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March 3, 2010

RiskMetrics Group Releases Governance Risk Indicators (GRId) Tool to Measure Governance-Related Risk

RiskMetrics Group (formerly Institutional Shareholder Services, or ISS) recently introduced Governance Risk Indicators (GRId), a new tool for institutional investors to assess the level of governance-related risk at current or prospective portfolio companies. RiskMetrics will publish GRId ratings, beginning in early March 2010, in its proxy reports and on a few websites (e.g., Yahoo!Finance) for use by others to make investment decisions. GRId ratings will replace RiskMetrics' prior corporate governance assessment tool, the Corporate Governance Quotient (CGQ), which will be frozen in early March 2010 and discontinued in June 2010. Different from the CGQ ratings, GRId ratings will be determined on an absolute basis compared to "best practices" rather than on a relative basis compared to peer and general industry practices. "Best practices" are aligned with RiskMetrics' proxy voting policies and will be customized to reflect governance standards in each global market covered. However, RiskMetrics will not use the new GRId ratings as a determinant for its proxy voting recommendations, but will continue to use the underlying corporate governance policies upon which the ratings will be based.

GRId Methodology

GRId uses the same principles underlying RiskMetrics' corporate governance policies for developing proxy voting recommendations to model governance-related risk. RiskMetrics plans to release a document describing the underlying methodology and the data points used by GRId to assess risk in an effort to be fully transparent. GRId will measure the level of risk in the following four governance categories at three different "concern" levels (low, medium, and high, which are color-coded, respectively, as blue, yellow, and red):

1. Audit
2. Board
3. Compensation
4. Shareholder Rights

GRId will assess the governance risk in the four categories based on a total of 60 to 80 questions for each market covered. For the U.S. and Canadian markets there will be approximately 70 questions. Each category is divided into subcategories (e.g., the Board category is composed of three subcategories: Board Composition, Composition of the Committees, and Board Practices), with questions addressing risk-related topics in each subcategory (e.g., Board Composition includes whether a former CEO of the company serves on the board). The methodology for assessing risk will be updated annually in conjunction with RiskMetrics' annual update of its corporate governance policies, which occurs in November.

Unlike the former CGQ tool, GRId ratings recognize that not all capital markets are the same and will take the applicable capital market into account by factoring local market nuances to assess best practices. However, scoring mechanisms will be identical across all markets to allow for meaningful comparisons across all markets. Initially, GRId will cover roughly 8,000 global companies, of which approximately 6,400 (80%) are U.S.-based. The remaining markets represented will be Canada (420 companies), France (240 companies), Germany (220 companies), the Netherlands (120 companies), and Sweden (100 companies). A complete dataset of the companies included in the initial GRId will be available by June 30, 2010. Expansion to additional markets, including Japan and Australia, is planned by the end of the year.

Answers are captured in numerical or percentage values, binary format, or other forms as appropriate for the question. Answers are graded on a scale of (-5) to (5), with higher numbers representing greater alignment with best market practice. Each answer is weighted and summed to provide a score for each subsection, which in turn are weighted and summed to provide a rating (low, medium, and high) for each of the four categories. Only the four category ratings will be reported in the GRId report, and they will not be combined into a single rating.

Companies will be able to verify their data prior to the publication of the initial ratings on a data verification site that will be made available without charge in early March 2010. RiskMetrics will send each company an email once its data is available for review, and each company will be provided a limited timeframe to verify its data. If any errors are found after a proxy report has been published prior to the shareholder meeting, RiskMetrics will issue a revised proxy report.

Potential Implications

We expect that the increased transparency of the GRId methodology and alignment of the rating factors with RiskMetrics' proxy voting policies will increase acceptance of these policies as governance "best practices." This will make it increasingly difficult for companies to continue practices that result in high-risk ratings under the new GRId system.

Additional information will be forthcoming on the questions to be included in each of the four governance categories, but insights on sound compensation practices can be gleaned from the initial published materials. In addition to familiar stances taken by RiskMetrics that the presence of poor practices (e.g., tax gross-ups) may increase risk concerns while the presence of positive practices (e.g., stock ownership guidelines) may decrease risk concerns, there are new stances, such as minimum vesting periods should be included in stock plan documents and minimum restricted stock vesting should be 36 months.

Visit www.riskmetrics.com/grid-info for more information on GRId, as well as a list of FAQs for corporate issuers and institutional investors and a sample GRId profile.

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