

VRS Corporate Governance Practices

Report for the VRS Board of Trustees

Prepared by the

Corporate Governance Task Force

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Table of Contents

Executive Summary	Page 1
Corporate Governance Overview	Page 2
Investments: Good Corporate Governance Practices	Page 8
Asset Recovery through Securities Litigation	Page 13
Proposed Policy Statement and Guidelines	Page 16
Corporate Governance Task Force Members	Page 19
Corporate Governance Task Force Meeting Speakers	Page 22
Bibliography	Page 24
Corporate Governance Task Force Meeting Minutes	Page 28
Corporate Governance Metrics Ratings Overview	Appendix A
ISS U.S. Proxy Voting Policy Summary	Appendix B
ISS Global Proxy Voting Policy Summary	Appendix C

EXECUTIVE SUMMARY

The Corporate Governance Task Force (Task Force), appointed by the Virginia Retirement System (VRS) Board of Trustees in August 2002, adopted three objectives:

- review and evaluate the existing practices at VRS with respect to corporate governance issues;
- examine methods to improve accountability of public companies; and
- identify appropriate actions to safeguard the assets of the Plan.

This Report summarizes the major findings and provides the recommended enhancements to the corporate governance policies and procedures that emerged from this six-month study. The Task Force finds the existing VRS practices and procedures related to corporate governance to be comprehensive with few deficiencies. The proposed policy statement and the guidelines for its implementation seek to formalize these activities, to elevate their importance, and to facilitate the monitoring of governance-related activities by the Board of Trustees.

The Task Force identified three broad categories of activities related to corporate governance, and this Report summarizes each in turn. The first area of focus is proxy voting. As an institutional investor, one of the most important rights is the right to vote, by proxy, on the matters put forth by management and shareholders. Voting in this fashion is the most effective tool for promoting good corporate governance, probably seconded by the ability to sell the shares (which is problematic in the case of passive investments). For separate account investment managers (both internal and external), the Task Force recommends implementing VRS Proxy Voting Guidelines, which would be used by these managers. An annual review of proxy voting is recommended. With respect to commingled funds, where participants do not have the ability to vote proxies, the Task Force recommends that VRS closely monitor how proxies are voted compared to the VRS Proxy Voting Guidelines and report differences to the Board in their annual proxy report.

The second area of focus involves increased involvement in institutional investor organizations. VRS currently does not participate in formal institutional investor organizations that focus on corporate governance. The Task Force believes participation in these investor organizations, such as the Council of Institutional Investors, would provide an effective and unified voice for VRS and its peers.

The third area of focus involves securities litigation. VRS currently participates in all eligible class action lawsuits, but has yet to act as lead plaintiff or to pursue separate legal actions. The Task Force recommends that VRS staff work with the Office of the Attorney General to evaluate securities litigation options available to VRS on a case-by-case basis, which could include being a lead plaintiff in a class action suit or bringing a separate legal action. To help facilitate this process, the Task Force recommends engaging the services of an outside monitoring service.

This Report is organized as follows. Section 1 provides an introduction and overview of corporate governance issues. Section 2 discusses proxy voting and institutional investor organizations. Section 3 focuses on asset recovery through securities litigation. Finally, Section 4 presents for consideration by the VRS Board of Trustees a proposed corporate governance policy statement and guidelines for its implementation.

1. CORPORATE GOVERNANCE OVERVIEW

1.1. INTRODUCTION

Corporate governance is an expansive topic that refers to the power-sharing arrangement between a company's shareholders, its board of directors, and its senior management. The actual power-sharing arrangement of a corporate entity depends upon its rules of governance — the rules that define and protect the rights, responsibilities, and claims of the three relevant parties: shareholders, directors, and management. Corporate governance rules are established by firm-specific charters and bylaws, as well as by statutes and regulations promulgated by state and national governments. The federal and state judicial systems likewise play a major role in corporate governance matters through an on-going process of litigation, interpretation, and enforcement.

The essence of a corporate governance failure is where the managers of a firm, acting as agents for the shareholder, seek to improve themselves at the expense of the shareholders. The recent collapses of Enron and Worldcom have been characterized as corporate governance failures. These very public corporate “blow-ups” have resulted in actions taken by legislators, regulators, stock exchanges, and institutional investors such as the Virginia Retirement System and have caused a rethinking of the relationship between corporate management and shareholders. Shareholders have finally started to protest, claiming that management is not serving them, as they should. As the owners of the companies, shareholders are able, at least in theory, to rectify this. There is a growing perception that managers have become insufficiently accountable to shareholders, from blatant theft, as is alleged in the case of Adelphia, to bad investments in the case of Time Warner's purchase of AOL. The objective of the Corporate Governance Task Force is to identify sources of governance problems and to recommend actions that should be taken by VRS to encourage good corporate governance practices in order to improve the returns generated by VRS. Achieving this objective requires a consideration of the costs to VRS associated with reducing possible future corporate governance failures.

Many researchers have examined the subject of corporate governance. Perhaps not surprisingly, their findings do not reach a clear consensus regarding the effectiveness of particular governance rules for improving corporate performance and whether shareholders are successful in changing governance rules. These mixed results serve to emphasize that “good governance” practices may not be universal — one practice does not necessarily fit all enterprises — and thereby the task of identifying best governance rules requires considerable expertise and idiosyncratic analysis. In practical terms, this simply means that the knowledge to distinguish between good and bad corporate governance and the actions required to address governance problems involves costs that must be weighed against the potential benefits.

Research findings likewise question whether investor activism in corporate governance is worth the cost. With regard to the judicial system, existing studies provide little useful guidance about the relative costs and rewards of alternative litigation strategies to recover assets lost to corporate malfeasance. In particular, one finds no empirical evidence to evaluate the net benefits to an institutional investor from “lead plaintiff status” in comparison to a passive role in a class-action lawsuit. Despite these caveats, a growing body of evidence and practical experience find that the rules of corporate governance are

material and relevant determinants of corporate financial performance. Some activities by institutional investors appear worthwhile, producing positive and cost-effective improvements in long-run corporate performance and thus the return on fund investments. Rapidly emerging legal practices — particularly with respect to the involvement of state courts in corporate securities litigation, and limitations on the number of times that institutions may take on lead plaintiff status — indicate that lead plaintiff status might well increase net asset recovery under exclusive conditions.

These observations have important implications for the corporate governance practices of VRS as they pertain to its investments. Any funds invested by VRS in public corporations are inescapably affected by governance rules. As such, cost-effective mechanisms to improve governance at corporations can and should be integrated, systematically and methodically, into the investment practices of VRS. The Task Force finds the existing VRS policies and procedures related to corporate governance to be fairly comprehensive with few deficiencies. However, the proposed corporate governance policies and guidelines in Section 4 of this Report should provide cost-effective enhancements to the investment practices at VRS. The benefits of improved corporate governance policies will accrue primarily to the performance of the VRS public equity portfolio, and thus much of the discussion in this Report will involve public equities. Corporate governance is theoretically not a problem in private equity because investors should have superior information and are directly involved with the management of each investment. It should also be less of a problem in fixed income investments because managers of a company must abide by the covenants in each bond indenture. Fixed income problems will primarily involve issues related to securities litigation.

VRS has two broad tools at its disposal to integrate corporate governance into the investment process: (i) using “good governance practices” as a screening criterion in buying and selling stocks or bonds, and (ii) encouraging the adoption of good governance practices by those corporations in which VRS invests. The second tool is particularly relevant to passively invested stock portfolios, which replicate a market index such as the Russell 3000. To state these two options differently, VRS can take the governance rules as “fixed” and buy or sell accordingly, or VRS can seek to change the governance rules of those companies in which it is a “passive” (indexed) shareholder. We describe the first option in Section 1.4 and the second option in further detail in Section 2. Regarding securities litigation and asset recovery through the judicial system, VRS should adopt a two-pronged approach. On the front end, VRS should systematically screen for potential cases to determine the appropriate venue and filing status. On the back end, VRS must ensure that it recovers all settlements to which it is legally entitled. These procedures are laid out in additional detail in Section 3. Section 4 concludes with a summary of the policy recommendations and some guidelines for their implementation.

1.2. BACKGROUND

An ideal system of corporate governance would provide management with enough freedom to manage effectively, while ensuring that the interests of shareholders are protected. Further, if other managers could add value, a management change would occur. The system would also keep shareholders sufficiently distinct from managers to let them buy and sell freely without

breaking rules against insider trading in stock markets — a virtue of the public company is that it provides investors with liquidity.

The different models of corporate governance fall into two broad types. The American and British model exemplifies the first type, which emphasizes liquidity in the stock market to facilitate capital formation. Shareholders in this system permit managers to run firms for the benefit of the shareholders while allowing market share prices to act as an approval rating of the managers' performance. Shareholders unhappy with a firm's management can sell their shares. Such selling causes the price to decrease, which may send management a message. However, if poor managerial performance persists, an outsider may take control by buying a majority of the shares through a hostile takeover bid (that is, one rejected by managers but accepted by shareholders). Hostile bids are an effective way of replacing under performing managers. The system requires full disclosure of financial data to shareholders and tough insider-trading laws banning people from buying or selling on the basis of confidential information.

The second model is exemplified by the German and Japanese systems in which liquidity for investors is less important (because many German companies are private, their shares are often illiquid.) Instead, shareholders reduce risks by monitoring managers closely or having an intermediary such as a bank do the monitoring on their behalf. The parties forge close, long-term relationships with management by owning large stakes in firms and holding them for a long period of time. They learn information about managers' plans in the course of these relationships rather than through disclosure of public financial data. Stock markets play a lesser role in these markets, in comparison to the American-British model.

The first model relies on liquidity, price flexibility and the takeover market to control corporate governance failures. The second model relies on informed investor involvement to control corporate governance problems. This second model also characterizes the private equity market, which has largely overcome corporate governance problems. The two models also lead to differences in the types of owners. Individuals, who own minor stakes and have minimal incentives to monitor management, are more significant in the United States compared to other nations. In Japan and Germany, the large shareholders are banks and firms that often have business links with the companies they own. Shareholders own relatively small stakes in firms in America and Britain, reflecting their desire for liquidity. However, there is a blurring of the distinction between the two systems. The relative extent of institutional ownership in the U.S. is on the rise, increasing from 19% of total equities in 1970 to 56% of the total in 2001.

