get into on this panel a bit so I won't foreshadow them. The Staff's decision was appealed to the full SEC by the AFSCME. The Commission supported the Staff's position. At the same time though, the Commission announced that it was going to do a full review of the proxy rules, in particular the 14a-8 process.

The SEC staff has been increasingly burdened with an ever-increasing number of 14a-8 resolutions and the need to process them. The Staff is considering that and the burdens of that process, and as part of that will consider the subject of whether the company proxy statements ought to include the nominees of shareholders other than the Board of Directors. The Staff has requested comments by

the middle of June and is due to issue a report by the middle of July, so this program I think is timely in that context.

### Reasons Why Investors are Upset

**Romanek:** Rich, why did the AFSCME submit the proposals? What was the motivation?

**Rich Ferlauto, Director of Pension and Benefit Policy, AFSCME:** It was our pension system, actually the employees' pension plan that submitted the proposal. Today I'm speaking as the director of investment policy for the union, however. We fundamentally believe that corporate governance can be improved through an access right that Board processes and that shareholder value in the long term is best determined or will receive its highest value when there's a process in which non-incumbent directors do not have the exclusive right to essentially picking who the new directors will be. Therefore, we're not only interested in promoting directors who are independent from the current Board; we're interested in the process that is much more democratic in its origins so that in companies where we feel there is a substantial corporate governance deficit, shareholders have an opportunity to make their voices known and to actually get somebody who will represent their interests on the Board.

**Brownstein:** Rich, doesn't that opportunity exist today? I mean, why doesn't it? Shareholders can nominate; shareholders can solicit proxies. Last year there were more than 40 proxy contests.

**Ferlauto:** That's actually a very good question. For most shareholders-or just about all shareholders that I'm aware of who are not interested in a hostile takeover-the cost and the complication of running a solicitation really makes the kind of reform initiative that they're interested in prohibitive.

**Larry Hamermesh, Professor, Widener University:** Why is that, Rich? With someone who has three percent or more of a company's stock, I would have thought that putting one director up as a nominee, given the availability of the '92 amendments to the proxy rules and the availability of significant institutional holders influenced by ISS or whatever, wouldn't be such a big deal anymore. Am I wrong?

**Ferlauto:** No, I think the solicitation costs still remain to be quite a hurdle. Where we've requested the action-again, at least in terms of the 14a-8 that we filed and some of the comments that we're filing with the Commission-is that we're not necessarily talking about a three percent holder or a large holder of outstanding shares, but a group of holders that would reach whatever threshold or benchmark would be appropriate.

**Brownstein:** But somebody would have to solicit them.

**Ferlauto:** These are holders that are seeking reform that don't necessarily have the deep pockets that have been behind just about every one of those contests, [unintelligible] contests that have happened in the past year.

**Romanek:** One thing I've heard, and maybe Ted or Beth can flush this out, is that one of the other reasons that is a particular time where shareholders are seeking access is that the companies that have received majority votes on non-binding proposals did not take satisfactory action after the fact in response to that vote. Is that a major motivation?

**Ted White, Director of Corporate Governance, CalPERS:** Yes, I think that's part of it, but I'll boil it down even just a little simpler than that. This is about accountability-that we need a little bit of a tweak to the system to raise the level of accountability of directors, of individuals, to shareholders. This is the most effective way to do that, in our opinion, and that's really what it's all about. Your question as to the response of this shareholder proposal that passed by majority vote-that's part of it. Not addressing underperformance in situations after it goes on for long periods of time-that's part of it. Abusive executive compensation-that's part of it. So it's all that rolled up into one.

**Beth Young, Senior Research Analyst, TheCorporateLibrary.com and Corporate Governance Consultant:** I just would be careful about describing this as being sort of a mechanism for majority vote implementation, if you will, because I think that I see the majority vote issue as kind of a symptom of an underlying problem rather than the central problem to be solved.

**Rich Koppes, Of Counsel, Jones Day:** Broc, can I speak as a director? As a director of three public companies, I just think it's about time that we commend the SEC for doing this initiative. Too often, in my experience, boardrooms are full of directors that still don't understand that they have a fiduciary duty to shareholders at large.

I think what Ted White said was absolutely correct: it is the issue of accountability. I think it's time that we get more shareholder input here. After all, it's the Board of Directors where the real power is in Corporate America.

**Brownstein:** I agree with Rich and Ted that the issue is about the performance of the Board. Not accountability per se; it's the performance of the Board and the effectiveness of the Board of Directors in furthering the interests of shareholders and the company. I think that there's a pretty low threshold to begin with respect to the ability to have a proxy contest.

I think that there are many organizations today that have been effective in getting representation on Boards of Directors of a company without even undertaking a proxy contest, just by virtue of their ownership. There's David Batchelder and Ralph Whitworth's group, for example, which has made their investment thesis trying to get on the Board and influence the direction of the companies, and I don't believe they've engaged in any proxy contest yet-maybe one. But significant shareholders who have something to say and have something to add can get on Boards, particularly when it's clear they have the support or would have the support of other significant institutional shareholders. What this proposal will do is increase the nuisance value of groups that don't have the requisite level of interest to pursue a nomination today or the requisite level of support to be successful.

On the other hand, at least from my experience counseling directors, boards function like any group - chemistry and collegiality develops over time. That's not to say that there shouldn't be dissent and debate on Boards of Directors; absolutely, there should be. It is to say that you don't need to politicize a Board of Directors so that you have a representative of one group of shareholders or a representative of another. All the directors represent all the shareholders together, and I think that what this proposal will do is in effect precipitate more disruption in the boardroom and decrease the effectiveness of boards by the nuisance of these "freebie" proxy contests and an increasing trend to politicize at a time when we're all focused on making them better and when we have just passed and are just starting to implement a whole host of new regulations designed to improve the effectiveness of the Board.

**Ferlauto:** I think that's exactly the point is that most Boards, a number of Boards, have been asleep at the wheel, and that has led to a decline in investor confidence in the market to such an extent that at least the public funds that our members are with have suffered very significant declines and that we're looking for ways, as Ted said, to tweak the system to make Boards more responsive.

The way to do that is absolutely to deal with Board functioning, and we believe that a Board will function much better, at least in the interest of the shareholders, if they don't function as an insider club that can self-perpetuate; and that is to have another input into the process.

**Brownstein:** Why are you so convinced that the nominating process is ineffective, and particularly that it won't improve in light of the Sarbanes-Oxley and Stock Exchange regulations that have just recently been passed? At the same time, you need to recognize that open access is not a tweak. The whole structure of the proxy rules—the disclosure rules, the way the card works, the way the list works and the SEC Staff clearance process—are all predicated on separate disclosures for contesting parties. Would you propose that the insurgent proxy material gets slowed down at the SEC because there's some disclosure problem with the company or vice versa?

**Koppes:** I think we have too much in boardrooms today a feeling that you have kind of a divine right to continue on the Board without anybody challenging that assumption. I think we need to have a dialogue about the proposals from AFSCME and CalPERS and understand that they're not radical - but yet they make people sit up and realize that there could be people that might challenge this "clubbish" atmosphere and somewhat unanimous view that people continue on Boards without any challenge.

**White:** If I could add just one point to this, let's not forget that this process includes at the end of it a majority vote for somebody to get on. No matter where the thresholds are for somebody being nominated, they still have to be elected by over 50 percent of the shareholders. So if owners want to put somebody on and a majority of them vote to do it, then so be it. I'm not sure I understand where your concern is that it's going to politicize the process because owners want somebody new or different on the Board.

**Hamermesh:** I think I can speak to one concern that does exist in an obviously different context. Many states have judges elected by popular vote, and I don't think anybody on this call would assert that the quality of democracy that goes into that choice is really aided significantly by having multiple candidates on the ballot. My concern, as a matter of effective use of the franchise and meaningful and valuable selection of Board members, is that the process unchecked will result in multiple candidacies and more confusion on the part of who's running, what their qualifications are, and perhaps even just other disaffection with the quality of shareholder voting.

I realize—and I don't disagree—that with the phenomenon that, Rich, you pointed out, that some directors and some Boards feel they have something of a divine right of self-perpetuation, but I agree with Andy's point that we're in the middle...actually not the middle—we're at the very beginning of a process in which Boards through listing standard changes to some extent promoted by Sarbanes-Oxley, others by SRO initiative, are changing the rules dramatically in a way that I think will significantly affect the phenomenon that you've been talking about. The question I've got is whether it makes sense to undo or radically—and I think it is a radical alteration of the voting structure that's existed historically—to do that at a time when we really have yet to evaluate the efficacy of the reforms associated with the Stock Exchange and Nasdaq.

**Young:** I just think it would be useful though for us to step back for a second and recognize that I'm getting the feeling from some of what people are saying that they anticipate that this is somehow a wholesale change to how all companies will be governed. Although this would apply to all '34 Act reporting companies, in reality this would be used very rarely.

I don't think we will be seeing even 50 companies a year where this right was exercised, just knowing the institutional shareholder base as I do. There will be high enough hurdles that this will be something that will be used sparingly, and so I don't think that it will confuse the marketplace so much that we are not allowing the Sarbanes-Oxley and Stock Exchange reforms to also work their magic if that is what will happen.

**Hamermesh:** What hurdles did you have in mind, Beth?

**Young:** All of the proposals back many decades have included requirements for a minimum ownership threshold, in some cases for a holding period or other kinds of procedural requirements for this right to be exercised. I don't think anyone contemplates that I could go in with my 400 shares of Citigroup and have this right; that's not really what we're talking about. We're talking about something that would be used in pretty extraordinary circumstances at companies where there was a broad consensus that some serious changes were needed.

**Brownstein:** But still, notwithstanding that consensus and notwithstanding the ownership concentration among wealthy institutions, there would be unwillingness even to threaten one nominee on a short slate.

I don't buy the fact that it's expense of solicitation because it's just not that expensive. Certainly any institution that either has three percent or could spearhead a coalition to get three percent of the shares of a large company can bear the cost of a mailing of a card and a letter to a shareholder list.

**Koppes:** You make those contests sound like they're so inexpensive, but they're not. In my experience at ICN last year where I was a "dissident director" and the group did not advertise, they spent almost \$3 million-I think that's outrageous-just so that they could have our names on the ballot. I don't know why a CalPERS or an AFSCME should not be able to use the company-not the management's proxy, the company's proxy-to have their candidates on the ballot.

**Ferlauto:** And then remember on top of that is that most of the large funds, or at least some portion, are broadly indexed and we may not be interested in one proxy contest as such but in two or three or four, which would be a very limited number as a percentage of our holdings, but that cost quickly escalates beyond what any fund or group of funds can afford.

**Brownstein:** I think that the reason has to do with the fact that it is the company's proxy statement, and the decision to use that company asset, company space, is in essence a fiduciary decision in and of itself. The nominee of the Board, whether you like that nominee or not, has been vetted by a state law fiduciary process as a representative of all the shareholders. A nominee of a three percent stockholder, whether they're the best nominee or not, in the end of the day is just a nominee of that particular shareholder.

**Ferlauto:** That's actually a very interesting question that you raise. Does that mean that you would think that shareholders would have standing to derivatively sue members of nomination committees



in which follow-on directors were engaged in something that led to a dramatic decline in shareholder value or accounting fraud or a variety of other sins in the eyes of shareholders?

**Brownstein:** Shareholders bring derivative lawsuits all the time when stock prices fall. I don't need to comment on the merits of those cases, but they're brought all the time.

**Young:** So are you saying that the contents of the proxy statement reflect fiduciary decisions of the Board?

**Brownstein:** As a matter of state law, the proxy statement is a corporate asset, and the use of any corporate asset is in effect the result of a fiduciary decision.

**Young:** How is that consistent with 14a-8 then?

**Brownstein:** Rule 14a-8 is a federal law that to that extent would preempt that element of the state law.

**Young:** And so an SEC-created right of access to the proxy would similarly layer on a federally-created right to have certain disclosures regarding shareholder nominees in the proxy statement, notwithstanding the resistance of the corporation's Board.

**Hamermesh:** That's right. Andy's right.

**Brownstein:** Subject to the Business Roundtable case. I mean, there are Business Roundtable issues in any rule-making that would come out. But I was really making the point about fiduciary duty before, not so much as a legal argument-although we can get into it-but to get to the policy as to why it makes sense to have a screening for the use of a company asset as opposed to a personal asset.

### Availability of Shareholder Nominees and Who Selects Such Nominees

**Young:** But then the question becomes who gets to decide what that screening consists of. I guess the proponents of shareholder access would say that to some extent shareholders should have input into that screening process by deciding that shareholders meeting a certain definition that guarantees a certain level of responsibility or whatever should be permitted to have material in the proxy statement as well.

**Brownstein:** If the rule was passed and was a valid one under state and federal law, it would basically delegate that responsibility currently held by the Board to any three percent stockholder or group representing three percent of the stockholders. The question is whether that's an appropriate thing to do.

**Ferlauto:** But it wouldn't delegate to them; it would share the responsibility with them.

**Brownstein:** It would delegate because any three percent stockholder would have the right to have its nominee in the proxy statement.

**Koppes:** One thing that you might consider, the SEC should consider, is whether there ought to be a process where these between three and five percent shareholder groups will be required or suggested-I don't know how you'd phrase it-to submit it to the Board of Directors nominating

committee so that there would be some vetting. It could possibly be that the Board would find an excellent candidate that they might want to nominate without having to go to a contested vote on the proxy.

**Hamermesh:** I think that goes a long way to meeting Andy's point, in my judgment. The question really is, and I wanted to raise this earlier and get the sense of the participants on it, to what extent if given the current environment are there genuine obstacles to a supply of qualified candidates. Who is really going to emerge from this process? What do people really think, and who is going to come out that can't come out now?

