

Corporate Governance Ratings

Summary: It is becoming more common for investors to consider governance issues when making investment decisions. In response to this interest, several organizations now rate the corporate governance practices of public companies, either as a stand-alone offering or as part of a credit rating. This memo provides a summary of the governance ratings provided by Institutional Shareholder Services (ISS), The Corporate Library, and Governance Metrics International. It also summarizes the governance issues considered by several credit ratings agencies: Moody's Investor Services, Standard and Poor's and Fitch Ratings.

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Introduction

The current focus on corporate governance has led many to seek more information on the quality of governance practices at specific companies. It is becoming more common for investors to consider governance issues when making investment decisions. In response to this interest, several organizations are offering corporate governance ratings which evaluate governance practices of public companies.

This memo provides a summary of the governance ratings provided by Institutional Shareholder Services, The Corporate Library and Governance Metrics International. For each ratings organization, we describe and summarize the company and governance-related products, the major governance issues addressed by the ratings, as well as the specific areas analyzed which relate to executive and director compensation and board structure and practices.

Several credit ratings agencies have added governance issues to their ratings methodology. The governance issues most important to creditors are often different from those which most affect stockholders. The credit rating agencies have explored this issue and developed approaches for evaluating governance with a focus on the issues that most affect creditors. The governance issues analyzed by Moody's Investor Services, Standard and Poor's and Fitch Ratings are summarized in this memo.

This memo was compiled based mainly on information currently posted on the websites of the organizations discussed. Some additional information was gathered from conference presentations and other materials made publicly available by the organizations.

Corporate Governance Ratings Organizations

The corporate governance ratings organizations have all begun offering rating services during the past five years. The audience for these services is varied, and the market is still developing. Potential users of the ratings services include institutional investors, fund managers, smaller investors, executive search firms, accounting firms, compensation and governance consultancy firms, insurers offering directors' and officers' liability insurance, rated companies and academics.

INSTITUTIONAL SHAREHOLDER SERVICES' CORPORATE GOVERNANCE QUOTIENT (ISS CGQ)

Company and Ratings Products

In June 2002, Institutional Shareholder Services (ISS) launched a corporate governance rating system, which is included with the proxy analysis service they provide for their institutional investor clients. ISS is a leading provider of proxy voting and corporate governance services to institutional investors. ISS provides its subscribers with voting recommendations on each ballot item for which shareholder approval is sought (including the adoption of incentive plans and the election of directors). Presumably, subscribing investors use the CGQ as a part of their investment and voting decisions.

ISS's corporate governance rating system compares companies' corporate governance practices with a market index, as well as with one of Standard & Poor's 23 industry groupings. All of the companies in the Russell 3,000 are assigned two scores – one relative to the relevant market index (S&P 500, Mid-Cap 400, Small-Cap 600) and one relative to the appropriate peer group. Each CGQ is a comparative score based on a scale from one to 100, representing the company's percentile rank among the relevant peer group.

ISS ratings are calculated on the basis of 61 variables across eight core categories, discussed further below. ISS looks at many of the factors in combination “under the premise that corporate governance is enhanced when selected combinations” of practices are adopted.

Information is collected from public sources such as proxy statements, annual reports and prospectuses as well as company websites and press releases. Companies may verify and supplement their data, free of charge, via the ISS CGQ website.

For an annual subscription fee, ISS offers a premium benchmarking service that allows companies to:

- ◆ See their current CGQ scores (since the scores are relative to their peer groups and market indices, they will change throughout the year)
- ◆ Learn how to improve their governance structure and practices by testing “what if” scenarios
- ◆ Select peer companies from the Russell 3000 database and view their own governance data in side-by-side comparisons against their market index, against their industry group and against self-selected peer companies.

Governance Topics Assessed

ISS assesses the corporate governance practices of covered companies, focusing on the following eight core topics:

- ◆ Board Structure and Composition
- ◆ Audit Issues
- ◆ Charter and Bylaw Provisions
- ◆ Laws of the State of Incorporation
- ◆ Executive and Director Compensation
- ◆ Qualitative Factors
- ◆ Director and Officer Stock Ownership
- ◆ Director Education

A complete list of 61 rating factors is available on the ISS CGQ website.