In 1932, Adolf Berle and Gardiner Means wrote "The Modern Corporation and Private Property," which first discussed the idea of the "separation of ownership and control." Berle and Means argued that the management of public corporations could deceive, manipulate and transfer wealth from shareholders, as a result of ineffective monitoring. Separation of ownership and control was also predicted to lead to excessive management compensation and perquisites, and self-perpetuating boards of directors. One avenue for controlling such "agency costs" is through the market for corporate control, namely the use of "hostile takeovers." Henry Manne recently noted that the number of hostile takeovers has decreased, the result of federal (Williams Act of 1968) and state legislation that made such transactions difficult and costly for the acquirer.

Takeovers have also been reduced by the adoption of poison pills by many public corporations. Manne contends that the decline in hostile takeovers (reduced from 14% to 4% of all mergers) has coincided with this recent period of higher executive compensation and management scandals. Without the threat of takeover, shareholders need to increase their monitoring of management — in other words, insist upon and take steps to improve corporate governance to prevent the transfer of wealth from shareholders to management. As the takeover threat becomes less likely to control management, two other avenues available to investors become more important — voting with their feet by selling shares or becoming more activist shareholders by trying to effect change in the management of a company. Jack Bogle, founder and former Chairman of Vanguard and member of the Conference Board Commission on Public Trust and Private Enterprise favors the latter. He recently argued that institutional investors such as pension funds are failing to use shareholder power to improve corporate governance and are not adequately reining in poorly performing executives. Mr. Bogle also argues against institutional investors voting with their feet or selling off stock when they perceive a company's prospects to be poor. He believes that pensions should act more like owners and less like traders, taking responsibility for encouraging long-term performance in the companies in which they invest.

Despite the intuitive appeal of shareholders acting more like owners, the empirical evidence regarding the success of shareholder activism is mixed. In reviewing all research related to shareholder activism, Jonathan Karpoff (2001) finds inconclusive evidence regarding the value of such activism. He looks at 20 recent empirical studies that attempt to measure the effects of shareholder activism on target firms' values, operations and governance structures. Smith (1996), for example, concludes that, "Overall, the evidence indicates that shareholder activism is largely successful in changing governance structure and, when successful, results in a statistically significant increase in shareholder wealth." Strickland, Wiles, and Zenner (1996) agree: "Our results.... suggest that monitoring by small shareholders is possible and that it can be successful." These statements indicate that shareholder activism tends to improve target companies' operations, a conclusion also reached by Bizjak and Marquette (1998), Carleton, Nelson, and Weisbach (1998), Del Guercio and Hawkins (1999), and Opler and Sokobin (1997). Sunil Wahal (1996), however, disagrees: "Collectively, [my] results cast doubt on the effectiveness of pension fund activism as a substitute for an active market for corporate control." Karpoff, Malatesta, and Walkling (1996, p. 393) also disagree: "There is no persuasive evidence that [shareholder] proposals increase firm values, improve operating performance, or influence firm policies." Reaching similar conclusions, Gillan and Starks (2000), Johnson and Shackell (1997), Wagster and Prevost (1996), and Woods (1996) all report that shareholder activism tends to have little impact on target companies.

1.3. REGULATORY ENVIRONMENT

In addition to actions by shareholders, government and regulatory bodies proposed a number of changes in 2002 that may deter outright corporate fraud. Recent legislation and NYSE and NASDAQ rule changes should help prevent similar abuses in the future. On July 30, 2002, President George W. Bush signed the Sarbanes-Oxley Act. This corporate reform legislation creates a five-member Public Company Accounting Oversight Board, two members of which will be certified public accountants, to regulate the accountants who audit

public companies. The new law expands the definition of obstruction of justice, creates a new felony for the destruction of audit work papers, doubles the maximum sentence for violations of securities laws to 20 years, and increases the maximum criminal penalty for an individual to \$5 million and for a company to \$25 million. The companies they audit may still hire accountants, but they will be responsible to the audit committee of the outside board rather than to management. In a change opposed by the accounting industry, firms will be prohibited from providing some consulting services to companies they audit. On August 1, 2002, the NYSE approved major changes to the rules for accounting, auditing and corporate governance as necessary conditions for listing a firm's stock on the exchange. NASDAQ also adopted new rules in July 2002. These rules require companies to have more independent directors, and provide audit and compensation board committees with enhanced power.

1.4. THE IMPACT OF CORPORATE GOVERNANCE ON PASSIVE AND ACTIVE INVESTING

As of December 31, 2002, 65% of VRS' U.S. public equity portfolio was passively invested. The benchmark for the U.S. program is the Russell 3000 index. VRS owns all 3000 companies in the index, and is unable to sell companies with poor corporate governance. Voting its disapproval by selling is only an option if VRS adopts a custom benchmark, which is screened for companies that do not meet a minimum corporate governance threshold. This is possible given new database products introduced by Institutional Shareholder Services (ISS), Standard & Poors, and Corporate Governance Metrics. A summary of Corporate Governance Metrics' ratings is contained in Appendix A of this Report. The ratings are based on factors that include board accountability, financial disclosure, shareholder rights, executive compensation and takeover restrictions. All three data providers publish corporate governance ratings on a large number of public companies. The VRS investment staff is currently researching the value of these ratings. If it can be shown that the ratings can help deliver higher returns on either the equity or bond portfolio, then these ratings will be used to help construct a custom benchmark. John Serhant, Vice Chairman of State Street Global and architect of their proxy voting policies, recommends that large investors lobby the index providers to use corporate governance information for purposes of constructing benchmarks.

Research findings offer contradictory evidence, however, regarding the value of using corporate governance ratings. Recent research by Paul Gompers of Harvard Business School and two colleagues (2002) looked at 1,500 firms in the 1990s and found that the best firms from a corporate governance standpoint outperformed the worst firms (after controlling for risk and style) by about 850 basis points per year. There is also some evidence that the worst governed firms — those appearing on CalPERS' and the Council of Institutional Investors' target lists — outperformed the market. Other than the custom benchmark option, VRS could follow Jack Bogle's advice and act more like a long-term owner by becoming more involved or active in the affairs of a company. This Report discusses these options in Section 2.

Some of the same strategies discussed in the remainder of the Report that may be undertaken for the passive portfolio also apply to active investments made by VRS. However, active managers (which include both internal VRS portfolio managers and external managers) can additionally make the decision to sell. Active equity investors are always looking for an edge in managing a portfolio in

order to beat their benchmark. Active managers have and always will look at various actions taken by management that are not in the best interest of shareholders to determine if they want to liquidate their shares. Managers that can sell short may even take short positions in such companies. An example of data used by active internal and external quantitative VRS managers are measures of accounting quality, which may provide signals when management is attempting to hide problems at a firm. Active managers may also look at management's ability to invest profitably the capital of the firm. In addition, VRS internal equity management staff and some of VRS' external managers are currently assessing the value of corporate governance rating companies (e.g., ISS, S&P and Corporate Governance Metrics). Certain active fundamental investment managers may be skilled at digging deeply enough into company operations to avoid investing in the Enrons and Adelphias of the world. However, identifying investment managers who can consistently execute this strategy is difficult, as many apparently good active investment managers fell into the trap of investing in these troubled companies (e.g., Alliance investment in Enron). VRS is always looking for active external investment managers who excel at avoiding these problems, but the challenge is identifying enough of these skilled investment managers with the capacity to help invest VRS' \$19 billion equity portfolio (as of December 31, 2002).

2. INVESTMENTS: GOOD CORPORATE GOVERNANCE PRACTICES

2.1. GOOD CORPORATE GOVERNANCE PRACTICES: PROXY VOTING

As institutional investors, one of the most important rights is the right to vote, by proxy, on the matters put forth to shareholders. Voting in this fashion is the most effective tool for promoting good corporate governance, probably seconded by the ability to sell the shares (which is problematic in the case of passive investments).

As background on the proxy voting process, shareholders typically get to vote on proposals by management and proposals by shareholders once a year. Management proposals include the election of directors, the approval of auditors, compensation of directors and auditors, authorization of share repurchase programs and the general updating of or corrective amendments to the corporate charter. Shareholder proposals include requirements that auditors attend the annual meeting of shareholders, the establishment of an annual election of the board of directors, mandates requiring a majority of independent directors on the Board of Directors and the audit, nominating, and compensation committees, mandates that amendments to bylaws or charters have shareholder approval, repeals of various anti-takeover related provisions and the reduction or elimination of super-majority vote requirements

According to the VRS Investment Advisory Committee's Investment Policy Statement:

"It is the policy of the Virginia Retirement System to review all proxy issues carefully and to vote them in the best interest of the participants/beneficiaries of the fund. Each investment manager, both domestic and international, will vote VRS proxies in accordance with this policy and will submit a report to the VRS annually summarizing their votes."

The current VRS policy agrees in spirit with the United States Department of Labor's position that "where proxy voting decisions may have an effect on the economic value of the plan's underlying investment, plan fiduciaries should make proxy voting decisions with a view to enhancing the value of the shares of stock" (Pension and Welfare Benefits Administration Interpretive Bulletin 94-2 or "IB 94-2").

2.2. PROXY VOTING FOR SEPARATE ACCOUNTS

VRS invests using both separate and commingled accounts. A separate-account manager holds assets in a segregated account instead of placing in them in a pool with those of other investors. For separate accounts, Mellon Bank, the VRS master custodian, and Goldman Sachs, the VRS sub-custodian, collect and mail proxy ballots to VRS internal and external managers or their designated proxy voting service. Most of the VRS external managers (79%) along with the VRS internal accounts use ISS as their designated proxy voting service. Mellon has contracted with an outside vendor, ADP, to monitor all annual meetings and the aforementioned proxy votes. This is where the custodian's responsibility ends. However, if a company sees that a large block of stock held by the custodian has not been voted, they will notify the custodian, who will in turn contact ISS or the external manager (in those instances where the external manager does not use ISS). ISS provides an analysis and recommendation for each proxy issue approximately two weeks prior to the vote

date. At this point, in accordance with VRS policy, the investment manager has the capability to deviate from the recommendation.

ISS is the industry-leading provider of proxy research with over 950 clients worldwide. ISS researches the financial implications of proxy proposals and makes recommendations that will protect and enhance shareholder returns. With a staff of over 185 professionals, ISS delivers policy guidelines, proxy analyses, and consulting services to clients who vote proxies in-house, as well as a turnkey voting agent service. ISS analyzes proxy issues for more than 9,000 U.S. companies and bases analyses and voting recommendations on empirical research measuring the impact of proxy issues on shareholder value. ISS Global Proxy Advisory Service is used by 75% of our Non-U.S. managers. This service offers broad analytical coverage of more than 10,000 securities in over 79 non-U.S. markets. ISS global research goes beyond vote recommendations to provide a review of economic, legal, corporate and accounting structures that influence corporate governance in each market. Summaries of ISS U.S. and Global proxy voting policies appear in Appendices B and C.