**Koppes:** I think you're going to see a lot of people who have been on the shareholder side of issues, who have an understanding of that side, and they're not of a management bent.

**Hamermesh:** Where have they been?

**Koppes:** Hey, I've got a large file of them if somebody wants them - a lot of very good people. The search firms are just not looking for them and then Boards aren't considering them.

**Hamermesh:** Are these people presenting themselves to the nominating committees these days? If not, why not?

**Koppes:** Because most of them are thrown in the trash when they come into companies, and people know that self-nomination is a waste of time and effort.

**Hamermesh:** If they are really qualified and we have independent director nominating committees, then I don't think there will be this problem of "throwing in the trash."

**Brownstein:** I think there's a shortage of well-qualified director candidates, particularly for large, complicated companies where a substantial time commitment is required and a substantial level of sophistication is required in order to do an effective job. I think that there's a shortage of qualified director candidates, and I fear that this proposal, which I think could sort of trivialize the proxy contest process, will shrink the available pool.

I think directors understand that they're subject to criticism in the press, they're subject to lawsuits, they're subject to proxy contests including short slates, and I mentioned before firms like Relational Investors that had real influence on several companies. But then if you sort of go beyond all of that and say that a group of people large enough to own three percent of the stock of the company but are unwilling to invest in the amount necessary to elect one candidate can just have sort of a free ride, plus maybe have their own proxy solicitation on top, I just think you trivialize the process and shrink the pool of serious qualified people willing to participate.

**White:** Let me weigh in on that a little bit. First, I'm not sure that it's just an issue about the number of candidates. I think that there is a large universe of very well-qualified candidates that don't get fair consideration under the current system, but I think this issue is broader than that. The issue here is about the process.

The process leads to accountability for management, who by and large controls the nominating process. This tweak to the system will provide shareholders with some ability to have a larger role than that. That is what will bring the accountability-when the directors know that they can be re-

nominated or nominated by shareholders, that's who they're going to feel accountable to. Again, that's what this is all about to us.

### More Disclosure as a Possible Solution

**Romanek:** What about sort of baby steps as we wait to see how the recent reforms take hold what if the first step was merely a disclosure regime where the governance committee included a report in the proxy statement - just like the audit and compensation committees now do - about what their process is, whether they received shareholder nominations, whether the governance committee did consider them, and what criteria was used to assess the candidates? What are people's reactions to that?

**Brownstein:** My question, Broc, is why do you need to enshrine that in an SEC rule. I think that if I were a shareholder advocate and I submitted a qualified candidate to the nominating committee that was rejected, I can ask the Board for an explanation just as I would ask them for a response on any other shareholder proposal.

Boards respond to institutional shareholders as to their actions on shareholder resolutions. Shareholders may not always like the response, but Boards tend to respond and their responses are publicized. Do we really need to get the SEC in the business of monitoring that, regulating that, reviewing it? There will undoubtedly be issues as to compliance with such a rule. It seems to me that the disclosure regime can be self-generating, and if I were at the SEC I would ask why do we as an institution have to sort of get involved in that from a regulatory perspective.

**White:** I'll add to that, Broc. I think actually disclosure in this particular case, while never bad, is really a weak solution to a fairly significant problem. We would never be against greater disclosure or the process for nominating committees; in fact, we focus on it a lot-it's important. But that's really not going to affect the accountability that much.

**Romanek:** Anybody else?

**Koppes:** I would agree with Ted. I think it's very much a baby step, but I would like to see something much stronger put in. Let me talk to the view that there's a scarcity of good directors; I just simply don't agree with that. That's not been my experience.

What we're going to have a scarcity of, and we already do, is CEOs who serve on too many Boards - and directors that want to serve on six, seven or more boards. Yes, those people are going to be scarce, and that's a good thing. But I think we still have an excellent pool of potential directors out there. I think the search firms need to do a better job. I think these proposals will help that process.

**Romanek:** I would imagine the search firms would also have a new line of business in that investors would be hiring them perhaps to help recruit their nominees as well. I don't know if that's been tapped into yet.

**Koppes:** Certainly, and that's another good vetting process.

**Ferlauto:** It hasn't been worthwhile for shareholders to search out directors when the likelihood that those directors are going to be moved through a nominating committee is very, very low.

## Importance of Board Collegiality

**Romanek:** I know in Europe, at least Germany, boards must include labor representatives on the Board. I've talked to a few people that work inside companies who have attended Board meetings of those types and they believe those boards are not as effective as collegiality definitely suffers. Even if this only happened at 50 companies, if that's truly what happened, how would you imagine the scenario would play out at those companies to ensure that they had effective boards over time?

**White:** In Germany they have a designated right to a number of seats to a constituency. I fail to see the comparison here. There's no designated right for a constituency at all. You have to get elected by 51 percent. That's fundamentally different.

**Ferlauto:** I would imagine that as candidates were being run through this process were it to take place is that these would be credible candidates who've got a background in the industry and who are independent.

**Koppes:** And who would understand that once elected they would have a fiduciary duty to all shareholders.

**Ferlauto:** Absolutely.

**Brownstein:** I think that that's not clear. Given the institutional share holdings at a lot of companies nowadays, there are many companies where there are three percent shareholders or where a handful of institutions control a sufficient number of shares to get the election of one candidate. And who is to say that the nominee will have industry experience or will not view himself or herself as primarily the spokesperson of the nominating group.

It's often more difficult to oppose a single candidate than a slate - because a slate, to take control, is fundamentally changing or usually is expected to have a proposal to fundamentally change the direction of the company. The attitude of many institutional shareholders with respect to another shareholder nominating a single candidate is: how could one person upset the apple cart so much, what's the downside? Which is why the short slate proposals enacted in 1992 have been so effective in changing the composition of Boards when they've been used or threatened.

I think what all this discussion ignores is that, at least in my experience, there's more open discussion, greater freedom to dissent and to ask questions on a Board of Directors that is not a politicized Board.

It's my feeling that if you have the three percent "freebie proxy contest" regime, you'd have just more proxy solicitations and politicization of boards because it's just that much easier to wage a proxy contest. I think that will reduce the quality of Boards rather than increase it - which is the fundamental judgment we should all be talking about.

**White:** One point. You've mentioned three percent here numerous times. I just want you to know that there's not universal agreement that three percent will be the right threshold. In fact, I think there's probably a larger universe at five percent, including the counsel and our own. That's not something that I would use as an arguing point if you're against this, to say that you should forget it because everybody's at three.

**Brownstein:** I'm just responding to the AFSCME proposals that were made this year. I also believe that there was a request for rule-making last summer at the Commission also at three percent.

The SEC can consider whatever percentage it thinks is appropriate - and obviously at very high percentages it's less of a concern to folks like me than it is at lower ones. I think that given the shareholder makeup of most large companies whatever percentage is picked I have to assume is going to be one that will be effective at increasing these "freebie proxy contests." This debate is not about shareholder nominations because shareholders can nominate director candidates and can solicit proxies if they choose. What it's about is freebie proxy contests.

**White:** Actually it is about those two things because that doesn't exist.

**Koppes:** I think we have a fundamental disagreement on that, too.

### Use of "Short Slates"

**Koppes:** You know, Broc, Andy's mentioned and maybe other people-Larry, I believe the short slate idea, one of the "reforms of 1992." I wonder how often the short slate has even been used. I don't think all that often, but I don't know for certain. That would be one area that some research ought to be done - to see how "effective" the short slate reform of 1992 has been and how often its been used in the last ten years.

**Young:** It's interesting. I can't speak to how often contests are threatened. I think Andy pointed out, this has been in the background of negotiations between companies and shareholders that sometimes don't result in consummated proxy contests; but I spoke with ISS about how often it is voting on proxy contests in its universe of 10,000 companies, and since January 1st of last year, 2002, it has voted on 45 which, when I kind of did the math, came out to about 33 in a year over that 18-month period.

I went back to an old law review article about equal access to the proxy that reported IRRC statistics from well before 1988 or so that said that they had about 30 that year - which means that this "short slate reform" has not resulted in an increase in the number of contests overall. Keeping in mind of course that both of those totals include control contest proxy contests as well as short slates, but there has not been a large shift overall in the number of contested elections just in general.

**Brownstein:** The short slate is a powerful threat, though. It is a powerful threat and has, at least in my experience, changed the composition of Boards when you have a serious stockholder that is proposing one or two nominees.

**Hamermesh:** And what we're talking about today would not actually be reflected in significant new numbers of contests, but would rather be reflected in amicable negotiation and resolution- it would just be a factor in the discussion between management and the stockholder who wants to put a candidate on the slate. I think that the real question is what it does to the dynamics, and I'm not sure it's possible to tell how it will ultimately affect people in the long run.

If, however, it's a significant point of leverage for a three percent or five percent or ten percent stockholder group, then the real question is what happens when that group's nominee enters the boardroom if it does. I just suggest, as Andy did, that there is an unhappy history of outright animosity between a person like that and the incumbent directors, and a process that encourages that

kind of opposition will I think lead to the kind of problem that we see in German corporate governance with co-determination where the incumbents or the people who are actually managing day-to-day just simply don't cut in the other constituency on the decision-making or informational process.

**Ferlauto:** That actually may be the very reason why we need it. You have to remember that this person-if they were elected from a three, five or ten percent group-would have to be elected by a majority of the shareholders, number one; and number two is that wouldn't be a constituency group nominee by the very fact of the election process, but would be broadly representative of shareholders who were moved to engage in this because they thought there was a fundamental deficit in corporate governance of a particular company.

If that were case, maybe the directors should be upset and maybe there should be others that join that one- or two-person short slate.

**Romanek:** Do you think in the cases where there were these types of contests, should discretionary voting still reside with management?

**Severall:** No. No. Absolutely not.

**Ferlauto:** That would subvert the whole purpose for this.

#### Number of Candidates and Disclosure Framework

**Romanek:** And would the SEC Staff still referee the process of reviewing the materials and providing comments? I would imagine it would be the same proxy card.

**Ferlauto:** We imagine that there would be one proxy card and that the SEC, as they would now, would review that for the various disclosure requirements.

**Brownstein:** I think that the difference between then and now is that when the SEC reviews contested proxy contests, one side's materials do not hold up the other's. What you have in a common situation-everything gets held up because the staff adds another layer to the process.

It's all in the company's materials, and how does the company protect itself against that? The whole structure of the proxy rules in contested situations is premised on separate cards and separate statements and reviews. It will undoubtedly be, in a contested situation, quite confusing to have it through one document. I think that this is not a tweak to the system. I think that all the rules would need to be thought through with respect to how they would apply in a hard fought contested situation if you have sort of single card, single statement.

And then I say, why? Is it true that the cost of the current system is that significant for large companies with five percent stockholders or even three? And is it true that there's not today sufficient pressure through the short slate mechanism to effect change? What you're really talking about is somebody who has the ability today to elect a director and has the ability to nominate a director. Up to this point they've been unwilling to bear some expense, and that's proposed to be shifted over to the company in a format that could engender significant confusion and a significant number of nuisance situations.

**Koppes:** I just don't feel we have enough proof or statistics on the effectiveness or the power of the short slate. I just don't think that it has been much of an effective form, but I don't think we have enough proof or statistics to say one way or the other on that.

**Brownstein:** If that's true, why do you think that this...

**Koppes:** Because the expenses are still there for the short slate. I just think it's an outrageous situation and I disagree that it's going to be more confusing. Frankly, it will be less confusing for shareholders to have one ballot.

**Ferlauto:** Clearly it's confusing for shareholders at this point. If they don't want to vote for the director and want to vote against them, what do you do? You don't vote. The way we have elections right now are really quite cryptic is you withhold votes and then you read the tea leaves by comparing vote totals as to who's down and who's up. I can't think of a more convoluted, confusing system than that where there's no clarity to the ballot at all.

**Brownstein:** But at least you know who is nominating and supporting each candidate. You can't compare a contest to a non-contest. You're right-if you want to vote against - and there is no contest - you can withhold because there's no opponent. But that is not what we are talking about.

You can't compare a single ballot in a non-contested situation to a proxy contest where today there are two ballots. In the current system, it's very clear who is the company nominee, who is the alternative nominee. They have different colors, there's different recommendations, there's different materials.

**White:** Why would you assume that shareholders be confused because their choices are on one page instead of two?

**Brownstein:** Who's making the recommendation, and what is the reason for the recommendation?

**Koppes:** You can say that in plain English on the card - on either side of the two sides of a proxy card.

**White:** You're assuming that there would be some kind of prohibition from management saying this is an incumbent and a shareholder saying this is a dissident. That seems ridiculous to me. Neither side would want their candidates to be put into a blind pool and shareholders just sort of take a lottery; that's not the point.

**Hamermesh:** You're also assuming there's just going to be one non-management or non-incumbent nominee. What if we have multiple ones?

**White:** Multiple ones for the same seat, you mean?

**Hamermesh:** Well, I don't know if it's for the same seat or not; that's the problem. It's very confusing.

**White:** Right, I would call for less than a majority in a situation for seats to be up for open access, but I don't think it would be productive to have multiple shareholder groups putting up multiple candidates, nor do I think it would be possible.

**Brownstein:** What would we do to prevent that?

**White:** I think the rule could be pretty simply designed to do that. For example, shareholders can't put in two shareholder proposals on the same issue, and it's based on a first come, first served. In any event, if you left that alone, the likelihood that two shareholder groups independently could get a mass of the thresholds together and would end up running two individual slates is remote, at best.

**Brownstein:** Again, we're all sort of speculating on what would happen, on how many of these things you would have, on whether they'd win or not. It's still not clear to me that it is worth changing, particularly at this point. There are a lot of things that have been done in the past year in particular to improve the effectiveness of Boards of Directors.