Topics Related to Executive and Director Compensation

Executive and Director Compensation: ISS considers a company's executive and director compensation practices when determining their CGQ score. Option plan dilution and cost is assessed using ISS's Shareholder Value Transfer (SVT) and Voting Power Dilution (VPD) measures. In this category, ISS also considers whether the company requires shareholder approval of option plans. ISS looks at the company's policy regarding repricing stock options, taking into account the company's history with repricing. A policy which allows repricing without shareholder approval or a history of repricing will lower the CGQ.

ISS analyzes the compensation paid to outside directors. The existence of a pension program for nonemployee directors negatively impacts the CGQ. Compensation committee interlocks also lower a company's CGQ.

Director and Officer Ownership: The CGQ is positively impacted by stock ownership among directors and officers. The amount of company stock owned by directors after one year of service is considered when determining a company's CGQ. ISS will consider the amount of stock owned by the company's officers and directors as a percent of company shares outstanding. They will also take into consideration whether or not the company enforces stock ownership guidelines for these groups.

Topics Related to Board Structure and Practices

Board Structure and Composition: ISS assesses various board practices when determining the CGQ. For example, the number of directors serving on the board and changes in board size are considered. The number of boards on which the CEO and other directors serve is taken into consideration as well. Too many directors, or directors who are serving on too many other boards, can lower the CGQ score. If former CEOs of the company are eligible to sit on the board, the CGQ score may be lowered.

The separation of the position of Chairman and CEO is also an important factor. In most cases, ISS prefers that these positions are separated. The committee structure is considered, with a focus on whether the key committees of Audit, Compensation, Nominating and Governance are in place.

Other board practices that are considered include:

- ◆ Cumulative voting
- ◆ Board guidelines
- ◆ Responses to shareholder proposals

Director Education: Director education programs positively impact the CGQ score. ISS has developed a list of "accredited" director education programs that qualify for the CGQ. When a director attends a qualified program, each board on which he or she serves benefits. A current list of ISS-accredited programs is available at <http://www.isscgq.com/programlist.asp>.

Qualitative Factors: The ISS reviewers also take into account various qualitative factors when determining the CGQ. The following governance policies positively influence the CGQ score:

- ◆ Mandatory retirement for board members
- ◆ Board performance review
- ◆ CEO succession plan
- ◆ Outside advisors available to the board
- ◆ Directors resign upon change in status

THE CORPORATE LIBRARY'S BOARD EFFECTIVENESS RATINGS

Company and Ratings Products

The Corporate Library (TCL) was founded in 1999 by Nell Minow and Robert A.G. Monks, well-known corporate governance experts and shareholder advocates. TCL is "an independent investment research firm providing corporate governance data, analysis & risk assessment tools."

"Board Analyst" is TCL's database of company boards and directors. The Board Analyst database includes information on over 2,100 US companies and 400 international companies. Numerous screening tools are made available to subscribers, which allow for comparisons across companies and directors. Data included in the database includes the following:

- ◆ CEO compensation
- ◆ CEO employment agreements
- ◆ Director names and contact information
- ◆ Director committee assignments
- ◆ Director profiles, including:
 - ◆ Tenure
 - ◆ Compliance with meeting attendance standards
 - ◆ Shares held
 - ◆ Age
 - ◆ Gender
 - ◆ Total number of current directorships
- ◆ Governance-related news events for each company

The TCL's "Board Effectiveness Ratings" are available as an add-on to the Board Analyst subscription. The Board Effectiveness Ratings are TCL's "proprietary system for rating board effectiveness, an important indicator of potential investment risk."

A single user subscription of \$10,000 provides access to the Board Analyst, Board Effectiveness Ratings and Board Interlocks databases for one year.

Governance Topics Assessed

- ◆ Board Composition
- ◆ CEO Compensation
- ◆ Shareholder Responsiveness
- ◆ Accounting
- ◆ Strategic Decision-making
- ◆ Litigation and Regulatory Problems
- ◆ Takeover Defenses
- ◆ Problem Directors

Each of the categories are assessed and given a score from A through F. The company's "Overall Rating" is determined based on the scores for these categories. Occasionally, an "Analyst Adjustment" is included in the Overall Rating. "If an Analyst Adjustment score is shown, it indicates that the board has been given a positive or negative adjustment in its overall rating by one of our senior analysts, for reasons that fall outside the scope of our statistical scoring system. The specific concerns leading to the adjustment will be detailed in the company's write-up."