A potential conflict of interest situation exists with ISS as a result of the firm's proxy consulting activity with public companies. ISS now offers advice to public companies on proxy issues (language, structure of ballot, etc) at the same time they advise institutional investors on how to vote these same proxy ballot issues. ISS insists their research objectivity will not be impacted, but there have been numerous recent examples (investment banking and sell-side research, audit services and consulting services, etc.) that cause us to be cautious. VRS staff is currently reviewing alternative providers of proxy voting services and have found the following providers to date (listed in alphabetical order):

- Automatic Data Processing Inc.
- Council of Institutional Investors
- Davis Global Advisors
- European Corporate Governance Service
- Georgeson Shareholder
- Institutional Shareholder Services (ISS)
- Investor Responsibility Research Center
- National Association of Pension Funds (UK)
- Proxinvest (France)

The Council of Institutional Investors (CII) stands out in this list of alternatives to ISS as a result of the organization's not-for-profit structure and institutional investor membership base. CII is reviewed in further detail in Section 2.5 of this Report.

2.3. PROXY VOTING FOR COMMINGLED ACCOUNTS

Commingled accounts differ from separate accounts in that VRS owns shares of the commingled vehicle and not shares of the underlying companies. The attraction of commingled accounts is the lower cost. When VRS selects a commingled account investment manager, the manager's approach to proxy voting should be considered along with other factors such as investment management skill and risk management procedures. State Street Global Advisors (SSgA), VRS' passive public equity manager, is a good example of an

investment manager offering commingled accounts. Oversight of the proxy voting process at SSgA is the responsibility of the SSgA Investment Committee. The SSgA Investment Committee, led by John Serhant (who presented to the Task Force), reviews and approves amendments to the SSgA Proxy Voting Policy and delegates authority to vote in accordance with this policy to ISS. For those clients for whom SSgA has undertaken to vote proxies (like VRS), SSgA retains the final authority and responsibility for such voting. In addition to voting proxies for such clients, SSgA does the following:

- Provides the client with this written proxy policy, upon request;
- Matches proxies received with holdings as of record date;
- Reconciles holdings as of record date and rectifies any discrepancies;
- Applies its proxy voting policy consistently and keeps records of votes for each client in order to verify the consistency of such voting;
- Documents the reason(s) for voting for all non-routine items; and
- Keeps records of such proxy voting available for inspection by the client or governmental agencies, both to determine whether votes were consistent with policy and to determine whether all proxies were voted.

In order to facilitate this proxy voting process, SSgA retains ISS to assist in the due diligence process.

2.4. RECOMMENDED PROXY VOTING POLICY AND GUIDELINES

The Task Force recommends that VRS policy continue to require the careful review of all proxy issues and to vote proxies in the best interest of the participants/beneficiaries of the fund. Each investment manager should vote VRS proxies in accordance with this policy and submit a report to the VRS annually summarizing their votes. The objective of the VRS proxy policy is to enhance and protect shareholder value for plan participants/beneficiaries.

The Task Force recommends that VRS continue to contract out the development of proxy voting positions to a Proxy Voting Service Provider. The decision by VRS staff to hire this outside Proxy Voting Service Provider should be based on a thorough review of their proxy voting policies. These proxy voting policies must be based on sound economic analysis and research of proxy issues and they must be driven solely by the objective of enhancing and protecting shareholder returns. The Task Force recommends that VRS Staff perform an annual review of the Proxy Voting Service Provider (currently ISS) used by the Plan.

In the absence of a specific directive from VRS, separate internal and external account managers should vote all proxies in accordance with recommendations provided by the VRS Proxy Voting Service Provider (the proxy voting policy of the current Proxy Voting Service Provider, ISS, is summarized in Appendices B and C). The separate account manager may choose to deviate from the recommendation, but must provide VRS with an explanation for such actions. Commingled account managers have their own proxy voting policy in which VRS has no direct authority. VRS expects managers to vote proxies in the best interest of the plan participants/beneficiaries. However, VRS will consider the proxy voting policies as a factor in deciding to hire and fire commingled account

managers.

As part of the existing VRS manager due diligence process, VRS staff should compile a report once per year that compares each manager's (both separate account and commingled managers) voting record to the proxy voting policy of the Proxy Voting Service Provider and review any discrepancies with each manager. VRS staff should use the results of this report to help evaluate each manager. The Board should receive this annual Proxy Voting Report, which should also provide a review and evaluation of the VRS Proxy Voting Service Provider. The Task Force believes this review process should reinforce the VRS policy of "voting proxies in the best interest of participants/beneficiaries" and sends a message of proxy voting accountability to the investment managers.

2.5. GOOD CORPORATE GOVERNANCE PRACTICES: ACTING AS A LONG-TERM INVESTOR BY JOINING INSTITUTIONAL INVESTOR ORGANIZATIONS

VRS typically holds a small slice of the equity of any one firm, giving little incentive to incur the costs of actively monitoring the management of each firm. VRS is a victim of the free-rider problem — if it becomes more activist, most of the benefit would accrue to other shareholders, but VRS would bear the entire cost. One approach for reducing the free-rider problem would be for VRS to share the costs of shareholder activism by joining an organization made up of other similar institutional investors. VRS currently does not participate in formal institutional investor organizations that focus on corporate governance. The Task Force believes participation in these investor organizations, such as the Council of Institutional Investors (CII), would provide an effective and unified voice for VRS and its peers. In addition to having collective clout dealing with individual corporations, this organization should be an effective vehicle for lobbying regulatory agencies, such as the SEC, and federal and state lawmakers.

Founded in 1985, the non-profit, non-partisan CII has over 130 pension fund members whose assets exceed \$2 trillion. The organization seeks to address investment issues that affect the size or security of plan assets. The organization's objectives are to encourage member funds, as major shareholders, to take an active role in protecting plan assets and to help members increase return on their investments as part of their fiduciary obligations. CII staff interacts extensively with individual companies, the Securities and Exchange Commission, the New York Stock Exchange, the National Association of Securities Dealers, the Financial Accounting Standards Board, the International Accounting Standards Board and key legislative committees in Congress. CII's website (www.cii.org), which is filled with a wealth of up-to-date information, has become a standard research tool for those interested in corporate governance. CII's "blast email" service supplements this information by allowing members to share information and to seek out experts on a range of investment, corporate governance, and litigation issues. CII is a leader pressing the cause of shareholder rights and good corporate governance.

Given the large number of companies and limited staff resources, the Task Force believes that VRS should leave active involvement with companies to organizations such as CII, large investors (e.g., CalPERS and TIAA-CREF) and external money managers. While this approach may not be feasible for VRS,

there may be opportunities to hire external active managers who become involved in management issues at portfolio companies. This “relationship” type of investing is where active external investment managers identify and invest in companies in which they seek to increase shareholder value through shareholder activism with each company in their portfolio. The external manager takes an active interest in each investment — taking relatively large stakes in each company and perhaps seeking a board seat. The goal of such external managers is to cause positive operational, financial, strategic and governance change, which should be reflected positively over time in the company’s market valuation. Successful investment managers often have experience serving as executives and directors at other corporations, providing valuable skills in corporate finance and operations. VRS investment staff should consider hiring external managers that have a demonstrated record of successful relationship investing.

The Office of the Attorney General currently participates in peer organizations, such as the National Association of Attorneys General (NAAG) and the National Association of Public Pension Attorneys (NAPPA). These organizations offer significant educational opportunities, forums to interact with counterparts in other states to see how they are approaching various issues and, in some cases, more in-depth analysis opportunities on issues using a task force approach.

A benefit of CII membership for VRS, and NAAG and NAPPA membership for the Office of the Attorney General is to stay abreast of regulatory and legislative changes affecting corporate governance. The Task Force recommends that VRS staff report to the VRS Board of Trustees annually regarding such corporate governance initiatives.

3. ASSET RECOVERY THROUGH SECURITIES LITIGATION

Since the introduction of the Private Securities Litigation Reform Act in 1995, securities class actions against corporations have quadrupled and the average settlement value has doubled. For example, in 1999, the California Public Employees Retirement System (CalPERS) was lead plaintiff in a successful \$2.8 billion shareholder settlement after the disclosure of accounting irregularities at Cendant. A recent study by Price Waterhouse Coopers (PWC) found that the majority of securities class action cases involve accounting improprieties. The PWC study also finds an increasing number of New York Stock Exchange and Fortune 500 companies are being named in suits. Many of the lawsuits are being filed by a small number of law firms. The most active securities law firm brought more than half of the 303 non-initial public offering class-action securities suits that were settled in the United States between 1996 and 2001. This same firm is involved with the two biggest scandals from last year, Enron and WorldCom. The other trend is reaching beyond suing just the company, company executives and directors (D&O settlements) and auditors, to suing other “deep pockets” such as investment bankers. The higher costs of settlements paid by losing litigants is encouraging many companies to effect real corporate governance reforms.

There is some evidence that the frequency of securities litigation has increased too much. The Task Force is concerned that such litigation could be costly to all shareholders. Occasionally there is a valid claim to be made against a company or banker or underwriter that engages in fraud or truly fails to do the due diligence that is expected in bringing a security to market. VRS should consider appropriate legal action in these limited instances. However, it is important that VRS only take legal action where it is confident that litigation represents a means to recover losses and also serves to protect against future wrongdoing. Litigation to achieve short-term gain at the expense of a company not engaged in any wrongdoing causes long-term damage to the securities market because capital is wasted on litigation and market value is artificially depressed due to the uncertainty of litigation. A recent example of this type of litigation was a class action suit filed against Capital One in connection with the issue of bad-loan reserves. Without wrongdoing on the part of Capital One, a determination was made that it should have greater loss reserves. The market reacted dramatically to the news with shares falling significantly. A law firm saw this as an opportunity for short-term gain by filing suit against Capital One in Federal Court in Alexandria. The suit was thrown out, but not before time and capital was lost. As a shareholder of Capital One it seems clearly counterproductive to sue and use up resources that could be better utilized to regain market value.