**Young:** I want to just step back for one second again and make a point that seems really painfully obvious but that nobody has articulated here. I've heard a lot about "freebie proxy contests," and essentially this is shifting the cost to the company. Shareholders are the company in a real sense, and though there are many other groups and constituencies with claims against the company, but in the end shareholders are not shifting costs to an entity with which they have no relationship.

**Brownstein:** Yes, but a three percent stockholder is not the company.

**Young:** I guess I'm not really talking about this in a legal sense. I'm talking about this in the sense that there's been a lot of rhetoric here that makes it seem that shareholders have no relationship to the company. I'm just trying to stress that ultimately all of this is geared toward...however we may disagree about particular mechanisms, shareholders are interested in doing this because they believe it will improve the performance of the Board and thereby improve the performance of the company. The idea that the corporate treasury is somehow something to be used only by the incumbent Board and management, it strikes me as wrong-headed.

**Brownstein:** I don't disagree with the notion that what we're about here is improving the company and the effectiveness of the Board for the benefit of the shareholders. It's not for the benefit of the management or for the benefit of the Board of Directors.

The only point is that you're giving...if it's three percent or whatever percent, it could be one percent...you're giving that percentage of shareholders a call on the company assets that no other group has. Every other call on company assets passes through a fiduciary decision. If the federal government seeks to impose such an obligation preempting state law fiduciary principles we'd need to consider the implications of the Business Roundtable case.

### **Ideal Frameworks for SEC's Consideration**

**Romanek:** We just have just a couple of minutes-so I will ask each panelist to spend a minute or two laying out what they think would be the ideal framework for the SEC to propose. Why don't we start with Rich Ferlauto.

**Ferlauto:** This is the framework that we've laid out is that we're looking for an access threshold. We think that three percent is appropriate - but that could be under discussion. If it were to be five percent or above, there would have to be some relief from 13d that we haven't discussed, but so be it.



Number two is that there should be a holding period of some length so that this couldn't be used by arbitrage or short sellers or other types of short-term holders but definitely somebody who is intent on holding their stock for a long term.

Number three is that this only be used for short slate purposes. There's some discussion about what that right number should be-whether it's less than a majority, which is what we think is appropriate-but there should be some number of thoughts more than one and less than a majority.

Number four is that there be true equal access, and that is that the shareholder statement be a reasonable length and that there be some equity in the distribution of the campaign materials-there's been some discussion about use of the web, for example-so that there be equal access between the management and the shareholders for doing that. Not all disclosure requirements should equally apply to the incumbent director and the shareholder-sponsored candidates.

So I think that's the general framework that we're looking for. I think it will be up to the Staff to get wide input from shareholders to hone the specific rules, but that's certainly the context that we're looking to frame this type of shareholder right.

**Koppes:** I would say that a five percent minimum is a good place to start, and I guess I would go with two years holding. I think one year is just too short, and I think frankly beyond two years you're a long-term holder by any means these days. I would agree with Rich Ferlauto on the other limitations, and particularly this being used only for short slate purposes.

**Hamer mesh:** I think the real question that the SEC needs to come to grips with as it reviews this is, first of all, the subject matter jurisdiction or authority issue that Andy referred to; and second, and perhaps even more important, the question of whether or not or the extent to which existing mechanisms work or the extent to which there really are supplies of qualified individuals out there who will be freed up for this purpose. I think that's something that really ought to be considered -- is there really a bang for this buck?

**Young:** I'm not wedded to any particular formulation. I think that the SEC will weigh how best to ensure that this right is available and usable - but not abusable - and that it will be used responsibly by the kinds of shareholders who can be expected to really have the long-term interest of the company at heart.

**Brownstein:** I think that this is an issue that has sort of a surface political appeal, but when you really bear down and think about how it would work, there are lots of complexities and problems that the SEC needs to focus on. It's just not consistent with the current structure of the proxy rules. It's not a simple tweak. In the end, I think you get to Larry's question: Where's the bang for the buck? I don't think it's there. I think this proposal ultimately would have a negative impact on the quality of people serving on Boards of Directors - and on the effectiveness of Boards. This also is the wrong time to consider any change. We should have time to assess the impact of Sarbanes-Oxley and the new SRO rules.

**White:** We actually have a policy statement on our website from the March agenda item if anybody cares to look through it, but I'll just briefly touch on it. We address really what we consider to be the three primary policy issues.

First is the threshold—we think five percent is the right starting point and with 13d relief. We have a one-year holding period, but I would tend to agree that there's absolutely no problem with having that longer. On the control issue, we believe that it should be for less than a majority; and on the expenses, that there should be no automatic reimbursement provisions in this for shareholders but some mechanism where they might be able to seek it through like a concurrent proposal.

I'll just add one thing from the comments that were made. In regards to the supply of directors, with all due respect I don't think that's the SEC's purview. I think that's really the shareholders' purview—that it's really up to us to source and identify candidates and to solve the supply issue, so I don't that should really be a concern.

Then on one last point since I get the last word, I guess, is if you want a signal on how shareholders feel about this issue you should look at the policies that are being developed and the positions that are taken by organizations like the Council of Institutional Investors and us. Shareholders clearly think that there's something wrong with the current system, and so the statement that we shouldn't worry about it because it because there's nothing wrong with the existing nominating process I think is really deflated by the fact that shareholders are calling for this from all angles.

**Romanek:** I want to thank all the panelists for engaging in this debate. I believe it's a healthy debate and important in framing the complex issues that the SEC should consider during their deliberations.

## Corporate Governance Ratings Comparison

By Broc Romanek, Editor, TheCorporateCounsel.net

(last updated 3/18/03)

- A. [Institutional Shareholder Services](#)
- B. [GovernanceMetrics International](#)
- C. [The Corporate Library](#)
- D. [Moody's Investors Service](#)
- E. [Standard & Poors](#)

This comparison is a one-stop resource to compare the “nuts n’ bolts” of the growing number of services providing ratings on corporate governance practices. It will be updated continuously as the rating industry matures.

### A. Institutional Shareholder Services (<http://www.isscgq.com/>)

#### 1. Background

ISS's core services include global proxy services and database and research tools for institutional investors. These services are available by subscription and include a weekly informational newsletter and annual updates to the *ISS Proxy Voting Guide*. The *ISS Proxy Voting Guide* is a reference manual designed to provide recommendations to institutional shareholders, especially ERISA managers, on how to satisfy their obligations as shareholders and vote their stock to enhance long-term portfolio value.

Before launching its "Corporate Governance Quotient" or “CGQ” rating service last year, ISS had been working on it for almost two years. [It is important to note that CGQ is for investment decisions – not proxy advice. So its entirely possible for a company to have a low CGQ rating and yet have ISS recommend that shareholders vote for management’s proposals.] A demonstration of the CGQ ratings is available at <http://www.isscgq.com/demo>.

#### 2. Calculation of Ratings

\* **Which Companies** - For the 2003 proxy season, ISS expects to post two CGQ scores on the first page of every proxy voting report it issues for its 9,500 domestic-company universe. As of early March 2003, it was able to do so for 6,000 companies. [Interestingly, as ISS adds smaller companies to its database – the scores of companies that have already been rated have gone up considerably as larger companies tend to have better governance practices.]

\* **Scoring System** - Both scores are expressed as a percentile, relative to all other peer companies (100 is the best score; 0 is the worst). The first score shows how the company's corporate governance practices stack up against all other companies in their relevant S&P or Russell market index. The second score ranks each company relative to peers in S&P's 23 industry groups. For example, a 65/77 score means that the company outscores 65% of the companies in its index and 77% of the companies in its industry.

\* **Topics** - ISS ratings are based on 8 "core topics," with 61 sub-topics. The eight core topics are: auditor independence; board structure and composition; "anti-takeover" charter and bylaw provisions; laws in the company’s state of incorporation; executive and director

compensation; qualitative factors, including financial performance; D&O stock ownership; and director education. A current list of the rating variables and their distribution among the eight core topics is available at <http://www.isscgq.com/RatingCriteria.htm>

Overall, ISS already has factored the proposed SRO listing standard changes into its rating calculations. In some cases, ISS has gone even farther than what the NYSE and Nasdaq have proposed.

Some of the topics are analyzed in connection with others, so if a company has multiple "good points" - it can help the company receive a higher rating than if each point was earned individually. Presumably, the demerits work the same way.

ISS does not fully explain how the points are awarded, their values, relative weights, or the way the combinations and permutations play out. Some companies have spent \$10,000-\$25,000 to hire ISS to work with them in a consulting capacity on their corporate governance framework. Many companies complain about this aspect of ISS' framework as they feel they have to pay money just to understand how the rating process works.

However, based on analysis conducted by an investment banker, a number of the sub-topics have been identified as major differentiators. Topics that are not common to many companies so meeting these criteria gives a leg up. Topics that are not differentiators means that companies uniformly meet – or do not meet – the criteria. One example is incorporation in Delaware that gives companies a middle of the road score for that category – and many companies are incorporated in that state.

As of March 2003, the major differentiators included:

- \* board composition – over 2/3 independent directors (and independence is defined differently for ISS purposes as compared to the SROs)
- \* board structure – not having a staggered board
- \* limits on outside directorships – no more than 4 boards
- \* outside advisors available to board – include this availability in charters and/or governance guidelines
- \* capital structure – don't have dual classes or uneven voting rights

Criteria that have less significant importance but that are still differentiators included:

- \* corporate governance guidelines – publicly available and updated
- \* chairman/CEO separation – identification of a lead director (must be a "real" lead director and not a "presiding" lead that rotates around the board)
- \* poison pill features – must not be so onerous as to prevent shareholders from exercising a voice
- \* company loans to officers – related party transactions are closely scrutinized, including grandfathered loans under Section 402
- \* options expensing – announcement of intention to do so with a specific implementation date

\* stock ownership guidelines – directors and officers required to purchase company stock and hold stock received as part of compensation package

It is important to note that ISS only takes into consideration information that is made publicly available. Thus, a company might meet some of the criteria and tell ISS staffers so – but ISS won't take it into account unless its on a web site, in a SEC filing or somehow otherwise put into the public domain.

### **3. Corporate Input into Ratings**

Although ISS does its own homework in developing ratings, it also relies on companies to participate in the process and make corrections. This is done by companies going to the ISS website - <http://www.isscgq.com/>- and entering information about their governance structures that might correct or supplement what ISS has on file. Companies can do this without charge.

This information is inputted by appending documents that are publicly available right into a database through the ISS website. There is a column on the website for a company to note that it “disagrees” with selected information that ISS has used in its rating calculation. It is wise for a company to also call or email your ISS contact at the same time a disagreement is noted on the website.

In February 2003, ISS began a 24/7 system so that companies can continuously input new data. However, this data will not affect a company's scores until the next cycle of updated calculations – which occur every 120 days. However, it is our understanding that if companies subscribe to ISS' fee-based consulting service, they can alter their scores as they input the data.

To input information, companies can get their log-ins and passwords from either Ted Seaton ([edward.seaton@issproxy.com](mailto:edward.seaton@issproxy.com)) or AJ Patterson ([ahaseem.patterson@issproxy.com](mailto:ahaseem.patterson@issproxy.com)).

### **4. How Often are Ratings Calculated**

In general, once a company gets rated, ISS will update the rating on a 120 day cycle. However, it is our understanding that if companies subscribe to ISS' fee-based consulting service, they can alter their scores as they input new data.

### **5. How a Company Can Ascertain its Rating**

Often, companies find out their ratings through the grapevine (i.e. through institutional investors that are ISS customers). ISS doesn't routinely inform companies of their ratings, even if they input data through the ISS website (unless the company pays for the consulting service).

At this time, the exception is that ISS will provide companies with their rating once per year – if they go to ISS and ask for it. This request should go to Kevin McManus ([kevin.mcmanus@issproxy.com](mailto:kevin.mcmanus@issproxy.com)). Companies that ask more than once per year have to pay to receive their ratings – but we haven't heard what the cost is yet.

## B. GovernanceMetrics International

### 1. Background

GovernanceMetrics International (GMI) was founded in 2000 by PR advisor Gavin Anderson, IR pro Gary Kraut and governance experts Stephen Davis and Jon Lukomnik (formerly of NYCERS). ISS alum Howard Sherman is the chief operating officer. Their sophisticated methodology took over 2 years to launch.

GMI's research reports and scores primarily are developed for security analysts, portfolio managers and compliance officers, not the persons that make voting decisions (although GMI points out that their reports can be useful in contested votes in that they offer an independent point of view.) These managers pay upwards of \$18,000 per year for a subscription to the GMI database. Although GMI wouldn't say how many customers have signed up, they say that current users have about \$2 trillion under management.

### 2. Calculation of Ratings

\* **Which Companies** – As of March 2003, GMI rates companies in the S&P 500. GMI intends to triple that number by the end of 2003, including 500 non-U.S. companies.

\* **Scoring System** – GMI rates and compares 600+ data points against those of all other companies in its research universe using an "asymmetric geometric scoring algorithm" and boils them down to a 10-point score ("1" is lowest and "10" is highest).

GMI scores are relative and each company is scored against the all other companies measured - and also against all those in the same country of domicile. Companies are initially assigned 8 ratings in all, an overall GMI rating and one for each category of analysis. Each company's rating report includes a summary of the company's overall governance profile and commentary on each of the seven broad categories of analysis. In addition to an overall GMI rating, each of the seven research categories receives a separate rating. These are meant to help subscribers see where a company is particularly strong or weak.

The 600 data points are structured so that they can only produce "yes", "no" or "not disclosed" answers. This enables GMI to eliminate a large degree of subjectivity in its metrics as its cadre of analysts cull through publicly available information.

\* **Topics** - GMI employs a whopping 600 metrics covering seven broad categories including:

- \* board accountability,
- \* financial disclosure and internal controls,
- \* executive compensation,
- \* market for control,
- \* ownership base and potential dilution,
- \* "corporate behavior" (includes matters like environment, labor and foreign-sourcing practices), and
- \* shareholder rights.