Topics Related to Executive and Director Compensation

According to TCL, CEO Compensation is “one of the best available indicators of a board’s ability to oversee management authority. Broadly speaking, compensation policies and practices that reward management with little regard for shareholder interests indicate a weak, ineffective board. Policies that tie both short- and long-term management compensation closely to shareholder returns suggest a strong, effective board.”

TCL has established several “red flags” which have a negative effect on the CEO Compensation rating. These include:

- ◆ a CEO base salary of over \$1M
- ◆ a CEO bonus greater than twice the annual salary
- ◆ a declining number of CEO shares held
- ◆ excessive CEO stock options holdings
- ◆ high tax or leisure expense payments

Specifically, the following issues are considered by TCL when evaluating CEO Compensation:

- ◆ *Stock awards and stock ownership:* TCL considers the amount of stock awards as indicator of board effectiveness. “If stock option or restricted stock grants are excessive and unrelated to performance, the board’s rating will be impacted.” TCL also evaluates the rate at which options are being exercised. “If too few options are being exercised this is an indication of the company’s poor performance – options are under water – or of executives who are more interested in potential personal profit than in exercising and holding on to stock.”

“In most cases, the level of CEO stock ownership is considered in proportion to base salary. Any significant changes in stock ownership year-to-year are also scored, with decreases generally receiving negative ratings and increases receiving positive ratings.”

- ◆ *Actual base and incentive payments:* TCL “believes that a base salary in excess of \$1 million is excessive, and generally not in the best interest of shareholders, mostly due to the cap placed on non-performance-related pay by Section 162(m) of the Internal Revenue Code. At smaller companies, base salary limits are generally lower, based, in most cases, on prevailing industry and market cap standards.”
TCL considers whether additional compensation payments are performance-based.
- ◆ *Total annual compensation:* The review includes an analysis of “total overall compensation (which includes bonus payments, profits from the reporting period exercise of stock options and any other long-term incentive awards, as well as any other compensation), first, as multiples of base salary and, additionally, on the basis of other absolute standards. Where long-term incentive awards are only periodically awarded or where there are one-off option exercises, special care is taken with assessing the unusual effects of such awards.”
- ◆ *Restricted stock/stock option valuation:* TCL values restricted stock awards at the time of grant. “In addition, no attempt is made to place a value on the future benefits arising from a stock option grant. This will remain the case until a commonly accepted process for stock option valuation gains currency. Instead, the amounts recorded represent real profits from the exercise of stock options, rather than any notional future value.”
- ◆ *Benefit provision:* Several benefits provisions are analyzed and result in a negative affect on the rating if they are excessive. The following are among the benefits reviewed:
 - ◆ Corporate transportation usage
 - ◆ Tax reimbursement

- ◆ Financial planning and other advice
 - ◆ Payment of dividend equivalents on unvested stock and stock options
 - ◆ Country and other club memberships
 - ◆ Provision of accommodations
 - ◆ Life insurance
 - ◆ Supplemental retirement plan contributions
 - ◆ Severance payments.
- ◆ *Disclosure:* “Those companies providing a sufficient level of detail receive significantly raised ratings, while those who fail to provide sufficient transparency will receive significantly lowered ratings.”

Topics Related to Board Structure and Practices

TCL assesses various features of board composition since they have been, in the past, “strong indicators of overall board effectiveness and, therefore, investor risk.”

- ◆ *Director Tenure:* “[TCL] does not specifically advocate for establishing term limits, but recognizes that the best boards exhibit a good balance between long- and short-tenured directors.”
- ◆ *Director Age:* “[TCL] does not recommend specific mandatory retirement ages; rather, it notes that boards where a proportionally large number of directors are over 70 are statistically more likely to encounter governance-related difficulties.”
- ◆ *Independence:* TCL applies their own “stringent standards” when assessing director independence. In the case of former executive officers, they “review the specifics (how high-ranking was the executive and what were his/her specific responsibilities, both at a board and officer level?).”
- ◆ *Active & Former CEOs on Boards:* “[TCL’s] statistical studies suggest that most active CEOs should not sit on more than one additional board, and should *never* serve on compensation committees.”
- ◆ *Past CEOs as Chairman:* TCL suggests that long-standing CEOs leave the board completely upon retirement. “When they *do* stay on the board, particularly in the role of Chairman, former CEOs have an unfortunate tendency to second-guess their successors, making it difficult for the new CEO to develop a positive working relationship with the board.”
- ◆ *Over-committed Directors:* “The presence of a director who sits on more than four public boards will result in a lower Board Composition rating of those companies.” Additionally, “a few individuals have developed such abysmal reputations in recent years that their very presence on a board has proven cause for a ratings downgrade.”

