

# PROXY UPDATE

January, 2012

## GRId 2.0: ISS Updates its Governance Rating System

### SUMMARY

In an effort to more closely align voting policies with its corporate governance rating system - GRId (Governance Risk Indicators) - ISS will implement GRId 2.0 in February. ISS says that the changes to its rating system are “evolutionary, rather than revolutionary.”

U.S. companies (GRId 2.0 still uses the Russell 3000 as the universe ISS will evaluate) will have their updated profiles, based on the GRId 2.0 methodology, posted on February 20, 2012. At that time, companies will have access to the new profile on the ISS data verification site. If you need to obtain your log-in to the Governance Analytics platform which has the GRId Data Verification site you can contact ISS at [support@isscorporateservices.com](mailto:support@isscorporateservices.com).

We strongly recommend using the verification site immediately after the new profiles are posted to correct any potential errors in ISS’ research. ISS will accept or reject proposed changes at its discretion and subsequently issue official scores on February 24<sup>th</sup>.

ISS indicates that they will send the new GRId 2.0 scores to Yahoo Finance in their March transmission, but the actual date that Yahoo will post the scores is still to be determined.

The key changes to GRId 2.0 will be:

- ISS will be incorporating numerical scores, in addition to the current red, yellow, green “traffic light” rating with the corresponding High Concern, Medium Concern, and Low Concern rating.
- ISS has added more than 30 new or revised GRId questions, especially regarding compensation, in an effort to align the ratings more with ISS’ voting recommendations.
- Categories and sub-categories of questions have been realigned or changed to provide a clearer sense of the underlying data, and so that governance practices are properly reflected in the high-level scores and concerns.
- ISS will, throughout 2012, update GRId in six existing non-US markets, and will open new markets in Europe and Asia-Pacific.

What has not changed:

- GRId scores will continue to be absolute, and not relative.
- ISS will still evaluate governance practices in four areas: Audit, Board, Shareholder Rights, and Compensation.
- The methodology will continue to be tailored to individual markets.
- The ratings will reference market-specific best practices on governance.

## DETAILS

In late December, ISS announced changes to its Governance Risk Indicators that will become effective on February 24, 2012. GRId 2.0 is an expansion of the analysis ISS introduced two years ago (as a successor to its Corporate Governance Quotient (CGQ)) to measure concern based on the governance practices of public companies. It was created to provide ISS' institutional clients with “an understanding of high level areas of concern across a portfolio together with analytical tools to help them dive deeply into governance at individual companies” while also providing companies with “a basis for aligning their corporate governance structure and practices with shareholder interests.”

### *“Evolutionary, Rather Than Revolutionary”*

The basic question and answer process remains the same. GRId will ask governance specific questions, answer those questions based on public filings, and then score those answers relative to best practice. The GRId scores still measure a company's governance practices in four areas: Audit, Board, Compensation, and Shareholder Rights. The main goal of 2.0, however, is to provide a system that portrays the level of governance concern at companies while better aligning the ratings with ISS policy and vote recommendations. The key changes to the methodology are outlined below.

### *A Focus on Compensation*

According to ISS, in order to provide a more transparent view of governance risks, they have updated their framework with refined subcategories and additional questions. The Compensation category, which under GRId 1.0 demonstrated relatively little linkage between ISS' governance score and its vote recommendation on “Say on Pay” proposals, was given the most attention. Many of the questions that are new or updated are a result of ISS' new pay for performance methodology (Read our Proxy Update on the 2012 ISS Proxy Policy [here](#)), and the changes were made in an effort to incorporate ISS' new multi-faceted quantitative methodology and to capture a broader range of compensation criteria.