These seven categories then have scores of subcategories. Each individual metric has a numerical value and each sub-section and research category is weighted according to investor interest.

GMI derives its rating criteria from a variety of public sources, such as stock exchange listing requirements and model corporate governance codes like the OECD. In addition, the criteria incorporate the views of GMI's corporate governance and legal advisors as well as input institutional investors, corporate officers and company directors.

The use of asymmetric geometric scoring tends to magnify the impact of "outliers." This includes both those with the very best practices – who are then rewarded more – or those with the worst – who are penalized.

### **3. Corporate Input into Ratings**

All companies rated by GMI are given a chance to review their data entry report and provided 10 business days to review and respond. At this time, there is no web-based system to input data. Instead, companies should contact Howard Sherman (<mailto:hsherman@gmiratings.com>).

For \$50,000, companies can hire GMI to conduct a comprehensive corporate governance review that results in a lengthy report that is made publicly available. This review is quite involved – including interviews with directors and officers – and takes several weeks. It does not include advice on how to improve governance practices and in contrast to the service offered by Standard and Poor's, companies undertaking a comprehensive rating with GMI understand the final report will be shared with GMI subscribers (S&P allows companies to keep their reports internal.)

### **4. How Often are Ratings Calculated**

At this time, GMI plans to re-rate companies approximately every six months. Ratings for US companies will be recalculated at the end of the proxy season, since this is the time that companies disclose a lot of new information.

In between these rating periods, GMI monitors each company in its research universe on a daily basis and posts "Updates" as necessary. This can be helpful for companies to keep tabs on what peers are doing. GMI also provides a "red flag" service to alert subscribers about a governance issue that it thinks has the potential to affect shareholder value. E.g., GMI flags excessive potential dilution from stock option plans.

### **5. How a Company Can Ascertain its Rating**

Companies can obtain their first rating report at no charge by contacting Howard Sherman (<mailto:hsherman@gmiratings.com>). After that, they can obtain a ratings summary for free - or pay \$1,000 for the full report.

## **C. The Corporate Library**

(<http://www.thecorporatelibrary.com/products/boardanalytics.html>)

### **1. Background**

The Corporate Library was founded during mid-1999 by Nell Minow and Robert A.G. Monks, long-time partners in Lens Investment Management and co-founders of Institutional Shareholders Services. The site is a repository of corporate governance information.

The Corporate Library will launch its "Board Analyst" rating system just after the 2003 season. Investors can purchase access to the Board Analyst database for \$8,000 to \$35,000 per year, depending on the number of users and add-ons. The full ratings version is priced at \$18,000 per year for up to three users.

## 2. Calculation of Ratings

- \* **Which Companies** - Board Analyst provides thorough coverage of over 1700 domestic companies - and more limited coverage of 250 international companies. These include all US companies with market caps in excess of \$1 billion as of July 2002 - and incorporate the full S&P 500 and Russell 1000 indices.
- \* **Scoring System** – Board Analyst issues "A through F 'Board Effectiveness Ratings'" on boards as a whole. Board Analyst also provides a comparative best practices benchmark score using the same system - as well as Sarbanes-Oxley and SRO listing requirement compliance percentage scores.
- \* **Topics** – Board Analyst's Board Effectiveness Ratings are based on several proprietary indicators, including:
  - \* the company's ownership profile (indexed stocks and controlled companies are held to higher standards of board independence and strength than other firms),
  - \* the personal shareholdings of outside directors (to insure a strong alignment of interest between these directors and the shareholders they represent),
  - \* CEO compensation policies and practices (focused on the alignment of interest established and maintained by the board between the CEO's compensation and shareholder interests), and
  - \* overall board composition (problem areas covered in this last category might an excessive number of aging directors, or directors who have served on the board for too long, too many directors who are either active CEOs at other firms or sit on too many boards, retired CEOs who continue to serve as Chairman, and so on).

These scores may also include adjustments for accounting oversight failures, poor strategic decision-making by the board, including the approval of ill-advised M&A activities and shareholder unfriendly takeover defenses.

The best practices benchmark score is based on the OECD principles of good corporate governance – and are intended to help differentiate Board Analyst's Board Effectiveness Ratings that consider only a few statistically significant factors – as compared to other ratings systems that tend to rely more on best practices checklists.

## 3. Corporate Input into Ratings

Companies can regularly review their ratings at no cost. Company comments will be incorporated – unedited – into each company's ratings profile. The Corporate Library does not accept consulting revenues from the companies it rates.

## 4. How Often are Ratings Calculated

Board Analyst governance data for U.S. companies is updated continually throughout the year as CEO and director changes are announced. In addition, The Corporate Library monitors and posts 8-K announcements on a weekly basis. Other information, however, such as committee



assignments, may only be updated annually - as most companies do not reliably disclose such information between proxies.

International data is generally updated annually.

Board Effectiveness Ratings may change when this data is received - although major shifts are reviewed by senior staff on a case-by-case basis. Substantial changes are most likely to occur during proxy season, as new policies and practices are more fully disclosed.

Companies in bankruptcy or undergoing significant reorganizations will generally be rated a "C" for at least six months - to give the new board time to demonstrate its relative strengths and weaknesses.

Performance data updates are made for most firms on a quarterly basis (Jan 1, Apr 1, Jul 1, Oct 1.) This data includes one, three and five year total shareholder return results, as well as 52 week "Hi" and "Lo" share prices. This performance data is compared against both the S&P 500 index and company peers.

### **5. How a Company Can Ascertain its Rating**

Companies may contact The Corporate Library about their ratings via email at [ratings@thecorporatelibrary.com](mailto:ratings@thecorporatelibrary.com) - or by calling their toll-free number, 1-877-479-7500. The Corporate Library's staff takes calls and assists with any questions, data corrections or comments. If requested, senior analysts will contact callers by phone or e-mail.

In addition, companies may ask to be notified when their ratings change. Board Analyst Ratings subscribers can create their own watchlists - and set-up an email alert system to keep them informed of such changes most easily.

## **D. Moody's Investors Service**

### **1. Background**

Late in 2002, Moody's Investors Service hired Ken Bertsch to be Director of Corporate Governance, coming over from TIAA-CREF. This coincided with the decision to launch a corporate governance rating program.

For Moody's, the main motive is to bolster their core credit analysis as its target audience is buyers of bonds, rather than buyers of stocks or proxy voters. As a result, Moody's does not offer a separate product. Instead, corporate governance is considered when a company's debt is rated for creditworthiness.

### **2. Calculation of Ratings**

- \* **Which Companies** – Moody's main focus is on investment-grade and large companies.
- \* **Scoring System** – None, as its considered in the normal course as part of the credit rating of debt.

\* **Topics** – Moody's is still in the process of developing its criteria. These criteria act as screens for its analysts to look for red-flags. Due to the focus on debt, the criteria fall into two categories: financial statements and corporate governance.

Moody's analysts include accountants who thoroughly pour over a company's financial statements to look for risks, such as derivatives and other off-balance sheet items. Regarding corporate governance, the focus tends to be on the integrity of the financial preparation process, including auditor independence and audit committee strength. However, Moody's also takes into consideration other corporate governance issues, such as takeover defenses and shareholder rights.

### 3. Corporate Input into Ratings

Moody's relies on publicly available information, rather than on corporate input. Moody's may decide to purchase research from other providers.

### 4. How Often are Ratings Calculated

Whenever a company's debt is rated for creditworthiness.

### 5. How a Company Can Ascertain its Rating

Not really applicable as corporate governance is not a separate score.

## E. Standard & Poors (<http://www.governance.standardandpoors.com/>)

### 1. Background

S&P's began the development of the criteria and methodology for its standalone Corporate Governance Score ("CGS") in 1998. Following two years of research, S&P started assessing companies' globally in 2000. The U.S. operation commenced in October 2002.

The focus of the score is to evaluate the company's corporate governance practices and policies to determine the extent to which these serve the interests of the company's financial stakeholders, with a particular emphasis on shareholders' interests. The criteria are globally applicable - and scores are globally comparable.

Companies pay S&P if they decide they want to be rated. The cost of a CGS typically ranges from \$50,000 to \$150,000 depending upon the size and complexity of the company.

### 2. Calculation of Ratings

- \* **Which Companies** – Any company can apply for a CGS.
- \* **Scoring System** – S&P ranks companies on a 1 (lowest) to 10 (highest) score basis.
- \* **Topics** – The four individual components that contribute to the overall CGS are:
- \* Ownership and stakeholder influence
- \* Shareholder rights and stakeholder relations
- \* Transparency and disclosure
- \* Board structure and process.

The process involves analysts from S&P's Corporate Governance Services analyzing both public and confidential information from the company plus meetings with the senior executives, directors, auditors and potentially others. Following this diligence process, S&P prepares a detailed report covering the main elements of the analysis (key strengths & weaknesses), the individual scores for each of the four components, and the overall score.

Due to the fact that the S&P process is interactive and requires access to confidential information, they allow the company to withhold publication of the report. In this case, the company can use the diagnostic within the report as a road-map to improve its governance.

### **3. Corporate Input into Ratings**

S&P's approach is fully interactive and therefore the company has significant input into the analytical process. However, the opinions contained within the CGS are arrived at independently and are S&P's alone.

### **4. How Often are Ratings Calculated**

Once a CGS has been published, S&P monitors the company's corporate governance policies and practices on an ongoing basis. A full review is conducted annually.

### **5. How a Company Can Ascertain its Rating**

As companies pay to be rated, they automatically get access to their score. In fact, they can elect for S&P not to make its score publicly available. If a company agrees for its score to be published, S&P ratings are freely available on its website.

As of March 2003, some 50 companies have been assessed by S&P globally and some 12 companies have published the results – including Fannie Mae.

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# GovernanceMetrics International

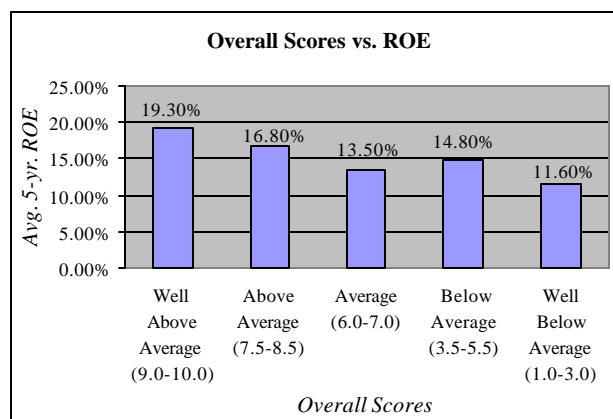
## Governance and Performance

There is an increasing amount of evidence to suggest that good governance pays in terms of overall performance. Following the release of our ratings on the S&P 500 in December 2002, GMI conducted a preliminary study of the correlation between governance ratings and performance. The results follow.

### A. GMI Return on Equity (ROE) Analysis - Methodology

GMI conducted a detailed analysis of all companies in the GMI rating universe (the S&P 500) as of November 7, 2002. These companies were then ranked against each other and assigned overall governance scores based on their performance relative to their peers. These scores were then compared to 5-year Return on Equity (ROE) data provided by Microsoft Money, as of December 30, 2002. Of the 499 companies surveyed (Sprint is covered by two stocks in the S&P 500, but covered in one GMI report) approximately 60 companies had no 5-year ROE data in the Microsoft Money database. In an effort to obtain ROE data for these 60 companies, GMI relied on a database provided by Multex which provided the remaining ROE data for all but 14 companies surveyed. GMI also eliminated two ROE outliers (one company with a 5-year ROE of greater than 100%, and another company with a 5-year ROE of greater than negative 200%) that skewed the overall data. The remaining 483 companies with available 5-year ROE data provided a statistically significant sample for GMI's research. This executive summary contains the basic results of that research.

### Overall Governance Score vs. Return on Equity



### Overall Governance Score and Top and Bottom Performers

GMI research found that companies that received GMI governance ratings in the top 10% (the highest 50 GMI overall scores) outperformed the S&P 500 as measure by five year ROE, by

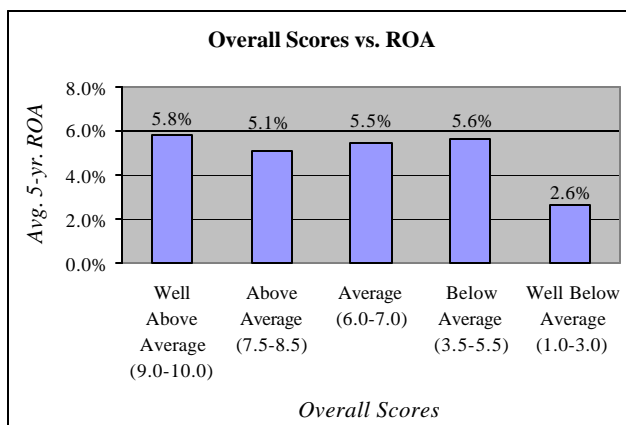
3.7%. Those companies that scored in the lowest 10% (the lowest 50 GMI overall scores) underperformed the S&P 500 as measured by five-year ROE, by 4.1%.

	Average Overall GMI Score	Average 5-Year ROE
Top 10%	9.05	18.6%
Bottom 10%	2.63	10.8%

**B. GMI Return on Assets (ROA) Analysis - Methodology**

GMI compared company overall and section scores to 5-year Return on Assets (ROA) data provided by Microsoft Money, as of December 30, 2002. Of the 499 companies surveyed (Sprint is covered by two stocks in the S&P 500, but covered in one GMI report) 34 had no 5-year ROA data.