VRS participates in existing securities litigation at the back-end through a service provided by its custodian, Mellon Bank, whereby they monitor all securities litigation settlements and ensure that we receive our fair share of the settlement proceeds. This service is provided for all accounts custodied at Mellon. Settlements received by VRS in recent years are as follows:

2001	2002
\$2,446,000	\$708,000

In commingled accounts (e.g., passively managed accounts with SSGA), VRS is the beneficiary of settlements paid for damages that were caused in the past, regardless whether VRS was an investor in the commingled fund at the time.

VRS has not taken lead plaintiff status in any class action lawsuit. Law firms frequently inquire about the System's willingness to take lead plaintiff status, but our analysis has found only limited circumstances where this may be advantageous. Specifically, some funds run very small cap portfolios and find themselves as the single largest shareholder in a company. In these situations, the plan must initiate action in order for the suit to be filed. In VRS' case, however, the System is usually one of several large institutional shareholders, in which case, VRS will certainly participate in any final settlement through our existing procedures.

Conversations with other public plans show varying degrees of securities litigation activity. CalPERS is very active in this area, but has served as lead plaintiff only twice since 1995. The \$144 billion plan (the largest U.S. plan) has a large commitment to corporate governance activities and employs 14 staff attorneys and substantial outside legal counsel. Leaders at other public plans see lead plaintiff status as a vehicle for political gain. While not actively seeking lead plaintiff status, VRS does participate in all class action legal actions in which it is eligible. Aside from potential savings related to lower negotiated fees, the Task Force has seen no compelling evidence that lead plaintiff status results in greater settlements in securities litigation cases.

In addition to the traditional class actions securities litigation, there are now a number of individual state actions being initiated on behalf of investors. In fact, the most active securities law firm is not involved in the Worldcom class action, but has instead initiated a series of lawsuits in state courts on behalf of public pension funds. A New York firm represents the class in Worldcom. Corporate wrongdoing that includes participation by underwriters and bankers presents opportunity for recovery from sources that may have assets. The potential for recovery and the best litigation method, if it is litigation at all, may involve not just determining whether to be lead plaintiff, but also whether a separate suit should be filed and where.

Recently there has also been a significant increase in litigation involving fixed income securities. The bankruptcies of high profile companies such as Enron, WorldCom, and Adelphia caused unprecedented losses for bondholders. Class action litigation is underway and VRS will participate in any recovery through these lawsuits. In addition, VRS is participating in a direct lawsuit against Adelphia, filed on its behalf by an outside investment manager through power of attorney. VRS has also been solicited by law firms to participate in direct lawsuits against a number of issuers. To date, VRS has not found that strategy to be in its best interest. In each situation, VRS investment staff seeks the opinion and recommendation of the Office of the Attorney General.

With respect to potential securities litigation activity, the Task Force recommends that VRS staff work with the Office of the Attorney General to evaluate securities litigation options available to VRS on a case-by-case basis, which could include being a lead plaintiff in a class action suit or bringing a separate legal action. To help facilitate this process, the Task Force recommends engaging the services of an outside monitoring service.

The Task Force suggests the following process with respect to potential securities litigation activity:

1. The Office of the Attorney General should field solicitations for a securities litigation firm to monitor and identify potential securities litigation cases. The outside firm should forward material pertaining to such cases to the Office of the Attorney General for further review.
2. When a situation of interest develops with legal merit, the Office of the Attorney General should forward relevant information to VRS investment staff for review with a recommended course of legal action (Class or State).
3. Following review, VRS staff should assess the costs and potential asset recoveries from the cases and forward appropriate situations to the VRS Board of Trustees for review and a recommendation as to whether to pursue legal action.
4. If the VRS Board of Trustees approves a recommendation to pursue legal action, the Office of the Attorney General will hire outside counsel for VRS and work with outside counsel and VRS to pursue the agreed upon litigation.
5. The VRS Board of Trustees should receive an annual report on the total asset recoveries from securities litigation received during the year, as well as a status report on any litigation in which VRS is the lead plaintiff.

It is anticipated that lead plaintiff status will be sought rarely.

4. PROPOSED POLICY STATEMENT AND GUIDELINES

Based on the findings described in this Report and our six-month review of the relevant issues, the Task Force unanimously recommends for consideration by the VRS Board of Trustees the following Corporate Governance Policy Statement (Section 4.1) and Guidelines for its implementation (Section 4.2).

4.1. CORPORATE GOVERNANCE POLICY STATEMENT

I. Corporate Governance Principle

The guiding principle for VRS Corporate Governance activity is fiduciary responsibility, only taking actions that are in the best interest of the plan's participants and beneficiaries.

II. Proxy Voting

It is the policy of the Virginia Retirement System to review all proxy issues carefully and to vote them in the best interest of the participants/beneficiaries of the fund. Each investment manager, both domestic and international, should vote VRS proxies in accordance with this policy and submit a report to the VRS annually summarizing their votes. The Board should review a report on VRS Proxy voting annually, which includes an evaluation of the outside Proxy Voting Service Provider and an analysis of the proxy votes cast by each investment manager.

III. VRS as Long-term Investor

VRS should act like an owner in companies in which it invests by encouraging long-term value creation at these firms. However, the costs of becoming an active investor must be considered. VRS should always be seeking cost-effective means for acting as an owner. VRS can share the costs of shareholder activism by joining organizations made up of other similar institutional investors who are also concerned about creating and improving economic value for shareholders.

IV. Securities Litigation

VRS should consider securities litigation and evaluate litigation strategy as a risk management tool to recover losses related to illegal conduct, fraud, or willful wrongdoing. In considering litigation, VRS should assess the long-term consequences of any litigation and its potential impact on the stability of the fixed-income and equity markets. The Office of the Attorney General should assist VRS in determining whether a fraud or willful wrongdoing has occurred in connection with the acquisition or ownership of its investments. The Office of the Attorney General should retain outside counsel with expertise in securities litigation to help evaluate an appropriate litigation strategy.

4.2. CORPORATE GOVERNANCE GUIDELINES

I. Proxy Voting

VRS should contract out the development of proxy voting positions to a Proxy Voting Service Provider. The decision by VRS staff to hire this outside Proxy Voting Service Provider should be based on a thorough review of their proxy voting policies. These proxy voting policies must be based on sound economic analysis and research of proxy issues and they must be driven solely by the objective of enhancing and protecting shareholder returns. VRS staff should review and evaluate the Proxy Voting Service Provider used by VRS at least once per year.

In the absence of a specific directive from VRS, separate account managers (both internal and external) should vote all proxies in accordance with recommendations provided by the VRS Proxy Voting Service Provider (the proxy voting policy of the current Proxy Voting Service Provider is summarized in Appendices B and C). The separate account manager may choose to deviate from the recommendation, but must provide VRS with an explanation for such actions. Commingled account managers have their own proxy voting policy in which VRS has no direct authority. VRS expects managers to vote proxies in the best interest of the plan participants / beneficiaries.

As part of the existing VRS manager due diligence process, VRS staff should compile a report once per year that compares each manager's (both separate account and commingled managers) voting record to the proxy voting recommendations of the Proxy Voting Service Provider and review any differences with each manager. VRS staff should use the results of this report as one criterion in evaluating each manager. The Board should receive this annual Proxy Voting Report, which should also provide a review and evaluation of the VRS Proxy Voting Service Provider.

II. VRS as Long-term Investor

VRS should act like an owner in companies in which it invests by encouraging long-term value creation at these firms. VRS should share the costs of shareholder activism by joining organizations made up of other similar institutional investors who are also concerned about creating and improving economic value for shareholders. It is expected that VRS Trustees, Investment Advisory Committee members and/or staff will participate actively in these organizations. The goals of membership are twofold. First, VRS will have access to a cost-effective tool for promoting good corporate governance at portfolio companies and for lobbying regulatory organizations such as the Securities and Exchange Commission. Second, membership will provide information and analysis about corporate governance issues and solutions going forward. The VRS Board of Trustees should receive an annual report regarding the membership and activities of these institutional investor organizations. In addition to organization membership, VRS should always be seeking out cost-effective means for acting as an owner.

III. Securities Litigation

VRS staff should work with the Office of the Attorney General to evaluate securities litigation options available to VRS on a case-by-case basis, which could include being a lead plaintiff in a class action suit or bringing a separate legal action. The procedure used to consider securities litigation should involve the following:

1. The Office of the Attorney General should field solicitations for a vendor to monitor and identify potential securities litigation cases. The outside firm should forward material pertaining to such cases to the Office of the Attorney General for further review.
2. When a situation of interest develops with legal merit, the Office of the Attorney General should forward relevant information to VRS investment staff for review with a recommended course of legal action (Class or State).
3. Following review, VRS staff should assess the costs and potential asset recoveries from the cases and forward appropriate situations to the VRS Board of Trustees for review and a recommendation as to whether to pursue legal action.
4. If the VRS Board of Trustees approves a recommendation to pursue legal action, the Office of the Attorney General will hire outside counsel for VRS and work with outside counsel and VRS to pursue the agreed upon litigation.
5. The VRS Board of Trustees should receive an annual report on the total asset recoveries from securities litigation received during the year, as well as a status report on any litigation in which VRS is the lead plaintiff.

**CORPORATE
GOVERNANCE TASK
FORCE MEMBERS**

PATRICIA L. ATKINS-SMITH

Patty Atkins-Smith is the Legislative Liaison and Policy Analyst for the Virginia Retirement System. She came to the VRS in May 2002 from the Department of Medical Assistance Services (DMAS) where she served as a Policy and Planning Specialist in the areas of legislation and regulations. She has also served as the DMAS Freedom of Information Act Coordinator and Legal Liaison to the Office of the Attorney General. Additionally, Ms. Atkins-Smith has served as the Director of Credentialing, Regulatory Compliance and Legislation for Virginia Premier Health Plan, Inc., formerly Virginia Chartered Health Plan, Inc.

Ms. Atkins-Smith received her Bachelor of Science and her Master of Education degrees from Virginia Commonwealth University. She earned a Legal Assistant Certificate from the University of Richmond.

W. MARK CRAIN

Mark Crain is Professor of Economics and Director of the Center for Study of Public Choice at George Mason University. Dr. Crain has published over 100 articles and books in the fields of economics and political science. Most of these works focus on fiscal policy, industrial organization, government regulation, and the organization of legislatures.

Professor Crain's civic duties for the Commonwealth of Virginia include service on boards and commissions under four governors. He has previously been on the faculties at UCLA and Virginia Tech.