GOVERNANCE METRICS INTERNATIONAL (GMI)

Company and Ratings Products

Governance Metrics International (GMI) is an independent corporate governance rating agency which was founded in 2000. The evaluation of governance practices is the only service the company provides. GMI’s clients include institutional investors, including mutual funds, money management firms and pension funds, as well as corporations, law and accounting firms, insurance underwriters, regulators and others.

The rating system used by GMI is the result of extensive research and testing and includes a scoring algorithm which has a patent pending. Currently, the GMI universe includes ratings for 2,100 companies from all over the world. There are plans to increase the universe of rated companies during 2004.

GMI clients can purchase subscriptions based on geographic or market sector categories. Smaller investors and analysts can also purchase subscriptions for a customized portfolio of at least 40 companies across geography and industry groups. The following are the geographic categories:

- ◆ North American coverage includes complete coverage for companies in the TSX 60 (Canada), S&P 500, S&P MidCap 400 and Russell 1000 Index.
- ◆ Industrialized Asia-Pacific includes coverage of the Nikkei 225 (Japan) and ASX 50 Index (Australia and New Zealand).
- ◆ Industrialized Europe includes a total of 625 companies, including complete coverage of the following market indices: FTSE Eurotop 300, FTSE 350 (UK), CAC 40 (France), DAX (Germany), MIB 30 (Italy), AEX (Netherlands), IBEX 35 (Spain), OMX (Sweden) and SMI (Switzerland), plus coverage for additional companies in Austria, Belgium, Denmark, Finland, Greece, Ireland, Norway and Portugal.

The market sector categories are as follows:

- ◆ Automobiles
- ◆ Banks
- ◆ Basic Resources
- ◆ Chemicals
- ◆ Construction
- ◆ Cyclical Goods & Services
- ◆ Energy
- ◆ Financial Services
- ◆ Food & Beverage
- ◆ Healthcare
- ◆ Industrial Goods & Services
- ◆ Insurance
- ◆ Media
- ◆ Non-Cyclical Goods & Services
- ◆ Retail
- ◆ Technology
- ◆ Telecommunications
- ◆ Utilities

Subscribers to the GMI database pay an annual fee for access to the universe of ratings. For example, the annual fee for access to the North American universe is \$36,000 for two passwords.

Covered companies do not pay a fee to be included in the GMI universe. All companies in the universe receive a complimentary “Basic Rating” report from GMI. The Basic Rating is developed by GMI analysts based on “regulatory filings, what companies publish about themselves in print and on their websites, litigation and regulatory sources, and by our screening of other data sources.”

In addition to the Basic Rating, companies can request a “Comprehensive Rating” which is a much more detailed analysis of governance practices. During the Comprehensive Rating review, GMI reviews documents provided by the company which are not available to the public and conducts interviews with members of the senior management team. GMI only offers this service upon the invitation of the company and the company pays a fee for the review. The results of the Comprehensive Rating are always made available to subscribers to the GMI universe. According to GMI, “a company undergoing a Comprehensive Rating in many ways is subjecting itself to a form of non-financial due diligence. It is a means to demonstrate to subscribers that it believes in transparency, is confident of its governance practices and warrants investor consideration.”

Governance Topics Assessed

The GMI approach includes a comprehensive review of the following six areas of governance:

- ◆ Board accountability
- ◆ Financial disclosure and internal controls
- ◆ Shareholder rights
- ◆ Executive compensation
- ◆ Market for control and ownership base
- ◆ Corporate behavior and corporate social responsibility issues

Topics Related to Executive and Director Compensation

GMI examines “the care with which the board exercises its oversight duties with regard to executive compensation.” Categories analyzed include:

- ◆ Remuneration committee
- ◆ Remuneration disclosure
- ◆ CEO incentive pay
- ◆ Senior management incentives
- ◆ CEO remuneration disclosure
- ◆ Board remuneration
- ◆ Stock ownership guidelines
- ◆ Director stock ownership
- ◆ Cost of stock options
- ◆ Potential dilution

The following are among the specific issues considered in the analysis of compensation practices:

- ◆ 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 a stock option exchange program in which senior management was allowed to participate?
- ◆ 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?
- ◆ Has the number of company shares held by the senior management decreased by 10 percent or more over the last twelve months?
- ◆ 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?