**Overall Governance Score vs. Return on Assets**



**Overall Governance Score and Top and Bottom Performers**

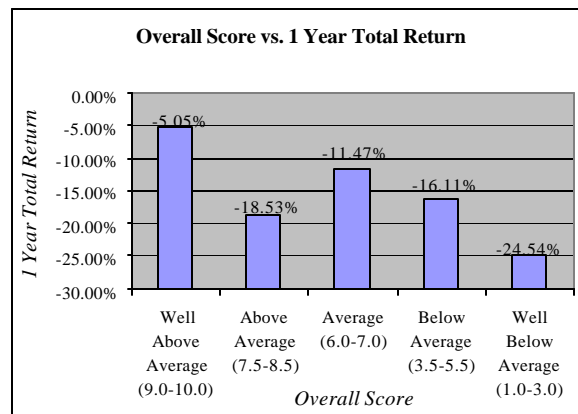
GMI research found that companies that received GMI governance ratings in the top 10% (the highest 50 GMI overall scores) narrowly outperformed the S&P 500 as measured by 5-year ROA, by 0.1%. Those companies that scored in the lowest 10% (the lowest 50 GMI overall scores) underperformed the S&P 500 as measured by 5-year ROA, by 1.7%.

	Average Overall GMI Score	Average 5-Year ROA
Top 10%	9.05	5.3%
Bottom 10%	2.63	3.5%

**C. GMI 1-Year and 3-Year Total Return Analysis - Methodology**

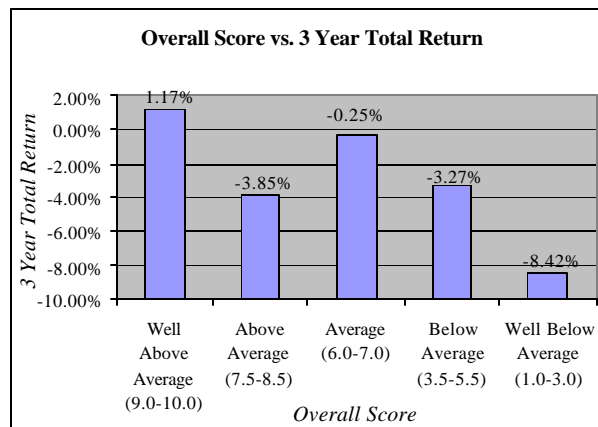
GMI compared company overall and section scores to 1-year and 3-year total returns. The total return data was provided by Morningstar, as of January 2, 2003. Of the 499 companies surveyed, (Sprint is covered by two stocks in the S&P 500, but covered in one GMI report) 18 had no 3-year total return data and 3 had no 1-year total return data.

## Overall Governance Score vs. 1-Year and 3-Year Total Returns



### 1-year total returns

GMI research found that companies that received GMI governance ratings in the top 10% (the highest 50 GMI overall scores) outperformed the S&P 500 as measured by 1-year total returns, by 4.73%. Those companies that scored in the lowest 10% (the lowest 50 GMI overall scores) underperformed the S&P 500 as measured by 1-year total returns, by 13.46%.



### 3-year total returns

GMI research found that companies that received GMI governance ratings in the top 10% (the highest 50 GMI overall scores) outperformed the S&P 500 as measured by 3-year total returns, by 3.49%. Those companies that scored in the lowest 10% (the lowest 50 GMI overall scores) underperformed the S&P 500 as measured by 3-year total returns, by 8.77%.

## Overall Governance Score and Top and Bottom Performers

	1 Year	3 Year
Top 10%	-10.00%	1.16%
Bottom 10%	-28.19%	-11.10%

## GMI Research Categories and Sample Metrics

The GMI database is divided into seven research categories. These seven categories are further divided into a number of research topics, as shown below. Each research topic, or sub-category, includes a number of metrics designed to measure how well the company conforms to the issues addressed in that section. (Metrics are the individual questions that generate GMI ratings.) A selected sample of GMI metrics is included for each section below. The total number of metrics in GMI's research database is 600+. The GMI database also includes hundreds of additional datapoints for each company to capture specific information for each company's voting securities and board of directors, among other things. Importantly, all datapoints in the GMI system include a Source Document field and in most cases a secondary reference to the specific page or section within the source document or website.

### 1 BOARD ACCOUNTABILITY

This section includes a number of metrics you would expect to find in a corporate governance rating system, including metrics concerning board independence and board leadership. Below are the sub-categories for section one and some sample metrics that go beyond traditional measures of corporate governance in an effort to gauge overall board accountability.

#### Sub-Categories

- 1.1 Board Leadership
- 1.2 Board Composition
- 1.3 Board Elections
- 1.4 Pursuit of Shareholder Value
- 1.5 Review of Corporate Strategy
- 1.6 Senior Management Incentives
- 1.7 CEO Evaluation
- 1.8 Succession Planning
- 1.9 Governance Committee
- 1.10 Corporate Governance Policies
- 1.11 Board Evaluations
- 1.12 Board Meetings
- 1.13 Board Procedures
- 1.14 Code of Ethics
- 1.15 Scrutiny of Related-Party Transactions
- 1.16 Director Stock Ownership

#### Sample Metrics

- Does a committee of the board evaluate the performance of the board on a regular basis?
- Does each board committee undertake an evaluation of its own performance on a regular basis?
- Do board members undertake self-evaluations or evaluations of other board members on a regular basis?
- Is training required for new board members?
- Is there a limit to the total number of years an individual is able to serve as a board member, or is there a limit to the number of times a director is allowed to be re-elected to the board?

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## GMI Research Categories and Sample Metrics

Have any directors served on the board for fifteen years or more?
Does the board have a policy concerning directors whose principal occupation has changed?
Has there been a related-party transaction involving the Chairman, CEO, President, COO or CFO or a relative of the Chairman, CEO, President, COO or CFO within the last three years?
Has the number of company shares held by the senior management decreased by 10 percent or more over the last twelve months?
<b>2 FINANCIAL DISCLOSURE AND INTERNAL CONTROLS</b>
This section contains metrics pertaining to the company's financial control mechanisms and the company's disclosure of financial information to shareholders. Topics considered range from the composition and specific powers of the audit committee to indicators of the quality of the company's financial statements. Sub-categories and examples of metrics contained in this section are as follows.
<b>Sub-Categories</b>
2.1 Audit Committee Composition
2.2 Audit Committee Oversight Powers
2.3 Audit Board
2.4 Annual External Audit
2.5 Review of Internal Controls
2.6 Financial Statements
2.7 Earnings Management
2.8 Accounting Standards
2.9 Management Discussion and Analysis
2.10 Cost of Stock Options
<b>Sample Metrics</b>
Is training required for audit committee members?
Has the company restated earnings at least twice within the past three years?
Does the company have a policy for selection of auditors that includes either periodic rotation of the outside audit firm or competitive procurement?
Has the company taken two or more extraordinary charges representing five percent or more of revenue within the last three years?
Does the company measure, value or report one or more intangible assets such as intellectual property, long-term service contracts, and brand equity on a regular basis?
Has the company been forced to restate earnings within the past three years due to regulatory action or pressure?
<b>3 SHAREHOLDER RIGHTS</b>

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## GMI Research Categories and Sample Metrics

As the name implies, this section examines issues pertaining to shareholder rights. We examine shareholder rights as defined under law or the company by-laws as well as the general legal and regulatory environment in which the company operates to uncover the rights of shareholders in practice.

### Sub-Categories

3.1 Shareholder Protection

3.2 Annual Meeting Agenda

3.3 Ballot Access

3.4 Votes Per Share

3.5 Confidential Voting

3.6 Cumulative Voting

3.7 Dissident Resolutions

3.8 Right to Convene an EGM

3.9 Votes Results Disclosure

### Sample Metrics

Do all common or ordinary equity shares have one vote per share with no restrictions?

Is there a securities regulatory body with significant enforcement powers in the main jurisdictions in which the company operates or is headquartered?

Are voting rights different depending on the duration of ownership?

Does the company have confidential voting with no exceptions other than those required by law or when shareholders expressly request disclosure of their own votes?

Do shareholders have the right to convene a special meeting with 10% or less of the shares requesting one?

Do shareowners have the right to act in concert through written communication?

## 4 REMUNERATION

This section examines the care with which the board exercises its oversight duties with regard to executive compensation. Specifically, we look for indicators that the board structures executive compensation to closely align management and shareholder interests and that the board is appropriately transparent regarding its efforts to do so. GMI also examines board compensation and stockownership requirements in this section.

### Sub-Categories

4.1 Remuneration Committee

4.2 Remuneration Disclosure

4.3 CEO Incentive Pay

4.4 CEO Remuneration Disclosure

4.5 Board Remuneration

4.6 Stock Ownership Guidelines

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## GMI Research Categories and Sample Metrics

<b>Sample Metrics</b>
Is the remuneration committee wholly composed of non-executive board members?
Does the company disclose specific performance benchmarks?
Within the last three years, has the company either repriced outstanding executive stock options or used
Was the CEO's last annual bonus cut or capped in response to a decline in earnings or a loss?
Are there stock ownership guidelines for the CEO and the other members of the senior management team?
Are a portion of executive stock options granted with exercise prices set 5% or more above market value at the time of grant, or does the company require that executives already holding a certain amount of company stock pay a premium to exercise additional stock options?
<b>5 MARKET FOR CONTROL</b>
Here we examine the takeover defense mechanisms employed by the company as well as other factors that could have an effect on the influence of the market for corporate control on company management and shareholder rights.
<b>Sub-Categories</b>
5.1 Unilateral Defenses
5.2 Takeover Defenses
5.3 Ownership Structure
5.4 Right to Elect Board Members
5.5 Tag-Along Rights
<b>Sample Metrics</b>
Has the company's poison pill been ratified by a shareholder vote?
Does the poison pill include a provision allowing it to be redeemed by a vote of the majority of shareholders other than the potential acquirer ("chewable" pill)?
Does the poison pill have a "dead-hand" provision?
Is there a single shareholder or shareholder group that controls a majority of the voting power of the company?
<b>6 OWNERSHIP BASE AND POTENTIAL DILUTION</b>
In this section we look at dilution from stock options as well as any possible impact of significant ownership stakes on the rights of minority shareholders.
<b>Sub-Categories</b>
6.1 Large Block Holders
6.2 Insider Ownership
6.3 Potential Dilution

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## GMI Research Categories and Sample Metrics

6.4 Debt Risk
<b>Sample Metrics</b>
Does every board member own stock in the company?
What is the potential dilution as a result of stock options and related awards outstanding?
What is the total potential dilution as a result of stock options and related awards outstanding, plus options and other equity-based awards approved for grant but not yet granted?
<b>7 CORPORATE BEHAVIOR</b>
A company's interactions with its employees, suppliers, and other stakeholders can have a large impact on long-run shareholder value. GMI examines company performance in these areas and looks for indicators of practices that could lead to future external relations problems.
<b>Sub-Categories</b>
7.1 Labor Relations
7.2 Sourcing Policies
7.3 Environmental Policies
7.4 Overall Reputation
<b>Sample Metrics</b>
Does the company disclose its workplace safety record in the annual report or in another form accessible to shareholders?
Does the company disclose its environmental performance in its annual report, on its website, or in a special environmental report?
Does the company employ ISO 14001 as its environmental management system?
Is there a board committee responsible for environmental, health and safety concerns?
Does the company have pending criminal litigation against it, has it been found guilty within the last 3 years, or has it pled the equivalent of no contest in such litigation in the past three years?

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**American Corporate Counsel Association  
2003 Annual Meeting**

**Corporate Governance Practices: Investor Perspective  
October 9, 2003**

**Howard Sherman  
Chief Operating Officer  
GovernanceMetrics International**

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**Why Governance Ratings Matter to Investors**

- Governance is about risk. Companies with weak governance are now perceived as representing increased investment risk. That is why more investment professionals are factoring governance criteria into their models.
  - Some investors use rating reports to prepare for calls and meetings with portfolio companies. Some use rating reports to arrive at proxy voting decisions, especially in contested elections. Some activist institutions use ratings to screen portfolios to identify target companies.
  - On the flip-side, good governance can be seen as an insurance policy, a hedge to ensure that management does not take short-cuts when business strategy or industry conditions move against the company. That's one reason fund managers are looking at governance and accountability ratings to develop new investment vehicles.
-

### Why Governance Ratings Matter to Companies

- Companies perceived as having good governance practices may be able to lower their cost of capital and raise valuations.  $PV = FV \times 1 / (1 + i)$  discounted over a number of years. To raise PV, lower the discount rate. To lower the discount rate, reduce perceived risk.
  - As credit rating agencies add governance criteria to their models, companies with strong governance profiles can achieve lower borrowing costs
  - Companies with strong governance profiles may also benefit from reduced or more moderate increases in D&O premiums
  - Governance reputation also matters more to regulators, the media, employees, directors, new candidates to the board and retail investors than ever before
- 

### Ratings and Performance

- Several studies indicate correlations between governance and performance (e.g., Gompers) and between governance and valuation (e.g., McKinsey)
- GMI undertook its own study in March and found that 1 and 3 year total shareholder returns were significantly better for our top 50 companies and significantly worse for the bottom 50 compared to the S&P 500

Total Return		
	1 Year	3 Year
Top 10%	-10.00%	+1.16%
S&P 500	-14.73%	-2.33%
Bottom 10%	-28.19%	-11.10%

- Next test: are ratings, or changes in ratings, predictive?
-

# GovernanceMetrics International

## 2003 Global Performance Analysis

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### ***Introduction***

The link between corporate governance and performance is often cited, but less often well-documented. In the following paper, GMI highlights some of its findings showing further support for the link between corporate governance and company performance.

GMI currently rates the corporate governance of over 1600 global companies. GMI's corporate governance ratings are based on a set of metrics structured in a manner that can only produce yes, no or not disclosed answers derived from a company's publicly disclosed information. More information on GMI's methodology and scoring is available at [www.gmiratings.com](http://www.gmiratings.com).