Dr. Crain holds a Bachelor of Science degree in Economics from the University of Houston, and a Ph.D. in Economics from Texas A & M University. He resides in McLean, Virginia with his wife and two children.

NANCY C. EVERETT, CFA

Nancy Everett is the Chief Investment Officer for Virginia Retirement System's \$34 billion defined benefit plan and over \$500 million defined contribution plans. She joined the VRS in July 1979 and is currently responsible for all investment programs including equity, fixed income, alternative investments, real estate and cash. Previously she managed in-house equity funds and all international programs.

Ms. Everett holds a B.S. in Accounting, Virginia Commonwealth University, 1978 and Chartered Financial Analyst, 1987.

Ms. Everett is currently a Member of Investment Advisory Committee, Randolph-Macon College; Business Council, Virginia Commonwealth University and Board of Directors, VCU Foundation. She was the Past President, Board of Directors, Richmond Society of Financial Analysts.

(K.C.) KENNETH C. HOWELL, CFA

K.C. serves as Director of Global Equity in the Public Equity group at the Virginia Retirement System (VRS). He is responsible for the design, research and risk management of the U.S. and Non-U.S. Equity programs and contributes to the Internal Equity Management program. He joined VRS in 1998 from Crestar Asset Management Company where he managed a U.S. equity mutual fund and served as a fundamental research analyst. He holds a BSBA from Christopher Newport University, a MBA from the College of William & Mary, and is a CFA Charterholder.

NORWOOD (WOODY) JACKSON

Norwood (Woody) Jackson is a Partner in KPMG's Health Care and Public Service practice.

Woody joined KPMG in August 1999. Prior to joining KPMG, he was the Deputy Controller of the Office of Federal Financial Management at the Office of Management and Budget from 1992 through 1999. In that capacity, he was responsible all accounting, financial management, and auditing policies pertaining to the preparation and audit of Federal agency financial statements and all grants management policies for States, local governments, institutions of higher education, and non-profit organizations. Previously, he was Deputy Auditor of Public Accounts for the Commonwealth of Virginia.

Woody served on the Federal Accounting Standards Advisory Board (FASAB), which issues Federal Accounting Standards, from 1993 until 1999; he served on the U.S. Comptroller General's Advisory Council on Government Auditing Standards, which recommends government auditing standards for issuance by the Comptroller General, from 1992 until 2000; and he served on the AICPA Auditing Standards Board, which issues generally accepted auditing standards, from 1995 through 1999. In 1998, Mr. Jackson received the Outstanding CPA in Government award from the AICPA.

R. RUFFIN KING IV

Ruffin King served as Senior Vice President with Evergreen Investment Management Company (First Union/Wachovia) from 1994–2001. During his tenure with Evergreen, he served as the Investment Communications and Relationship Management Head, the Investment Information Management Head, and as a Senior Marketing Representative. Ruffin has worked in investments and finance since 1980, including his position as Vice President of the Real Estate Finance Department of Salomon Brothers.

Mr. King holds a MBA and J.D. from the University of North Carolina and a B.A. from Princeton University. He has also completed one year of study toward a Master of Divinity

LARRY KOCHARD

Larry Kochard is Managing Director of Public Equities for the Virginia Retirement System. In addition, he is an adjunct Professor of Finance at the McIntire School of Commerce at the University of Virginia. Prior to joining the investment staff of the Virginia Retirement System Larry was a full time faculty member at the University of Virginia. Larry's teaching has included courses in Investments, Fixed Income and Corporate Finance. Larry received his Ph.D. in Economics from the University of Virginia in 1998. Prior to his return to academia, Larry had over ten years of experience in corporate finance and the capital markets, most recently as a Vice President with Goldman Sachs. He served on the Investment Advisory Committee of the Virginia Retirement System for three years prior to joining the investment staff of the retirement system. In addition to the Ph.D., Larry has a BA in Economics from the College of William & Mary, and an MBA in Finance and Accounting from the University of Rochester. Larry is married and has four children.

STEVEN A. MARKEL

Steven Markel is currently Vice Chairman of Markel Corporation, where he has worked since 1975. Mr. Markel is on the Board of Markel Corporation and S&K Famous Brands. He also serves on the Board of Visitors of Virginia Commonwealth University, the Board of Trustees of VCU Health Systems, the Board of Directors of the Christian Children's Fund, and the Richmond Chapter of the American Heart Association. Mr. Markel has previously served as Chairman of the Business Council of Virginia Commonwealth University, and on the Board of Directors of the Jewish Community Federation of Richmond, Temple Beth Ahabah, and Beth Shalom Home. He was on the Community Planning Committee of United Way, and is Past President of the Jewish Community Federation of Richmond Endowment Fund. Mr. Markel is married with two children.

OWEN B. PICKETT

Owen Pickett was a member of the Virginia House of Delegates from 1972 to 1986, serving on the Appropriations, Privileges and Elections, and the Health, Welfare and Institutions Committees. He served in the U.S. House of Representatives from 1987 to 2001, serving on the Armed Services, Merchant Marine and Fisheries, and Resources Committees.

Mr. Pickett was admitted to the Virginia State Bar and District of Columbia Bar and is a CPA. He is a Senior Fellow with the Joint Forces Staff College (Norfolk, Virginia), is Of Counsel with Troutman Sanders LLP, and was formerly the senior partner of the law firm of Pickett, Lyle, Siegel, Drescher and Croshaw. He is a member of the Fourth Circuit Judicial Conference, the American Bar Association, and the American Institute of Certified Public Accountants.

Mr. Pickett is a member of the Oceana Lions Club, is an Honorary Member of the Princess Anne Rotary Club, is a Past President of the Princess Anne Ruritan Club, and the Virginia Beach Bar Association. He is also a member of the Board of Directors of the Central Business District Association, Meals on Wheels of Virginia Beach, Navy League of Hampton Roads, Old Dominion University Research Foundation, Tidewater Builders Association, United Way Foundation and the Virginia Beach Forum.

Mr. Pickett holds a B.S. degree from Virginia Polytechnic Institute and State University and L.L.B. Degree from the University of Richmond. He is married with three daughters.

PAUL W. TIMMRECK

Paul Timmreck has served the Commonwealth of Virginia in a variety of capacities for twenty-five years.

In his current position as Senior Vice President for Finance and Administration at Virginia Commonwealth University, which he began on August 1, 1996, he oversees VCU's financial, human resources, physical infrastructure, police operations, and administrative computing and communications services.

Prior to joining VCU, he served as Secretary of Finance for Governors Allen and Wilder. During his tenure as Secretary of Finance, *Financial World* magazine on 2 occasions named Virginia as the best-managed state in the nation. His tenure is also marked by service to Governors Baliles and Robb as Director of the Department of Planning and Budget. He came to Virginia in 1975 to take a staff position with the Joint Legislative Audit and Review Commission, where he worked for almost five years.

Paul received his undergraduate and graduate degrees from the University of Michigan in 1967 and 1968, respectively. He has been married to his wife Jennifer for 29 years, and has two children, Emily - 25 and Mark - 22.

**CORPORATE
GOVERNANCE TASK
FORCE MEETING
SPEAKERS**

STEPHANIE L. HAMLETT

Ms. Hamlett is an Assistant Attorney General in the financial services section of the Office of Attorney General. She represents a variety in state agencies, including the Virginia Retirement System, in financial and investment-related matters. In the private practice of law, she specialized in tax, bond and business legal issues. She is the former Executive Director and General Counsel of Virginia's Heartland Partnership, Inc., a cooperative economic development effort by the counties of Amelia, Buckingham, Charlotte, Cumberland, Lunenburg and Prince Edward. From 1996 to 1999, she served at Legislative Services as staff counsel to the Senate Finance Committee and House of Delegates Appropriations Committee. She has also served as an associate in the public finance section of McGuire, Woods, Battle & Boothe, L.L.P. A graduate of Mary Washington College, Hamlett received her law degree from the University of Richmond's T. C. Williams School of Law, where she was elected to the Law Review. She also earned a Masters in tax law from the College of William and Mary's Marshall-Wythe School of Law.

AMY HARKINS

Amy has been employed by Mellon Financial for 11 plus years and has held integral roles in integrating Mellon's business lines including the BSDT Corp 1992-1995, Dreyfus Retirement Services, CIBC, Canada Trust, Bank of Montreal and ABN Amro. Amy, a Key Business Sponsor over the last eighteen months on the development and implementation of Mellon's Straight Through Corporate Actions System (Cascade) and the Eagle PACE technology. Also, the Mellon Lead Business Sponsor on the strategic platforms to develop and maintain the data repositories including Pricing, Income, Dividends, Corporate Actions and Security Reference Data. Amy currently manages the Global Operations supporting Security Master, Broker Master, US and Global Income, US and Global Corporate Actions, Global Pricing and Global Class Actions, Bankruptcies and Proxies processes. She holds a BS in Accounting from Georgetown University and an MBA from Duquesne University.

ROBERT N. KAPLAN

Widely recognized as a leading securities litigator, Robert Kaplan has led the prosecution of numerous securities fraud class actions and shareholder derivative actions, recovering hundreds of millions of dollars for the victims of corporate wrongdoing. He also has earned a reputation as a leading litigator in the antitrust and consumer protection arenas. Mr. Kaplan has been with Kaplan Fox for 30 years, joining in 1971. Mr. Kaplan honed his litigation skills as a trial attorney with the U.S. Department of Justice. There, he gained significant experience litigating both civil and criminal actions. He also served as law clerk to the Hon. Sylvester J. Ryan, then chief judge of the U.S. District Court for the Southern District of New York.

Mr. Kaplan's published articles include: "Complaint and Discovery In Securities Cases," *Trial*, April 1987; "Franchise Statutes and Rules," *Westchester Bar Topics*, Winter 1983; "Roots Under Attack: *Alexander v. Haley* and *Courlander v. Haley*," *Communications and the Law*, July 1979; and "Israeli Antitrust Policy and Practice," *Record of the Association of the Bar*, May 1971. In addition, Mr. Kaplan served as an acting judge of the City Court for the City of Rye, N.Y., from 1990 to 1993. Mr. Kaplan sits on the boards of several community organizations, including the Board of Directors of the Carver Center in Port Chester, N.Y., the Board of Directors of the Rye Free Reading Room in Rye, N.Y., and the Community Advisory Board for Greenwich Hospital in Greenwich, Conn. Mr. Kaplan earned a BA from Williams College in 1961 and a J.D. from Columbia University Law School in 1964.

