Wilson Sonsini Goodrich & Rosati
PROFESSIONAL CORPORATION

WSGR ALERT

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"GOVERNANCE RISK INDICATORS": WHAT RISKMETRICS GROUP'S NEW GOVERNANCE RISK ASSESSMENT TOOL MEANS TO PUBLIC COMPANIES

Over the past decade, U.S. public companies have become familiar with RiskMetrics Group's "Corporate Governance Quotient," or CGQ, a system for ranking the governance of companies within an industry peer group on a relative basis against RMG's benchmark governance standards. In the shareholder activist context, companies and dissidents frequently tout CGQ scores as indicators of sound—or problematic—governance. Companies often labored to improve their scores by conforming their practices to RMG's standards, unless doing so would require the company to make unacceptable changes to its governance, such as forgoing the services of valued board members or abandoning strategically important takeover defenses.

The "GRId" Risk Assessment Tool

On February 3, 2010, RMG rolled out a successor to CGQ: "Governance Risk Indicators," or GRId.[1] GRId will be considerably broader in scope than CGQ, and will rank U.S. and foreign public companies' purported level of governance-related risk in four areas: audit, board, compensation/ remuneration, and shareholder rights. GRId will rank companies *on an absolute basis* against what RMG views as best practices for the relevant jurisdiction, based upon the answers to approximately 70 questions addressing the company's practices across the four categories. Rankings will identify the level of concern (low, medium, or high) in each category. U.S. "best practices" will reflect the corporate governance policies underlying RMG's benchmark U.S. proxy voting guidelines. For example, in the compensation/ remuneration category, factors such as director stock ownership and minimum vesting periods for equity awards that conform to RMG's guidelines will moderate concern, while change-of-control agreements for named executives and tax gross-ups will have an adverse impact. In the area of shareholder rights, the presence of such features as staggered boards, non-shareholder-approved poison pills, and authority to issue blank check preferred stock will unfavorably impact a company's ranking. RMG's voting guidelines are updated annually to reflect what RMG views as emerging issues and the latest governance trends, and the "best practices" underlying the GRId methodology will be revised accordingly.

RMG says that its new ranking system will be fully transparent, and that it will shortly issue a technical document providing full disclosure of the data points GRId uses, as well as the underlying methodology that determines assessment of risk. RMG touts GRId as "a robust dataset that lets users go well beyond the evaluation of responses . . . allowing them to drill far deeper by leveraging copious data on all matters of a corporation's governance." But RMG views GRId as more than an elaborate corporate governance scoring system: it cites what it calls "increasing empirical evidence that better governance enhances shareholder value" and describes GRId as a "tool . . . to help institutions and other financial market participants measure and flag investment risk."

RMG's Transition to GRId

Beginning in the first half of 2010, RMG will issue GRId rankings for approximately 6,400 U.S. public companies and about 8,000 companies globally. Companies with February and early March 2010 annual meetings will have GRId rankings by June 30, 2010. For companies with annual meetings after mid-March 2010, RMG will publish GRId rankings in its proxy research reports beginning in early March 2010. RMG's data verification site will be freely available to corporate issuers at around the same time. The GRId criteria and scoring methodology will be disclosed in mid-February.

How Companies Should Respond

While RMG's GRId methodology and the significance of its rankings may be highly debatable, the fact remains that RMG enjoys by far the largest market share of any proxy advisory firm and influences the voting decisions of numerous institutions. Inevitably, shareholder activists will invoke GRId rankings wherever this provides fodder for an activist campaign and factor GRId rankings into their process for selecting potential activist targets. Moreover, companies should be mindful of the implications of a widely disseminated ranking system that purports to flag investment risk.

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[1] RMG's white paper is available at http://www.riskmetrics.com/sites/default/files/grid_white_paper.pdf. RMG also has published an FAQ regarding the transition plan from CGQ to GRId, which is available at http://www.riskmetrics.com/sites/default/files/FAQ-GRId-corporate.pdf. In addition, it has launched a micro site, www.riskmetrics.com/grid-info.

"Governance Risk Indicators" . . .

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Corporate secretaries, general counsel, directors, and governance committees generally will want to familiarize themselves with GRId in order to understand its implications for the companies they serve. Companies should avail themselves of RMG's data verification site, when it becomes available, to ensure that their data is accurate. Once the GRId criteria and scoring methodology are published, companies should review their current practices, in order to evaluate whether any changes are advisable. In addition, companies need to be prepared to respond promptly once RMG's data for their company becomes available. According to RMG, most companies with shareholder meetings in the spring of 2010 will have a limited timeframe to review the data that will be included in RMG's proxy analysis. Companies will receive an email once data for their company is available for review, and if factual errors are identified after the proxy analysis is published, a corrected report will be issued as long as the meeting date has not passed.

In the past, the desire to increase CGQ scores has led many companies to make governance changes without appropriate regard for the impact those changes might have on the company's ability to pursue its corporate strategy to create long-term value for shareholders. Many companies undoubtedly will feel tempted to make changes to improve GRId scores. However, no company should base its governance practices on a scoring system: corporate governance is not "one size fits all" and should not be approached as a "check the box" exercise. Rather, the board of directors should evaluate the company's governance structure in the exercise of its fiduciary responsibility, in light of all relevant factors, including the company's performance, business objectives, existing and potential risks, shareholder composition, and other relevant considerations, and carefully assess the potential disadvantages, as well as the potential benefits, of any change.

For more information on RMG's new GRId governance assessment tool, please contact David Berger, Warren de Wied, Katharine Martin, or any member of your Wilson Sonsini Goodrich & Rosati team.

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This WSGR Alert was sent to our clients and interested parties via email on February 5, 2010. To receive future WSGR Alerts and newsletters via email, please contact Marketing at wsgr_resource@wsgr.com and ask to be added to our mailing list.

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