### ***Research Methodology***

In the present research, GMI compares the company performance of its top 10%-rated and bottom 10%-rated companies on a variety of measures. Company performance is defined as average annual total returns to shareholders for the past 1-, 3-, 5-year, and in some cases 10-year periods.

#### **Total Return**

Total Return (TR) is the return on investment, including income from dividends and interest, as well as appreciation or depreciation in the price of the security, over a given time period. It is typically expressed as a percentage increase or decrease. Since it is a percentage figure, TR can be easily used to compare across companies, and benchmarked against industry or market returns without having to account for a size bias in the price of the security.

Over short time periods, total return can fluctuate due to a variety of factors including exogenous economic shocks, industry specific events, and/or investor favoritism toward certain sectors. An example of the latter would be the technology sector which has seen a substantial run-up in stock prices over the past year (2003). Over the long-term, the temporary influences noted above and other acute events tend to distribute and even out over time providing robust measures of total return.

The performance data used in the research study represents the closing price of equities on August 12, 2003. Some outliers (14 out of 1607 for 1-year TR, less for other TR groups) were removed from the analysis.

#### **Top 10%-Rated and Bottom 10%-Rated Companies**

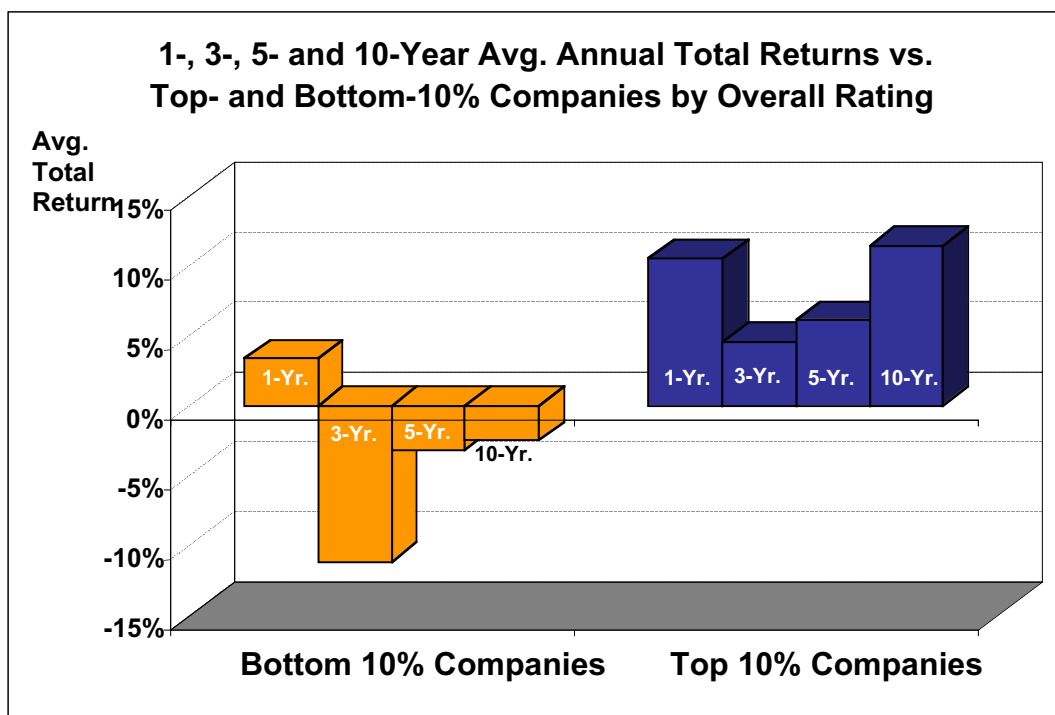
There are approximately 160 companies in each of the top- and bottom-rated company groups selected from the global pool of 1,607 GMI-rated companies based on the overall and two subsection ratings.

Companies in GMI's global universe receive two ratings—home market and global. Global ratings are relative to all 1,607 companies in GMI's research universe which includes the S&P500, the S&P Midcap 400, the Nikkei 225, the FTSE100, among other international indices. Home market ratings are relative within a particular index or country (e.g., the CAC40). All ratings in the present analysis are drawn from the global ratings.

### Performance of Overall Top-rated vs. Bottom-Rated Companies

Figure 1 below highlights a typical pattern in the current analysis. While the 1-year total return is positive for both the top and bottom 10% companies, companies with top-rated governance practices outpace low-rated companies 10.5% to 3.4%, respectively. Over longer time periods, the results are even more dramatic. Companies with the lowest rated governance practices consistently had negative shareholder return over 3-, 5-, and 10-year periods. On the other hand, companies with top-rated governance practices over the same periods had consistently positive total return to shareholders. Over a 10-year period the difference is remarkable, with nearly a 15% difference between top- and bottom-rated companies' TR, compared with an average annualized TR of just under 9% for all companies over that time.

Figure 1



	1-Year Avg. Annual TR	3-Year Avg. Annual TR	5-Year Avg. Annual TR	10-Year Avg. Annual TR
Top 10% Cos.	10.5%	4.5%	6.1%	11.4%
Bottom 10% Cos.	3.4%	-11.2%	-3.1%	-2.5%
<b>Average All Global Cos.</b>	<b>11.4%</b>	<b>-1.8%</b>	<b>3.8%</b>	<b>8.9%</b>

## ***Performance by Top- and Bottom-Rated Companies in Board Accountability and Financial Disclosure***

Two major components of a company's overall GMI rating are based on its *Board Accountability* and *Financial Disclosure* subsection scores.

In Board Accountability, GMI considers a number of different issues that impact directors' responsibilities. Some of the items GMI specifically looks at are director independence, various provisions of a company's corporate governance guidelines, the general board structure, the responsibility and powers of the board, the presence and nature of related-party transactions, and other criteria.

For Financial Disclosure, GMI looks at whether the company has significant provisions in place to ensure the integrity of the financial reporting and auditing process. Specific issues which GMI researches in this area are the composition of a company's Audit Committee and the various provisions of its charter, the responsibilities and powers of the Audit Committee, the Audit Committees' relationship with and oversight of both the external and internal auditors, whether the company has a history of taking large extraordinary charges or has made significant earnings restatements, a company's overall level of communication with the investment community, and other criteria.

When companies are selected on the basis of ratings in the top- or bottom 10% in either Board Accountability or Financial Disclosure, a similar pattern is evident (see Figures 2 and 3). Since these two subsection scores are weighted heavily in a company's overall scores, it is not surprising to see patterns similar to Figure 1. Figures 2 and 3 provide further support to the GMI rating methodology.



Figure 2

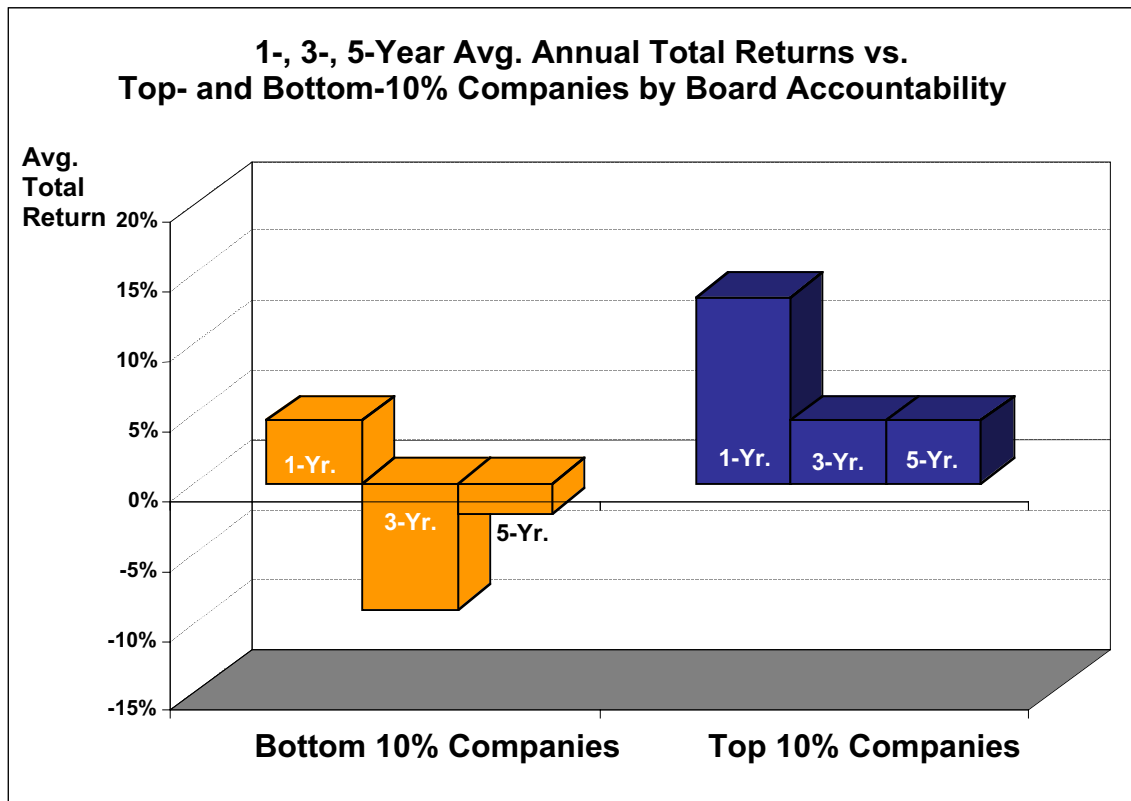
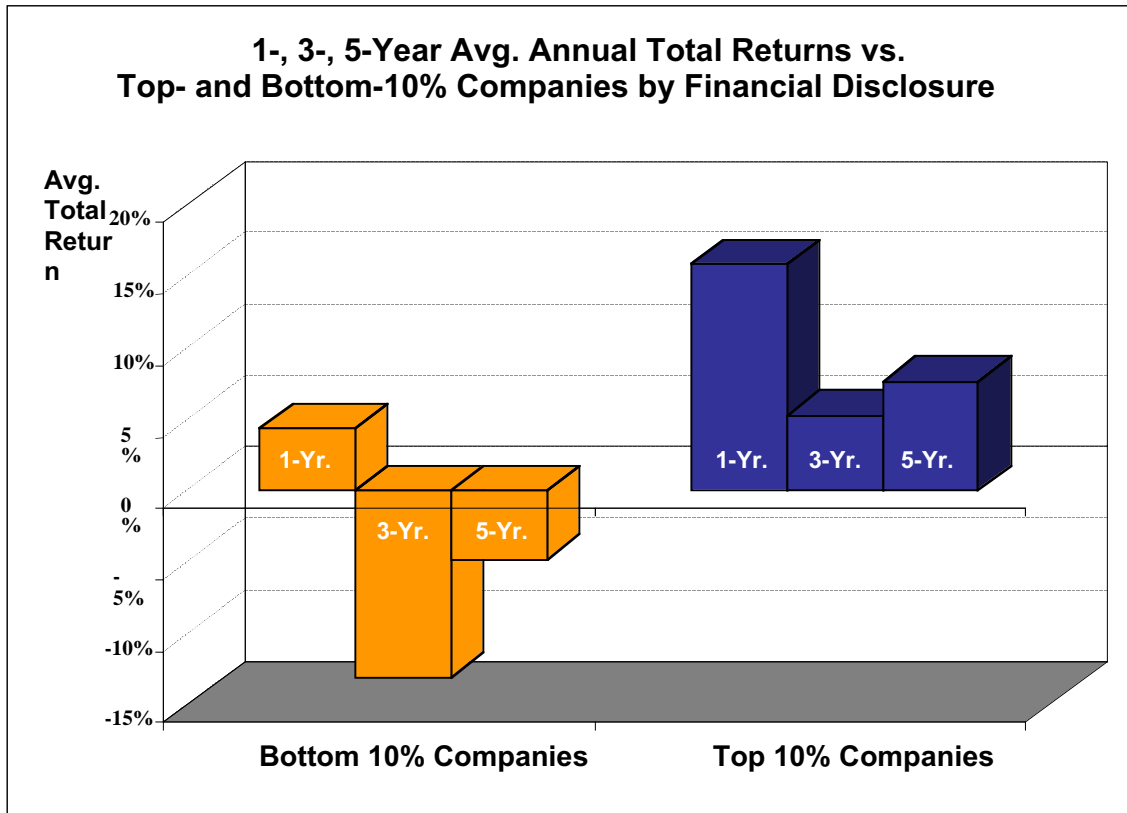


Figure 3



	1-Year Avg. Annual TR	3-Year Avg. Annual TR	5-Year Avg. Annual TR
Top 10% Board Accountability Cos.	13.3%	4.5%	4.5%
Bottom 10% Board Accountability Cos.	4.5%	-9.0%	-2.2%
Top 10% Financial Disclosure Cos.	15.8%	5.2%	7.6%
Bottom 10% Financial Disclosure Cos.	4.4%	-13.1%	-4.7%
<b>Average All Global Cos.</b>	<b>11.4%</b>	<b>-1.8%</b>	<b>3.8%</b>

## ***Performance by Top- and Bottom-Rated Companies in North America and Europe***

GMI also found that its two largest industrialized markets under research coverage—*North America* and *Europe*—produce a similar pattern of results of higher overall GMI ratings and higher average annual total returns to shareholders. The North American group consists of 1032 companies, while the European group has 303 total companies. Company totals for each country are listed below.

	<b><i>Total Companies</i></b>
<b>North America</b>	
Canada	30
USA	1002
<b>Europe</b>	
Finland	5
France	39
Germany	30
Italy	29
Netherlands	24
Portugal	4
Spain	16
Sweden	29
Switzerland	26
UK	101

Figures 4 and 5 below highlight the top- and bottom-rated companies TR performance for North America and Europe, respectively. While the 1-year average annual total return data for the North America region was actually higher for the bottom 10% overall rated companies, over 3- and 5-year periods this pattern does not hold up. European companies show an unusual pattern, but companies with top-rated governance characteristics outperform bottom-rated companies for each investment period in total return.