### *The New Framework*

In the Board category, the “Board Practices” section has been split into two subcategories: “Board Practices” and “Board Policies”, with Board Practices covering the “behavior” of the board (e.g., overboarding, attendance), and Board Policies covering the guidelines related to the governance policies of the board. A new Related Party Transactions subcategory was also added to flag this as an area of concern. Questions that were previously grouped together regarding combined CEO/Chair positions or the presence of an independent chair or lead director have now been presented individually to provide a clearer view of board leadership structures. Similarly, the “poison pill” section in the Shareholder Rights category now includes several supplementary questions to paint a better picture of the underlying data. These questions cover shareholder approval, trigger thresholds, Net Operating Loss (NOL) consideration, and other plan-specific provisions. As for the Audit category, two questions were added regarding outside regulatory enforcement and investigation in an effort to gauge audit-related risk.

### *Scoring Methodology and Display*

The essence of the new system is how each answer is scored, and how those scores intertwine with each other and the levels of concern for the company. ISS will now display the actual numerical scores for each of the four categories to go along with the current traffic light level system of Red (High Concern), Yellow (Medium Concern), and Green (Low Concern). The

scoring methodology begins with the individual questions and answers. Each answer is assigned points, with a negative score indicating a poor governance practice likely to raise concerns, a zero/neutral score indicating a practice that meets market practice and is in line with the ISS policy, and a positive score representing the best governance practices.

Under the previous methodology, all answers would receive a score on a scale from -5 to +5 with certain questions and subcategories being weighted for importance. In GRId 2.0, the number of points possible for each question will vary depending on the answer's significance in terms of governance-related risk. -50 points represents high concern while -25 points represents medium concern. Additionally, the methodology has been built so that certain positive points may lessen concerns in other areas. A "poison pill", for example, will receive negative points; however, shareholder friendly features related to that pill may garner enough positive points so that there is no concern.

### *The Rating System*

Once all questions have been scored, a subcategory score is generated. The subcategory score is the sum of all relevant answer scores, subject to high and low caps. These caps are in place to limit the ability of single questions to skew the results of an entire section, for better or worse. Next, an overall category score is calculated by adding the subcategory scores. These scores are subject to a floor of -75 and a ceiling of +25. Lastly, 75 points are added so that the final category score falls within a scale of 0 to 100. 50 points or less indicates High Concern; 75 points or less indicates Medium Concern; higher than 75 indicates Low Concern.

### *What Are the Next steps?*

Even with what ISS says is a more comprehensive and transparent system in place, we still view GRId as its name implies -- an indicator. A positive or negative GRId score will not automatically trigger a positive or negative recommendation in a voting analysis. A low or high concern within a GRId category, however, will likely give a good indication as to how a company's governance practices may be noted or criticized in a voting analysis. Since ISS intends to better align GRId 2.0 with its voting guidelines, the new GRId scoring, especially on compensation, may provide a stronger link to the eventual ISS voting recommendation on a "Say on Pay" proposal.

We recommend that companies review their current GRId reports in preparation for the short window to make changes once the new methodology is released. Most of this information will have been pulled from last year's Proxy Statement but it may give the company a head start on catching any errors and/or likely areas of concern under GRId 2.0. We also recommend reading the FAQs for Corporate Issuers along with the GRId Technical Document (available at <http://www.issgovernance.com/grid-info>) for additional information including the full list of questions. We would be pleased to help in this effort.

*Time for Review*

As mentioned, U.S. companies will have their updated profiles, based on the GRId 2.0 methodology, posted on February 20, 2012. At that time, companies will have access to the new profile on the ISS data verification site. We strongly recommend using the verification site immediately thereafter to correct any errors in the analysis. ISS will accept or reject the changes at its discretion and subsequently issue official scores on February 24<sup>th</sup>. While we expect the data verification site to remain open to issuers after the 24<sup>th</sup>, the data and scores will be available to institutional investors and shown within proxy reports at that time. We plan on sending a reminder during the week of February 13<sup>th</sup> so that our clients do not forget the February 23<sup>rd</sup> correction deadline. In the meantime, we will continue to keep you apprised of any new information as it is made available.

Should you have any questions, please contact your Morrow representative or call us at (203) 658-9400.

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