JOHN R. SERHANT

John is an Executive Vice President of State Street Bank and Trust and is Vice Chairman of State Street Global Advisors. He is a member of SSgA's Executive Management Group and Chairman of the Investment Committee. John is responsible for all High Net Worth business efforts of SSgA. John has 34 years of investment experience.

Prior to joining SSgA in April of 1993 his previous positions included: Managing Director of FX Concepts, Inc., Executive Vice President of Quantum Investment Management, Executive Vice President of Underwood, Neuhaus and Co., Inc. and General Partner of Boettcher and Company.

John holds a Bachelor of Arts degree in Finance from Baldwin-Wallace College. In addition, he taught Finance at the University of Northern Colorado.

SARAH A.B. TESLIK

Sarah Teslik is Executive Director of the Council of Institutional Investors. Founded in 1985, the Council is an organization of over 130 public, corporate and Taft-Hartley pension funds that seeks to address investment issues affecting the size or security of its members' \$2.0 trillion in assets.

Prior to the formation of the Council, Ms. Teslik was a corporate and securities attorney with Willkie Farr & Gallagher in Washington, D.C.

Ms. Teslik has a B.A. in History from Whitman College, Walla Walla, Washington, an M.A. in Modern History from Oxford University, and a J.D. from Georgetown University Law Center in Washington, D.C.

SHIRLEY A. WESTCOTT

Ms. Westcott joined ISS's domestic research staff in August 1996, where she handles U.S. voting policy matters and follows proxy contests, M&A, and restructuring activities. Previously, she braved two proxy seasons in ISS's Global Research Department covering Canada, Britain, Ireland, and South Africa. Ms. Westcott has 15 years of experience in business, finance, and economics which has included positions as a management consultant at American Management Systems, section chief and intelligence analyst at the National Security Agency, intelligence liaison officer at the Department of Commerce, and economic research assistant at the World Bank. She holds an M.B.A. in international finance from George Washington University, an M.A. in international relations from American University, and a B.A. summa cum laude in Spanish and mathematics from Purdue University, and has engaged in academic study at the University of Madrid and the Pushkin Institute in Moscow.

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**CORPORATE
GOVERNANCE TASK
FORCE MEETING
MINUTES**

A meeting of the Corporate Governance Task Force of the Virginia Retirement System was held on September 18, 2002 with the following members present:

Mark Crain, Chair
Woody Jackson, Jr.
Ruffin King, IV
Owen B. Pickett, Esq.
Paul W. Timmreck
Jay M. Weinberg, Esq.
Nancy Everett
Larry Kochard
K. C. Howell
Patti Atkins-Smith

The following VRS staff were also in attendance: Jeanne Chenault, Justin Metzgar and Phyllis Henderson. Douglas Conway, Jr. and Vernard W. Henley of the Board of Trustees, Tricia Bishop of JLARC, Stephanie Hamlett of the Attorney General's office, Raymond Jirran of the American Association of University Professors and Betty Jirran, a retired teacher with the Hampton Retirement System, were also in attendance.

The meeting was called to order at 12:00 p.m. Mark Crain introduced Al Samper, Chairman of the Board of Trustees, who thanked the members for agreeing to serve on the Task Force.

Phyllis Henderson gave a quick review of the administrative rules and procedures for the Task Force.

Dr. Crain stated his view that the objectives of the Task Force should be three-fold (1) to review and evaluate the current practices, (2) to examine methods for greater accountability of public companies, and (3) to identify the appropriate actions to safeguard the assets of the Plan. Dr. Crain suggested that the goal should be to make a recommendation of the appropriate corporate governance policy to the Board of Trustees by the February 20, 2002 meeting.

Mr. Timmreck made the motion that the goal of the Task Force was to review and evaluate the current practices, determine methods of accountability, identify the actions to safeguard the assets of the VRS, and to deliver the recommendation to the Board by the February, 2003 meeting. Woody Jackson seconded the motion and the motion was passed.

Ms. Everett gave a history of the governance of VRS noting that the Virginia Legislature enacted changes in 1994 to insulate VRS from some of the political issues faced by other public funds. Additionally, this revised legislation included the "prudent person" standard of care requiring the Trustees to discharge their duties exclusively in the best interest of the beneficiaries. She explained that while VRS hasn't traditionally been visible concerning corporate governance issues, it has been proactive in its steps to protect the interests of the beneficiaries. She reviewed the current asset allocation of the fund noting current practices in place with regard to corporate governance in each of the asset classes.

Dr. Crain then explained that the first principles for the Task Force would be to ensure that any corporate governance policies would first be considered in light of their impact on the investments of the fund and only implemented if considered to enhance investment performance. There was general discussion

concerning these issues with an emphasis on reflecting upon the priorities for VRS.

Mr. Kochard began a discussion on the topics for this Task Force to consider concerning corporate governance. He explained that of the \$18.5 billion invested in public equity, \$14.5 billion was U.S. invested with about \$4 billion invested in non-U.S. entities. Of the total U.S. equity portfolio, 70% is passively managed and 30% actively managed. Approximately \$3 billion of the U.S. equity portfolio is managed internally with the remainder managed externally. The non-U.S. equity program is externally managed with equal amounts invested actively and passively.

There was discussion about the different ways VRS could encourage better corporate governance such as selling or not buying stocks with poor corporate governance, creating a custom index that excludes certain issues using a corporate governance rating by an outside data provider, sponsoring proxy resolutions, or using in-house counsel to communicate with companies. There was discussion concerning organizations that are active in shareholder rights and issues (i.e., Council of Institutional Investors, Conference Board) and whether VRS should consider joining these organizations.

There was discussion concerning the legal process that VRS currently follows with regard to securities litigation. Stephanie Hamlett was asked to review the current process and advise the Task Force accordingly.

Mr. Jackson suggested that in addition to the recommendation of the Task Force to the Board, that supporting analysis and documentation also be presented to the Board.

Dr. Crain expressed concern over how corporate governance information is actually implemented and suggested that maybe a speaker could make a presentation to the Task Force.

Because of the numerous issues involved in corporate governance, Mr. Jackson suggested an analysis (i.e., "matrix") of the issues for the Task Force to review.

The current proxy voting process was discussed noting that external equity managers vote the proxies on our behalf. For internally managed funds, we generally abide by Institutional Shareholder Services' guidelines.

Securities litigation was discussed further. VRS has not attempted to gain lead plaintiff status in any suits to date, but instead has relied on our custodian to ensure our receipt of a pro rata share of any proceeds from a settlement. It is currently not clear whether there is any benefit in taking lead plaintiff status. The Attorney General's office has been asked to provide us with clarification in this regard along with any other options that may be available.

There was discussion concerning the direction of future meetings. It was suggested that we have speakers from State Street Global Advisors and ISS at the October 17, 2002 meeting, a speaker on securities litigation at the November 21, 2002 meeting (invited by Stephanie Hamlett), and a discussion of current and active legislation and a speaker from the Council of Institutional Investors at the December 19, 2002 meeting.

It was also suggested that if any Task Force member is approached by the press to refer them to Dr. Crain.

Our goal is to get organized, get a vision of the final product, set out objectives, determine what VRS currently does and the lessons learned from procedures of the past, determine the practices and activities to consider and to put together a matrix of alternatives as a guide.

Adjournment There being no further business before the Task Force, the meeting was adjourned at 2:00 p.m.

Mark Crain

A meeting of the Corporate Governance Task Force of the Virginia Retirement System was held on October 17, 2002 with the following members present:

Mark Crain, Chair
Woody Jackson, Jr.
Ruffin King, IV
Steven Markel
Owen B. Pickett, Esq.
Paul W. Timmreck
Nancy Everett
Larry Kochard
K. C. Howell
Patti Atkins-Smith

The following VRS staff were also in attendance: Jeanne Chenault, Forrest Matthews and Phyllis Henderson. Douglas Conway, Jr. of the Board of Trustees, Tricia Bishop of JLARC, Stephanie Hamlett of the Attorney General's office, Shirley Westcott and Rod Arends of Institutional Shareholder Services (ISS) and John Serhant and Jim Thorsen of State Street Global Advisors (SSgA), were also in attendance.

The meeting was called to order at 12:15 p.m.

The minutes of the September 18, 2002 meeting were reviewed. A motion was made by Mr. Pickett and seconded by Mr. Timmreck to approve the minutes of the September 18, 2002 meeting. The minutes were unanimously approved.

Patti Atkins-Smith entered the meeting at 12:25 p.m. and Woody Jackson entered the meeting at 12:35 p.m.

Dr. Crain noted that proxy voting might be the most important topic we will consider. Dr. Crain discussed the agenda for future meetings, which will include a discussion of securities litigation and a presentation from Sarah Teslik from the Council of Institutional Investors at the November meeting. The Task Force agreed to the schedule.

Nancy Everett discussed the draft Activities and Asset Class matrix and explained that it tried to include all issues that would be considered under corporate governance and their impact on each of the asset classes that VRS invests in. There was a general discussion of companies, such as ISS, that rank firms by their corporate governance standards and how VRS could develop a process to exclude firms that don't meet certain criteria. The issue of who would "police" firms not meeting this criteria was also discussed.

Mr. Kochard introduced Shirley Westcott, Chief Policy Advisor for ISS. ISS is a proxy-voting firm that is used by many institutional investors, including VRS. ISS is also used by three-quarters of VRS' external equity managers.

Ms. Westcott explained that corporate governance is important, and noted that investors, on average, are willing to pay a 20% premium for companies with good corporate governance. ISS has their own guidelines and continually updates these guidelines following the proxy season by reviewing Committee-suggested changes and issuing new guidelines yearly. She thinks 2003 will be a volatile year. Recurring themes will be auditor conflicts, board independence and runaway pay for executives. She feels that reforms (including the

Sarbanes-Oxley legislation) are not going far enough and that we will see a push for better corporate governance beyond the basic mandatory requirement. She thinks there are clear conflicts of interest if accounting firms provide audit services, IT consulting, and non-audit services (fees being paid for services that are not audit related). Sarbanes-Oxley caps non-audit fees at 25%. One survey indicates that 27% of the firms questioned support these proposals. Audit fees are now a big issue and Ms. Westcott feels an important issue. She stated that fees are now being disclosed and ISS does a quantitative and qualitative review of these disclosures. ISS does a cost-benefit analysis with shareholder value being the bottom line.