Figure 4

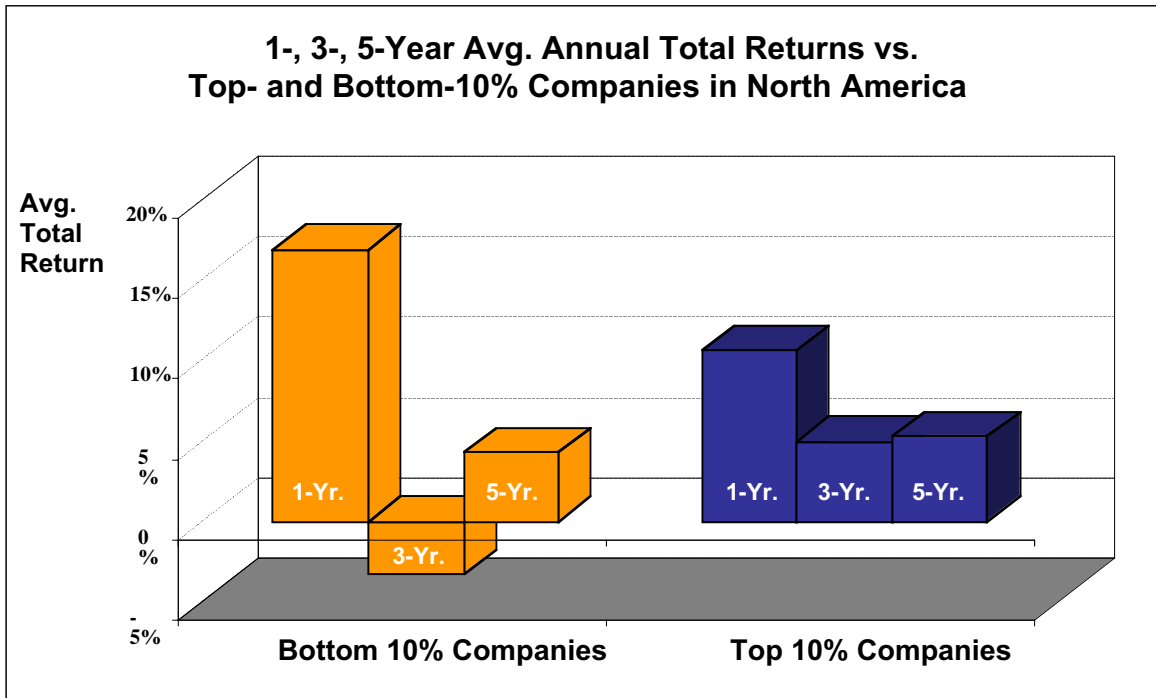
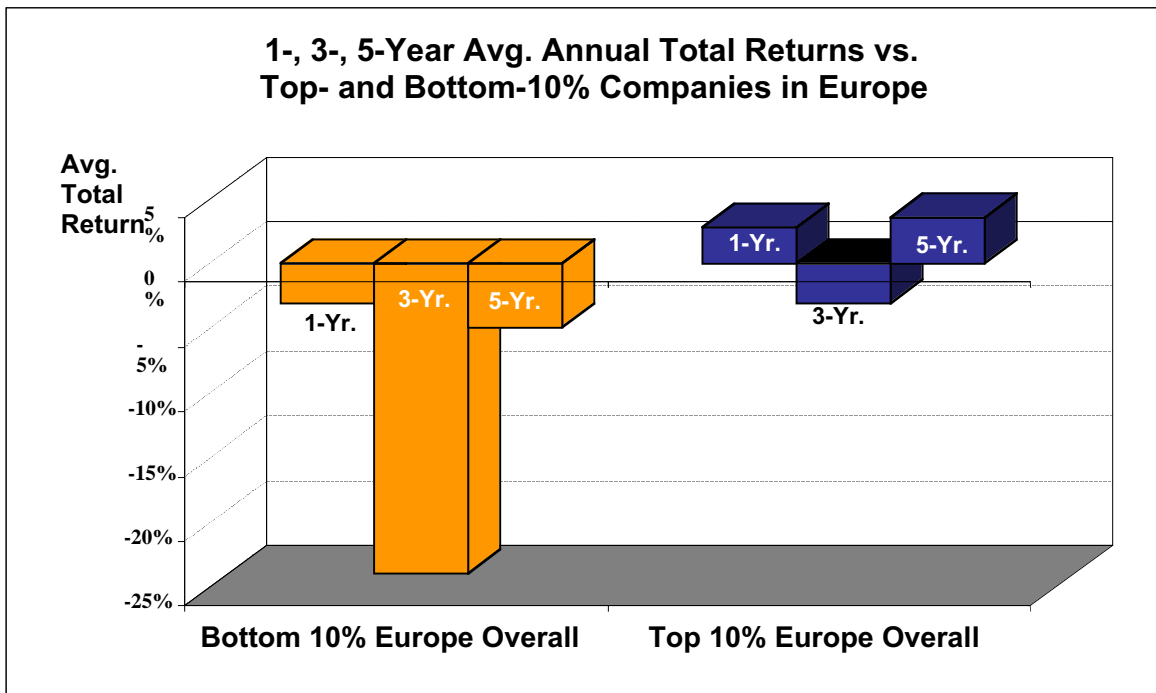


Figure 5



	1-Year Avg.	3-Year Avg.	5-Year Avg.
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	<i>Annual TR</i>	<i>Annual TR</i>	<i>Annual TR</i>
Top 10% North America Overall	10.6%	5.0%	5.3%
Bottom 10% North America Overall	16.9%	-3.3%	4.2%
<b>Average North America Cos.</b>	<b>15.8%</b>	<b>1.3%</b>	<b>5.8%</b>
Top 10% Europe Overall	2.7%	-3.0%	3.6%
Bottom 10% Europe Overall	-3.0%	-23.9%	-4.9%
<b>Average European Cos.</b>	<b>1.8%</b>	<b>-10.0%</b>	<b>-0.2%</b>
<b>Average All Global Cos.</b>	<b>11.4%</b>	<b>-1.8%</b>	<b>3.8%</b>

## Performance by Companies that have "Red Flags"

In the following analysis, GMI compared the performance results for companies that were given a "red flag." GMI's Red flags are given to companies for a number of reasons. The rationale behind a red flag includes: high potential dilution; unequal voting rights; significant related party transactions (in terms of number and/or magnitude); unified control over the board, management and voting power of a company by a shareholder or shareholder group; significant litigation, investigations or regulatory fines; and other areas of concern. GMI utilizes red flags in order to call attention to an issue that GMI believes represents serious potential governance risk and warrants significant consideration by shareholders.

Out of 1,607 globally-rated companies, 279 were flagged for extraordinarily high levels of potential stock option dilution. Of these 279 companies, 276 were U.S. companies however. Nearly 28% U.S. companies researched by GMI were flagged for high levels of dilution, while less than 1% of the non-U.S. companies received such a flag. In non-U.S. countries, stock option schemes are not used to the same extent as they are in the U.S. and such schemes overwhelmingly result in potential dilution of less than 10% for GMI's universe of non-U.S. companies. For this reason, GMI has looked at both the correlation between all red flags and average annual total returns, and the correlation between red flags other than dilution flags, and average annual total returns.

The figures below depict the 1-, 3-, and 5-year TR performance for all companies with GMI red flags (Figure 6) and for companies with flags except for potential stock option dilution (Figure 7). Companies that were flagged for issues other than potential stock option dilution, on average, underperformed those that were not flagged. When including red flags for dilution, the 1-year average annual total return data is skewed by technology companies that have experienced a near-term run-up in stock price (in percentage terms) are also those that typically have potentially high dilution levels given the nature of the industry.

Figure 6

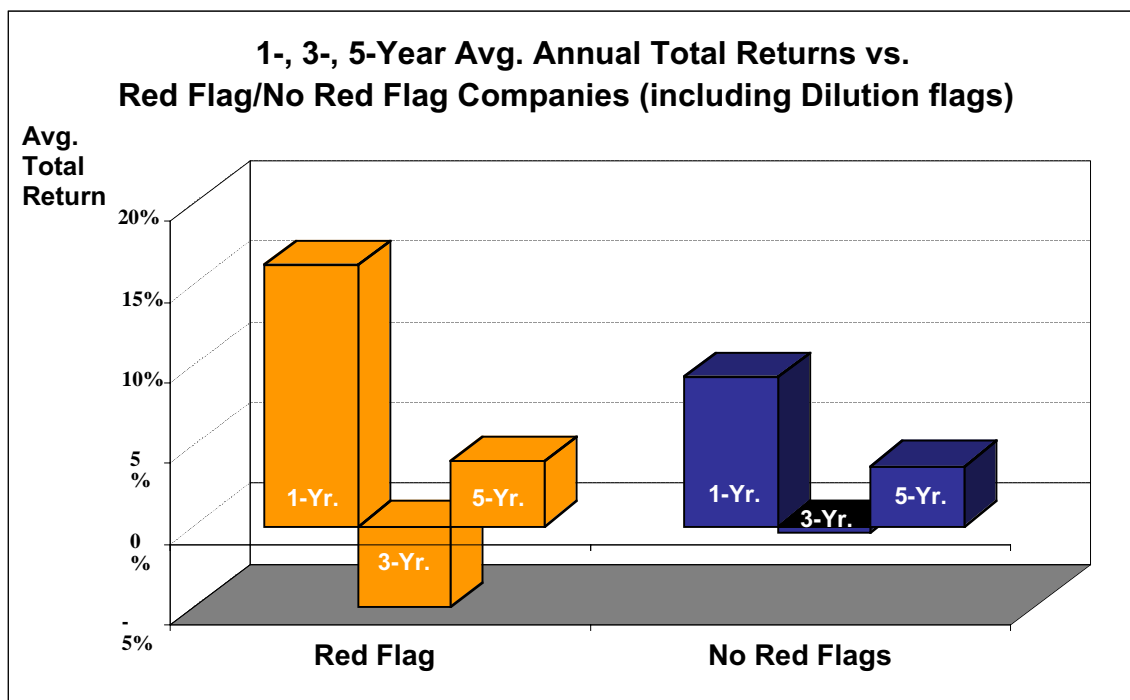
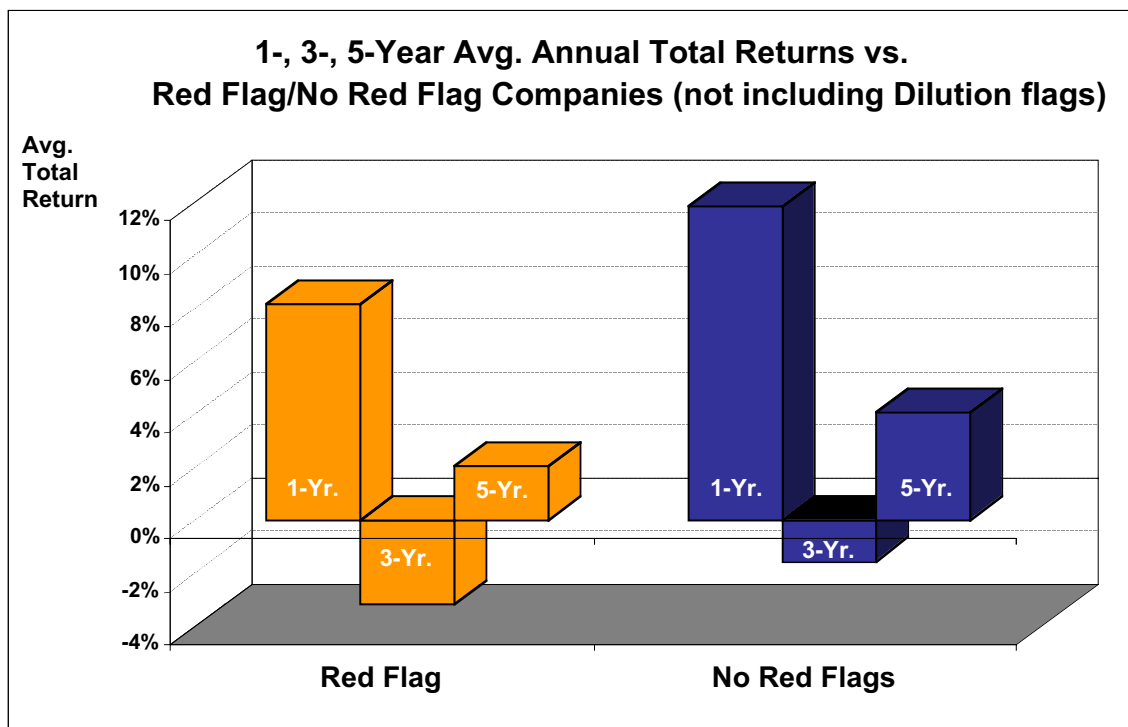


Figure 7



<b>Red Flags (including potential dilution)</b>	<b>1-Year Avg. Annual TR</b>	<b>3-Year Avg. Annual TR</b>	<b>5-Year Avg. Annual TR</b>
No Red Flag	9.3%	-0.4%	3.7%
Red Flag	16.2%	-5.0%	4.1%
<b>Red Flags (not including dilution flags)</b>			
No Red Flag	11.86%	-1.56%	4.06%
Red Flag	8.18%	-3.17%	2.06%
<b>Average All Global Cos.</b>	<b>11.4%</b>	<b>-1.8%</b>	<b>3.8%</b>