Topics Related to Board Structure and Practices

GMI conducts a thorough evaluation of board accountability. Specific categories include:

- ◆ Board leadership
- ◆ Board composition
- ◆ Board elections
- ◆ Pursuit of shareholder value
- ◆ Review of corporate strategy
- ◆ CEO evaluation
- ◆ Succession planning
- ◆ Governance committee
- ◆ Corporate governance policies
- ◆ Board evaluations
- ◆ Board meetings
- ◆ Board procedures
- ◆ Code of ethics
- ◆ Scrutiny of related-party transactions

The following are among the specific issues considered in the analysis of board practices:

- ◆ 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?
- ◆ 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?

Bond/Credit Ratings Agencies

In addition to the organizations offering corporate governance ratings, several bond/credit ratings agencies have added corporate governance to their services. As discussed earlier, the governance issues most important to creditors are often different from those which most affect stockholders. The credit rating agencies have explored this issue and developed approaches for evaluating governance with a focus on the issues that most affect creditors.

MOODY'S INVESTOR SERVICE

Company and Ratings Products

Moody's Investor Service provides clients with credit ratings, risk analysis and research of fixed-income securities. Moody's customers include corporate and governmental issuers of securities as well as institutional investors, depositors, creditors, investment banks, commercial banks and other financial intermediaries.

In 2002, Moody's announced a program to enhance their corporate credit analysis. As a part of this program they established a new corporate governance section which conducts "Corporate Governance Assessments" for selected major North American debt issuers. According to Moody's, the purpose of this endeavor is to "improve rating quality and help investors assess the credit risk of issuers." The Corporate Governance Assessments are prepared based on public information supplemented with discussions with executives and outside directors.

The Corporate Governance Assessments do not use a "checkbox" approach to evaluating governance practices and do not result in a score or ranking. Instead, Moody's provides "a textual opinion on the quality of governance." The report will include comments on "conformance with standard and best practice recommendations, and will focus particularly on implications for creditors."

Governance Topics Assessed

- ◆ Board of directors
- ◆ Audit committee and key audit/accountability functions
- ◆ Conflicts of interest
- ◆ Executive compensation and management development and evaluation
- ◆ Shareholder rights
- ◆ Ownership
- ◆ Governance transparency

Topics Related to Executive and Director Compensation

Executive pay: For the most part, Moody's focuses on the compensation program for the CEO. They consider "incentive structures and their possible impact on executive risk appetite and/or incentives that appear to pose danger to long-term shareholder interest and creditor interests."

The following are viewed to be red flags for potentially poor governance:

- ◆ "Risky and potentially highly remunerative top executive pay schemes that could encourage short-term actions that may be harmful to creditor interests in the longer term, or that could encourage excessive risk-taking
- ◆ Certain relatively unusual pay structures (such as payment to the CEO of a percentage of net income, which can encourage excessive acquisition activity)
- ◆ The presence of a celebrity and possibly overreaching CEO – particularly in combination with undisciplined pay structures and CEO compensation that is excessive relative to peers."

Director compensation: Moody's will review director compensation practices to ensure that it is not "excessive," which could limit the directors' independence. According to Moody's, "some director compensation arrangements that are substantial and rely heavily on stock options or other relatively 'risky' pay elements also may merit comment as potentially encouraging risk-taking that could be excessive from a creditor standpoint."

Share ownership: Stock ownership among directors and management is viewed positively (specifically, ownership guidelines).