There is consideration for a mandatory auditor rotation of every five to seven years.

ISS currently reviews the conflicts of interest among companies and researches companies as thoroughly as possible.

Regarding the evaluation of audit firms, ISS focuses on conflicts of interests.

Self-regulatory organizations (SROs such as NASDAQ, NYSE) will begin requiring that Boards have independent directors (at least two-thirds) to remain listed on the Exchange. The New York Stock Exchange will require independence of all key committees (compensation, nominating and governance).

There was also the suggestion of requiring separation of the Chairman and Chief Executive Officer.

ISS favors annual elections for Board members as it maintains continuity in leadership and allows shareholders to dispose of ineffective boards in a shorter period of time.

ISS recommends withholding votes for board members who have poor attendance and ignore majority votes. They also take a strong look at key Committee composition.

Regarding CEO pay, some suggestions include a mandatory holding period following option exercise, longer vesting periods, indexed options and restricted stock. Stock ownership is key as it is not option driven. Reviewing executive severance is another consideration to examine with CEO salaries.

SROs think shareholder approval should be mandatory for pay plans.

ISS is in favor of stock option expensing.

Mr. Kochard introduced John Serhant, Executive Vice President of State Street Bank and Trust and Vice Chairman of State Street Global Advisors (SSgA). Mr. Serhant advised the Task Force that VRS has \$12 billion of passively managed US and international funds and commingled funds. Mr. Serhant also clarified the distinction between commingled and separate accounts as it applies to proxy voting. SSgA has developed their proxy voting policy using the ISS policy as a base and making modifications on several issues on which they disagree.

SSgA has developed their policy with client feedback. They will withhold votes against boards of egregious companies (i.e., Enron).

He thinks shareholders have the right to assume that audited financial statements reflect the correct information regarding a company. He thinks Boards should act in the best interest of the shareholder and make certain that management is doing what it is supposed to do. Boards do have risk for their own personal assets.

He feels the accounting side of companies will improve and thinks that the NYSE proposals are excellent and should be adopted by companies that want to be listed on the NYSE. He also feels that index providers should adopt the NYSE requirements as a condition for being included in their indexes.

Good corporate governance is an important part of risk management and it will take time to improve.

He feels Board members should be familiar with the company and industry and must be able to dedicate the appropriate time to serve on a Board.

State Street has an open door policy and will see management when a shareholder brings an issue. Mr. Serhant doesn't feel there is a crisis concerning corporate governance, but there is too much media coverage on the subject.

VRS owns units in commingled funds that SSgA votes for us. They could customize a benchmark if requested.

Mr. Serhant emphasized that you review the policies that you and your managers vote and support the policies.

Adjournment There being no further business before the Task Force, the meeting was adjourned at 2:30 p.m.

Mark Crain

A meeting of the Corporate Governance Task Force of the Virginia Retirement System was held on November 21, 2002 with the following members present:

Mark Crain, Chair
Woody Jackson, Jr.
Ruffin King, IV
Steven Markel
Owen B. Pickett, Esq.
Paul W. Timmreck
Nancy Everett
Larry Kochard
K. C. Howell
Patti Atkins-Smith

The following VRS staff was also in attendance: Forrest Matthews, Brian Goodman, and Phyllis Henderson. Douglas Conway, Jr. of the Board of Trustees, Tricia Bishop of JLARC, Stephanie Hamlett of the Attorney General's office, Sarah Teslik and Michelle Gowens of Council of Institutional Investors and Frederic Fox, Donald Hall, Robert Kaplan and Mary Morris of Kaplan Fox, were also in attendance.

The meeting was called to order at 12:15 p.m.

The minutes of the October 17, 2002 meeting were reviewed. A motion was made by Mr. Pickett and seconded by Mr. Timmreck to approve the minutes of the October 17, 2002 meeting. The minutes were unanimously approved.

Nancy Everett advised the Task Force of her recent attendance at a Conference Board seminar in which executive compensation, corporate governance and auditing and accounting issues were discussed. She advised that a recurring theme in the seminar was whether institutions are "investors" or "owners" which is important because the objectives are different. "Investors" tend to consider return (if the return is not what you want, you sell the stock) while "owners" tend to be in it for the long term. It was discussed that by definition, you are an owner if you buy stock, but it is what your intentions are as to your holding the stock. VRS owns units of the commingled fund, not the individual stocks owned by the fund.

Dr. Kochard then introduced Sarah Teslik, Executive Director of Council of Institutional Investors (CII). Ms. Teslik thinks that while the majority of corporations are well run, she believes that reforming the process of selecting and retaining corporate directors would make a huge difference. There are many mechanisms currently in force to ensure a company is running smoothly, and maintains that when companies are watched, they perform better. While the means to fix many of the problems can be expensive, Ms. Teslik suggested several ways in which investors can protect their money: (1) proxy power – vote as you see best; (2) purchasing power – get in and out of various stocks as necessary (i.e., won't invest in companies that IPO shares goes to CEOs); (3) litigation; (4) lobbying – use the regulatory process – be at the bargaining table when the regulations are being formulated.

Ms. Teslik stated that CII currently has 250 members (of which 150 are pension funds), a number that continues to grow over time. She advised that the full membership approves policy and requires a majority vote. While CII doesn't recommend how to vote proxies, it does issue guidelines although members

are not bound to follow the guidelines. Each Fund gets one vote. Membership fees are determined by the size of the Fund. When questioned about what other pension funds are doing regarding corporate governance, it was stated that Calpers gets the most press and Wisconsin has the strongest litigation program.

In response to questions about staffing issues, Ms. Teslik stated that access to CII's research could eliminate the need for in-house staffing.

CII currently has two meetings per year in which most members participate (that will likely be reduced to a yearly meeting). Officers are elected yearly by the general membership, but that will soon become a constituency-based election.

Ms. Teslik advised that for pension funds to interact with the SEC, there should be an entity (such as CII) that is continually alerted to the various issues. She also advised that pension funds should participate.

Stephanie Hamlett then introduced Mary Morris of the Kaplan Fox law firm, a securities class action law firm. Robert Kaplan, Donald Hall, and Frederic Fox also participated in the presentation.

Robert Kaplan advised that recoveries are higher in a class action suit, if the lead plaintiff is a significant institutional investor, such as VRS. He advised that you can only be lead plaintiff five times in a three year period. Class members recover the same as lead plaintiff, but there are several benefits as lead plaintiff – selecting counsel of choice, exercising control over both the prosecution and recovery of the case, ensuring recovery is maximized, having input into the terms of settlement (i.e., including corporate governance issues) and having the ability to recover reasonable costs and expenses associated with the litigation.

In response to questions, no study or systematic evidence appears to be available on the determinants of recovery size.

As a monitoring tool (and usually in conjunction with a custodian bank), Kaplan Fox helps identify companies that may be candidates for legal action from large institutional shareholders such as VRS. If merited, a case is filed and notice published within 20 days. Within 60 days of publication, a lead plaintiff must be selected.

Robert Kaplan claimed that their monitoring service could maximize recoveries, and ensure that claims are identified, filed and collected. Their firm will then advise how to proceed in litigation and coordinate with the client's custodian to monitor trades and follow pending cases.

In determining counsel selection, Mr. Kaplan advised VRS to consider the reputation, philosophy, experience, responsiveness, accessibility, monitoring services and fees of the firm.

Kaplan Fox discussed VRS' consideration of the use of counsel for monitoring purposes as an evaluation tool for lead plaintiff status.

Dr. Kochard noted that Mellon Bank advises VRS of settlements and ensures our share of proceeds.

Adjournment There being no further business before the Task Force, the meeting was adjourned at 2:35 p.m.

Mark Crain

A meeting of the Corporate Governance Task Force of the Virginia Retirement System was held on December 19, 2002 with the following members present:

Mark Crain, Chair
Woody Jackson, Jr.
Ruffin King, IV
Steven Markel
Owen B. Pickett, Esq.
Paul W. Timmreck
Nancy Everett
Larry Kochard
K. C. Howell
Patti Atkins-Smith

The following VRS staff was also in attendance: Forrest Matthews, Jeanne Chenault and Phyllis Henderson. Al Samper and Douglas Conway, Jr. of the Board of Trustees, Tricia Bishop of JLARC, Stephanie Hamlett of the Attorney General's office, Amy Harkins and Irene Speridakos of Mellon Global Security Services were also in attendance.

The meeting was called to order at 12:15 p.m.

The minutes of the November 21, 2002 meeting were reviewed and discussed. A motion was made by Mr. Pickett and seconded by Mr. Jackson to approve the minutes (as revised) of the November 21, 2002 meeting. The minutes were unanimously approved. It was also discussed that the Task Force minutes may be put on the VRS website. There was no opposition to this idea from the Task Force.

Dr. Kochard introduced Amy Harkins, First Vice President and Director of Mellon Global Securities Services Global Asset Servicing Division. Ms. Harkins explained Mellon's participation in corporate governance once a class action has been settled. She explained that as custodian, this participation is included in VRS' contract. Steven Markel entered the meeting at 12:20 p.m.

She explained that because of the normal custodial services that Mellon provides VRS, their knowledge of our fund is more comprehensive. She advised that Mellon does no initiation services -- their participation starts once a statement of settlement is noted. She explained that once Mellon is advised of a settlement from a Claims Administrator, they perform research to determine the filing requirements; clients are then advised of their eligibility, claims are submitted to the Administrator, and correspondence from the Administrator is continually reviewed and responded to. Mellon will continue to monitor through the distribution of proceeds for all eligible clients.

When questioned about the likelihood that Mellon might miss a class action, she advised that Mellon is on a generic list of those being advised of class actions as well as their meeting monthly with claims administrators. She also advised that if Mellon were to miss a class action notification, that they assume the responsibility and will pay it to the client.

When questioned about hiring another firm to do this kind of work in lieu of Mellon doing it, Ms. Harkins advised that the firm would still need to go through Mellon for any necessary information and is charged for the information.

Ms. Harkins advised that Mellon has streamlined and revamped its program to be as efficient as it is today.

Mellon continues to track class action suits until payout, at which time, they retain 2% of cash proceeds.

She advised the Task Force that Mellon offers several reports to their clients that can be obtained for a fee (i.e., pending class action claims, claim filing deadlines, etc.)

The Task Force discussed VRS using a “two prong” approach to class actions – to use both a monitoring service and Mellon. There was also discussion concerning the claims made by securities lawyers that settlements are larger when large lead plaintiffs file suits. Dr. Kochard reminded the Task Force that they had seen no compelling evidence supporting this claim.