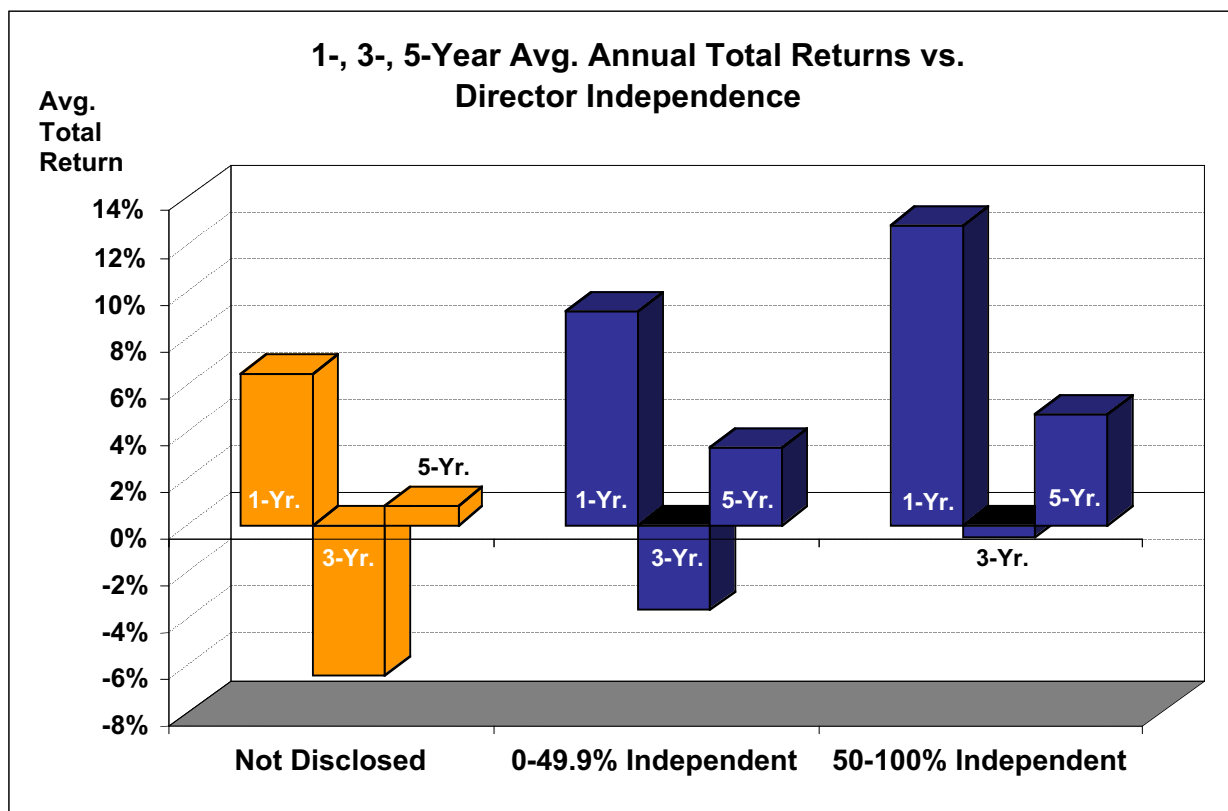
### Performance of Companies by Percent Independent Directors

GMI compared the TR performance of companies based on the percentage of independent directors (based on the GMI Director Independence Guidelines, available at [www.gmiratings.com](http://www.gmiratings.com)). The percentage of independent directors for 172 companies could not be determined due to a lack of disclosure concerning the relationships between companies and their directors.

Overall, average annual total returns are higher as the percentage of director independence increases. Companies with at least half independent directors outperformed companies with less than 50% independent directors in 1-, 3-, and 5- year average annual total returns. In addition, companies with greater than 50% independent directors received higher overall governance ratings than companies with less than 50% independent directors.

Companies in which director independence could not be determined (“independence not disclosed”) achieved the lowest governance scores and lower average total returns than companies for which director independence could be determined.

Figure 8



Global Independence	1 Year Avg. Annual TR	3 Year Avg. Annual TR	5 Year Avg. Annual TR	# of Companies	Avg. Global Rating
50-100% Independent	12.8%	-0.5%	4.7%	1,100	7.0
0-49.99% Independent	9.2%	-3.6%	3.3%	335	5.3
Independence Not Disclosed	6.5%	-6.4%	0.8%	172	3.6
<b>Average All Global Cos.</b>	<b>11.4%</b>	<b>-1.8%</b>	<b>3.8%</b>	1,607	<b>6.3</b>

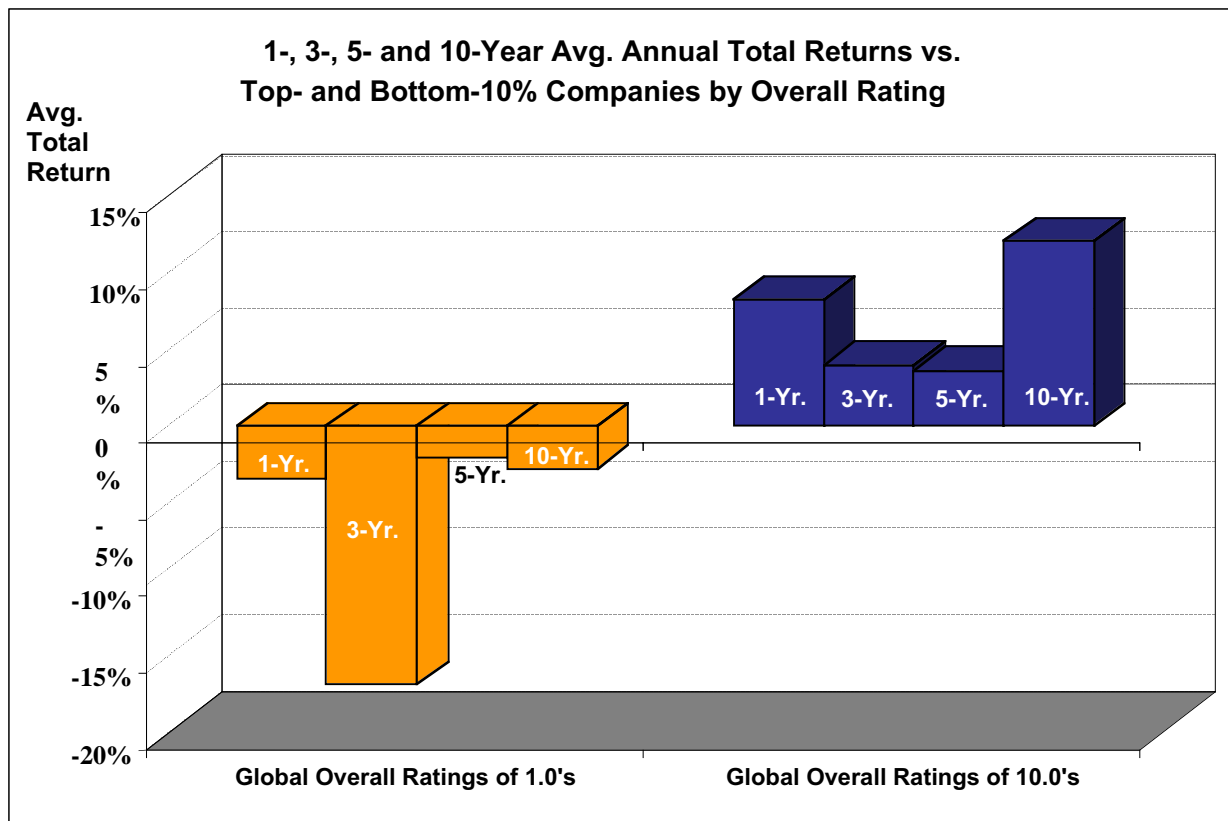


### GMI's Highest-Rated vs. Lowest-Rated Companies

Eighteen companies in GMI's global universe received overall ratings of 10.0 (GMI's highest governance rating), while 16 companies received overall ratings of 1.0 (GMI's lowest governance rating). GMI compared the TR performance of these two groups of companies<sup>1</sup>.

Figure 9 below depicts the results. Companies that received a 10.0 overall rating by GMI performed significantly better than those that received a 1.0 overall rating. In each of the four investment periods, companies that received GMI's lowest overall rating had negative TR, while the exact opposite occurs for companies receiving GMI's highest overall rating.

Figure 9



All 10.0's vs. All 1.0's	1-Year Avg. Annual TR	3-Year Avg. Annual TR	5-Year Avg. Annual TR	10-Year Avg. Annual TR
Global Overall 10.0's	8.2%	4.0%	3.6%	12.0%
Global Overall 1.0's	-3.5%	-16.9%	-2.1%	-2.8%
<b>Average All Global Cos.</b>	<b>11.4%</b>	<b>-1.8%</b>	<b>3.8%</b>	<b>8.9%</b>

<sup>1</sup> GMI measures do not include confounding performance measures of Total Return such as share price, dividends, etc.

## ***Conclusion***

GMI's research underscores a substantive link between strong, investor friendly governance practices and average annual total returns as measured over a number of multi-year periods. The connection between strong corporate governance and higher average annual total returns persists in a number of areas, demonstrating that investor will consistently pay a premium for companies with strong governance relative to their peers.

As a corollary, GMI's methodology serves to highlight those companies that are potential risks to investors. By highlighting companies with excellent governance practices, GMI provides investors and managers with prudent investment choices over the long term.

Many academic studies comparing corporate governance and corporate performance focus on one or two specific issues, such as takeover defenses or presence of large outside owners. GMI examines a broad array of governance attributes at companies including social and environmental practices and board integrity issues. In this way, we believe GMI captures a better-defined picture of a company's governance practices—and pertinent risks to shareholder value. In the present paper, GMI shows that broad-based measures of corporate governance can directly relate to critical measures of shareholder value and corporate performance.

The Appendix contains additional information on GMI-rated companies and corporate performance.

**September 2003**

## Appendix

GMI rates companies from 1.0 (lowest possible score) to 10.0 (highest possible). For subscribers, companies are further grouped into rating ranges based on the value of the overall or subsection score. Rating ranges correspond to the following values:

- Well-Above Average: (9.0 – 10.0)
- Above Average: (7.5 – 8.5)
- Average: (6.0 – 7.0)
- Below Average: (3.5 – 5.5)
- Well-Below Average: (1.0 – 3.0)

The following tables present additional information for the total return performance of GMI-rated companies by rating range for a companies' Overall rating, as well as for the Board Accountability and Financial Disclosure subsection ratings.

### Overall Performance

<b>GMI Rating Range</b>	<b>1-Year Avg. Annual TR</b>	<b>3-Year Avg. Annual TR</b>	<b>5-Year Avg. Annual TR</b>	<b>10-Year Avg. Annual TR</b>	<b>n</b>
Well-Above Average	10.7%	5.4%	6.0%	11.0%	113
Above Average	11.7%	1.7%	4.9%	10.3%	371
Average	14.8%	-0.2%	6.3%	12.5%	596
Below Average	8.4%	-6.2%	0.6%	5.3%	415
Well-Below Average	5.4%	-13.3%	-3.5%	-2.0%	112
<b>Average All Global Cos.</b>	<b>11.4%</b>	<b>-1.8%</b>	<b>3.8%</b>	<b>8.9%</b>	<b>1607</b>

### Board Accountability

<b>GMI Rating Range</b>	<b>1-Year Avg. Annual TR</b>	<b>3-Year Avg. Annual TR</b>	<b>5-Year Avg. Annual TR</b>	<b>n</b>
Well-Above Average	12.3%	5.6%	5.6%	114
Above Average	15.9%	0.3%	4.3%	374
Average	13.6%	-1.8%	4.8%	602
Below Average	12.0%	-3.5%	3.1%	428
Well-Below Average	3.4%	-12.0%	-3.0%	89
<b>Average All Global Cos.</b>	<b>11.4%</b>	<b>-1.8%</b>	<b>3.8%</b>	<b>1607</b>

### Financial Disclosure

<b>GMI Rating Range</b>	<b>1-Year Avg. Annual TR</b>	<b>3-Year Avg. Annual TR</b>	<b>5-Year Avg. Annual TR</b>	<b>n</b>
Well-Above Average	16.0%	5.1%	7.7%	131
Above Average	14.4%	4.4%	6.6%	421
Average	13.8%	-1.3%	5.3%	527
Below Average	5.4%	-8.2%	0.1%	433
Well-Below Average	5.2%	-13.3%	-5.5%	94
<b>Average All Global Cos.</b>	<b>11.4%</b>	<b>-1.8%</b>	<b>3.8%</b>	<b>1607</b>

## North America

<b>GMI Rating Range</b>	<b>1-Year Avg. Annual TR</b>	<b>3-Year Avg. Annual TR</b>	<b>5-Year Avg. Annual TR</b>	<b>n</b>
Well-Above Average	10.6%	5.0%	5.3%	103
Above Average	12.9%	2.2%	5.0%	324
Average	18.3%	1.2%	7.3%	462
Below Average	19.3%	-1.9%	3.3%	138
Well-Below Average	-22.7%	-34.0%	-5.4%	5
<b>Average All Global Cos.</b>	<b>15.8%</b>	<b>1.3%</b>	<b>5.8%</b>	<b>1032</b>

## Europe

<b>GMI Rating Range</b>	<b>1-Year Avg. Annual TR</b>	<b>3-Year Avg. Annual TR</b>	<b>5-Year Avg. Annual TR</b>	<b>n</b>
Well-Above Average	12.8%	8.1%	12.3%	5
Above Average	1.6%	-4.1%	1.9%	34
Average	2.5%	-7.2%	1.4%	113
Below Average	1.9%	-11.7%	-1.8%	117
Well-Below Average	-2.4%	-24.0%	-4.9%	33
<b>Average All Global Cos.</b>	<b>1.8%</b>	<b>-10.0%</b>	<b>-0.2%</b>	<b>302</b>

### Safe Harbor Statement

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