Topics Related to Board Structure and Practices

The following issues will be reviewed by Moody's:

- ◆ Board and committee independence
- ◆ Apparent director quality, depth and diversity
- ◆ Board and committee leadership
- ◆ General review of committee charters and processes and areas of explicit board responsibility (including stated mission and purpose)
- ◆ Board and director evaluation
- ◆ Director training

The following are viewed to be red flags for potentially poor governance:

- ◆ "Where the CEO and chairman positions are combined, lack of a coherent leadership framework for the independent directors
- ◆ Questionable composition of the board, with inadequate business experience and too many directors who appear to be on the board for their own celebrity, or for political or other influence
- ◆ The absence of an independent director nominating committee, or even the recent absence of such a committee
- ◆ Lack of board independence at publicly-held companies that are exempt from stock market listing requirements because they are majority controlled
- ◆ Director absenteeism, or lack of key committee meetings (particularly the audit committee)
- ◆ Lack of director orientation and development efforts
- ◆ Lack of reasonable director turnover . . . regular director turnover may be encouraged by strong director evaluation procedures, a mandatory retirement age, or director tenure limits
- ◆ Lack of clear director engagement on CEO evaluation and succession planning, or on oversight of broad company strategy, risk assessment and management, and/or internal controls"

STANDARD & POOR'S CORPORATE GOVERNANCE SCORES (CGS)

Company and Ratings Products

Standard & Poor's is a global provider of credit ratings and other services designed to "help individuals and institutions around the world make better-informed financial decisions." Standard and Poor's (or "S&P") has developed widely-recognized financial market indices, such as the S&P 500.

S&P formed a Governance Services unit in 1998 and launched a corporate governance scoring service in 2000. The Governance Services unit provides confidential corporate governance evaluations, customized research and corporate governance screens in addition to the public corporate governance scores (CGS).

A CGS is developed by S&P governance analysts upon the request of the company which is to be reviewed. The scores are not intended to be used as a credit rating or equity analysis. "By itself, it [the CGS] should not be intended to serve as financial advice, nor as a recommendation for a specific course of action. Its simple purpose is to provide an objective benchmarking of a company's corporate governance standards in a global context. In this regard, governance scoring can be viewed as a positive complement to traditional equity and credit analysis." However, credit ratings analysts at S&P often consider governance issues while assessing a company's management quality, accounting and financial controls.

The CGS is reported on a scale of 1 to 10, with 10 being the best possible score. Specifically, the CGS reflects “the effectiveness of the interaction among a company’s management, board, shareholders and other stakeholders. This focuses on the internal governance structure and process at an individual company.” S&P’s governance service also conducts a “Country Governance Review” which considers “the effectiveness of the legal, regulatory information and market infrastructure. This focuses on how external forces at a macro level can influence the quality of a company’s corporate governance.” The details of the Country Governance Review are beyond the scope of this memo (see the S&P website for more information).

Governance Topics Assessed

The S&P methodology for assessing governance includes approximately 80 factors which fall under the following four components:

1. Ownership structure and external influences
 - ◆ Transparency of ownership
 - ◆ Concentration and influence of ownership and external stakeholders
2. Shareholder rights and stakeholder relations
 - ◆ Shareholder meeting and voting procedures
 - ◆ Ownership rights and takeover defenses
 - ◆ Stakeholder relations
3. Transparency, disclosure and audit
 - ◆ Content of public disclosure
 - ◆ Timing of, and access to, public disclosure
 - ◆ The audit process
4. Board structure and effectiveness
 - ◆ Board structure and independence
 - ◆ Role and effectiveness of the board
 - ◆ Senior executive and director compensation

Topics Related to Executive and Director Compensation

S&P sets forth the following criteria for executive and director compensation:

- ◆ “Directors and executives should be fairly remunerated and motivated to ensure the success of the company.
- ◆ There should be clearly articulated performance evaluation and succession policies/plans for employed directors of the company.
- ◆ The company should link pay to performance.
- ◆ Executive management should not set their own pay.”

The following “key analytical issues” are considered:

- ◆ Performance based pay
- ◆ Independence of executive compensation setting
- ◆ Relationship with compensation consultants
- ◆ Form of compensation
- ◆ Performance evaluation criteria
- ◆ Compensation setting process
- ◆ Usage of stock options
- ◆ Compensation disclosure
- ◆ Executive contracts
- ◆ Compensation plan dilution

Topics Related to Board Structure and Practices

S&P sets forth the following criteria for board structure and independence:

- ◆ “A board should be structured in such a way as to ensure that the interests of all the shareholders may be represented fairly and objectively.
- ◆ Key functional areas, including audit, nomination and compensation are addressed either through formal committee structures or other structural mechanisms.”

The following “key analytical issues” are considered:

- ◆ Board size and composition
- ◆ Skill mix
- ◆ CEO/Chair split
- ◆ Board leadership and committees
- ◆ Director selection
- ◆ Director shareholdings
- ◆ Independence
- ◆ Director tenure

S&P sets forth the following criteria for the role and effectiveness of the board:

- ◆ “The board should bear overall accountability for the performance of the company.
- ◆ The board should play a meaningful role in directing the articulation and implementation of the company’s strategy, in overseeing the performance of the CEO and other senior managers and in ensuring that appropriate financial and operational controls and risk management systems are in place.
- ◆ Effective boards are active and engaged, and demonstrate true ‘independence of mind’ vis-à-vis company management.”

The following “key analytical issues” are considered:

- ◆ Definitions of board role
- ◆ Board access to information: committee meeting’s agendas and papers
- ◆ Articulation of mission and strategy
- ◆ Ethical boundaries
- ◆ Internal controls
- ◆ External stakeholder relationships
- ◆ Self evaluations
- ◆ Succession policies
- ◆ Attendance rates
- ◆ Other external directorships
- ◆ Meeting frequency
- ◆ Training
- ◆ Nominations process
- ◆ Board change

FITCH RATINGS

Company and Ratings Products

Fitch Ratings is a global credit rating agency. Fitch Ratings is owned by Fimalac, which also owns CoreRatings, a European rating agency providing independent investment analysis of corporate responsibility risks.

In April 2004, Fitch Ratings published a special report entitled “Evaluating Corporate Governance: The Bondholders’ Perspective” which announced their approach to incorporating corporate governance into their overall credit rating process. Fitch has “always taken aspects of corporate governance into account” but in this report, they outline a “more systematic framework for reviewing governance practices that affect credit quality.”

Fitch uses the analyses of corporate governance practices in a general way when determining credit ratings. They describe the effect on their credit ratings in the following way:

- ◆ “Exceptionally weak or deficient governance practices can contribute to a negative rating action, possibly including a downgrade.
- ◆ Exceptionally strong governance practices could warrant a special mention or other positive recognition in the credit analysis but will not drive a positive rating action generally.”

Fitch employs the following approach to conduct a review of a company’s corporate governance:

- ◆ “Leveraging data and information on the quality of governance practices across companies.
- ◆ Performing contextual reviews of the qualitative factors and nuances around a company’s approach to corporate governance.”

As one source of data, Fitch relies on the ISS CGQ discussed earlier in this memo. They also consider other sources of governance data. These data are combined with the “contextual review” which is conducted by Fitch analysts.

Governance Topics Assessed

Fitch states that the following are “core elements of sound governance from a bondholder perspective:”

- ◆ Independent and effective board of directors
- ◆ Oversight of related-party transactions
- ◆ Audit process integrity
- ◆ Reasonable and performance-based management compensation

Topics Related to Executive and Director Compensation

Fitch considers the following to be key elements in reviewing management compensation:

- ◆ “Performance-based compensation linked to the company’s long-term growth.
- ◆ The executive’s recent compensation relative to key indicators of the company’s financial performance and long-term stability.
- ◆ The company’s compensation levels relative to those of its competitors.”

Additionally, Fitch considers executive and director stock ownership an important aspect of governance. The following key elements are reviewed:

- ◆ “The size of each executive’s or director’s shareholdings or equity-based compensation.
- ◆ The features or terms of the equity instruments, particularly those that limit the stock’s liquidity or defer the financial benefits of these holdings.
- ◆ Activities or trends that might indicate an aggressive short-term, but unsustainable, financial strategy.
- ◆ Potentially unrealistic market expectations for the company’s earnings growth.
- ◆ Recent significant stock selling by corporate insiders.”

Topics Related to Board Structure and Practices

Specifically, during the contextual portion of the review Fitch analysts will assess the following issues related to director independence, board quality and effectiveness:

- ◆ “The presence of any important affiliations or business relationships between the director and key executives.
- ◆ The integrity of the company’s nomination process.
- ◆ The quality or depth of any non-independent relationships.
- ◆ The background and ability of directors to understand the business and financial implications of the company’s strategies and risk profile.
- ◆ The flow of information between management and the board.
- ◆ The rigor of questions or issues that the board poses to management.
- ◆ The process for determining the agenda of topics covered at board meetings.
- ◆ The amount of time and energy the directors devote to their responsibilities, in both preparing for and participating in board meetings.”



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