Stephanie Hamlett of the Attorney General’s office began her presentation of securities litigation. She advised that many law firms say litigation is a valid method to recover funds. She noted that suits are being filed simply to get a “piece of the action”. Ms. Hamlett suggested that VRS consider the cost of litigating and the venue in which to file (state or federal court). It was noted that while more actions are being filed in state court (because it is easier to make your case), some of these cases are being remanded back to the federal court system.

Developing procedures and methodologies within VRS for class action participation was discussed. A suggestion of retaining counsel to monitor potential cases and advise VRS as how to proceed was discussed. The Attorney General’s office could screen the recommendations of outside counsel, and present recommendations to VRS. At this point, a presentation could be made to the Board as to VRS’ participation in the class action. Discussion was also held concerning setting a guideline for economic loss before the possibility of proceeding in any legal action.

Concerning the hiring of outside counsel to do monitoring, Ms. Hamlett feels that is a good route to go since the firm itself would have a vested interest. When questioned about the risk to VRS for not taking the advice of counsel, Ms. Hamlett feels that our fiduciary responsibility would be met simply by having a monitoring process. It is the Attorney General’s office that ultimately makes the decision whether to file a suit or not and the hiring of counsel would be done through a request for proposal (RFP) to law firms.

Dr. Kochard intends to have a draft recommendation to be discussed by the Task Force at its January meeting. A tentative February date will be chosen in the event an extra meeting is needed.

Other Business There was general conversation concerning VRS joining the Counsel of Institutional Investors (CII). Ms. Everett advised that VRS had been a member of CII, and then quit. At that time VRS was less involved in corporate governance issues and there was a concern that VRS could not differentiate itself from other CII recommendations in which VRS did not share the same opinion. She feels that CII is much more mainstream now and that it would be to our benefit to join CII because it could give us a voice in many issues. It does not currently go against any of VRS’ policies.

No one among the Task Force was opposed to VRS joining CII and suggests that the Board be advised of its benefits.

Patti Atkins-Smith then passed out handouts regarding Legislative and Regulatory Reforms for 2002.

Adjournment There being no further business before the Task Force, the meeting was adjourned at 2:40 p.m.

Mark Crain

A meeting of the Corporate Governance Task Force of the Virginia Retirement System was held on January 23, 2003 with the following members present:

Mark Crain, Chair
Woody Jackson, Jr.
Ruffin King, IV
Steven Markel
Owen B. Pickett, Esq.
Paul W. Timmreck
Nancy Everett
Larry Kochard
K. C. Howell
Patti Atkins-Smith

The following VRS staff were also in attendance: Forrest Matthews, Jeanne Chenault and Phyllis Henderson. Al Samper, Douglas Conway, Jr. and Ray Wallace of the Board of Trustees, and Stephanie Hamlett of the Attorney General's office were also in attendance.

The meeting was called to order at 12:15 p.m.

The minutes of the December 19, 2002 meeting were reviewed and discussed. A motion was made by Mr. Pickett to approve the minutes of the December 19, 2002 meeting. The minutes were unanimously approved.

The purpose of this meeting was to discuss and to agree upon changes to be made to the working draft of the Corporate Governance Report. The final Report should be submitted to the Board of Trustees on February 20, 2003. While staff will be making the suggested changes to the Report, for purposes of the Minutes, only general comments are listed below:

There was a general discussion regarding how specific to make the proposed corporate governance policy statement within the Report. It was agreed by the Task Force to keep the policy of a broader nature and that the Report should include proposed guidelines to add more detailed procedures.

The mention of "ISS" as the proxy voting entity should be less specific because upon annual review, VRS may find a firm whom it feels is better suited for the task. It was suggested that an evaluation of the proxy-voting provider be done at least annually.

It was discussed that the proxy voting results of investment managers and the proxy voting service provider should be reviewed annually with the Board.

It was determined that the section on Securities Litigation will be changed to Section IV to keep in format with the Executive Summary.

Ms. Hamlett again stressed her view of the necessity of having a monitoring service, at least temporarily. Based on her research into the subject of fees for this program, almost without exception, law firms will do the monitoring at no cost with the hope that at some point, an investor will engage them for their legal expertise.

The question was asked regarding liability of the Board if a monitoring service suggests we file a suit and we choose not to. Ms. Hamlett feels this risk is outweighed by the risk of not doing anything because of other actions out there

and the difficulty in evaluating them. Ms. Hamlett feels that monitoring will not be forever -- this is a wave that will eventually die down.

It was also stated that perverse reactions could happen from litigation and to be cautious in choosing this route. It was strongly suggested that this be discussed in the final version of the Report.

There was discussion concerning the addition of language that would clarify VRS' intent -- to pursue an action in the event of wrongdoing or corruption.

It was recommended that the word "will" be replaced by the word "should" throughout the Report.

It was agreed that the format of the Task Force recommendations would be the Executive Summary; an analysis and discussion of the issues; recommended policies with supporting guidelines; biographies of task force members; summary/bios of experts; a bibliography and copies of the minutes.

It was determined the section "VRS as a Long-term Investor" will be changed to Section III to keep in format with the Executive Study. It was discussed that while it is good to be actively involved, we are not certain that VRS can do this on a cost effective basis and therefore we may have a need for the help of outside organizations. It was also considered that this section could be an implementation strategy. The consensus of the Task Force was to only join organizations in which VRS would actively participate because the goal is to have input with organizations that have a voice.

There was a comment to define "separate" and "commingled" funds.

Dr. Crain advised the Task Force that it was their objective to give the report to the Board by February 20, 2003 and, to his knowledge, there was no deadline for the Board to act upon the recommendations.

Adjournment There being no further business before the Task Force, the meeting was adjourned at 2:40 p.m.

Mark Crain

RATING CORPORATE GOVERNANCE

GMI's ratings are based on a set of 600+ metrics drawn from securities regulations, codes of best practice, listing requirements of major stock exchanges and the experiences of our partners who include corporate advisors, shareholder advisors, and widely recognized corporate governance experts. We also have had input on our ratings system from corporate officers, directors and a group of institutional investors with a collective \$3 trillion in assets under management. The metrics fall into seven broad categories:

- Board Accountability
- Executive Compensation
- Corporate Behavior and Social Responsibility Issues
- Financial Disclosure and Internal Controls
- Market for Control
- Shareholder Rights
- Shareholder Base

All seven sections are independently scored, making GMI's ratings flexible and easy to use. The ratings themselves are generated through a sophisticated patent-pending algorithm that utilizes asymmetric geometric scoring thereby reflecting investor sensitivity to "outlier" events. In addition to an overall rating and the section ratings, each company report features several pages of written analysis. Companies are scored relative to all those in our universe on a scale of 1 (lowest) to 10 (highest). Once coverage of non-US companies is instituted, all companies will be rated against the overall universe and how each compares to others in its country of domicile.

What You Will Learn

The past year has produced spectacular corporate disasters in the United States: Enron, WorldCom, Tyco and Adelphia to name a few. In several instances criminal activity has been alleged, but first and foremost these were corporate governance failures. Further, this was not just an American phenomenon; Railtrak in Britain, HIH and One Tel in Australia and Phillip Holzmann in Germany are similar examples. Often the signs of potential problems were evident in the practices of these companies and in their public filings with regulators. But few investors undertook the necessary detailed research nor had the breadth of data from which to draw conclusions about accepted practice. GMI provides this research and analysis.

Even with the passage of fresh legislation (e.g., the Sarbanes-Oxley Act in the US) and introduction of new stock exchange listing requirements (e.g., NYSE, NASDAQ and the London Stock Exchange), serious governance issues remain in more than a few of the world's most widely traded companies. For example, within today's S&P 500 you will find:

- One company where the Chairman and CEO and his son, who is also a director and Secretary control 92.9% of the voting power of the company. The two are able to elect all members of the board and effectively control all actions taken by shareholders. The company's three classes of stock include two classes of tracking stock. Holders of the two classes of tracking stock have no voting rights and are unable to influence the management or focus of the business.
- Another where a \$17 million loan was provided to a board member

when he was named CEO of a joint venture partially controlled by the company. The company has recourse to only 50% of the loan.

- Interlocked directorships involving CEO's and former CEO's of S&P 500 companies.
- A company in which the voting rights on common shares increase based on time held.
- Surprisingly large levels of potential dilution (e.g. 20%+) when shares available for grant but not yet granted are added to options outstanding in industries where you wouldn't expect to find it.
- One company in which the Board of Directors met only once and acted eleven times by unanimous written consent last year.
- A company where lock-in provisions for the charter and by-laws are set so high (80 percent of outstanding shares) that even a company-sponsored proposal to declassify its board failed to achieve the requisite vote.
- And at the other end of the spectrum, one company whose exceptionally broad disclosure of its ethics policies and outstanding 28 point corporate governance policy are published on its web-site, indicating a progressive and high-minded board.
- At another progressive company, an Audit Committee that doesn't just review quarterly financial statements prior to their release; the committee or the committee Chairman also discusses earnings press releases and earnings guidance provided to analysts and rating agencies with the management and independent auditor prior to their release.

The GMI Ratings Product

The opening screen lists all companies in our universe. Rating type refers to whether the rating is Basic – that is – developed from publicly disclosed data, or Comprehensive which involves GMI review of internal company documents and interviews with management and directors. These are more detailed analyses.

Real World Comparisons

An important feature of GMI's ratings is that they are relational and grounded in the real world. We understand that institutional investors are comparing opportunities for investment against each other, not against some gold standard.

Currently, our universe is limited to US companies. But by year-end, 2003, we expect to be rating companies worldwide. We will add companies to the universe throughout the year.

When a subscriber clicks through to a company the following screen appears – Note XYZ Capital is a fictional enterprise although some of the features described exist in companies today.

GovernanceMetrics International								
PIONEERING ACCOUNTABILITY RATINGS								
About GMI	Ticker	Company	Rating	Type	Country	Index	Market Cap	Industry
Products & Services	XYZ	XYZ	5.5	Basic	USA	S&P 500	\$32.5B	Financial Services
Company Ratings	ABC	Media Ltd.	8.5	Comprehensive	UK	FTSE 100	\$18 B	Entertainment Media
Overview	DEF	Dei Trucks KK	3.5	Basic	Japan	Nikkei 225	\$56 B	Autos
Browse All Ratings	GHI	Alfa Fin. SA	6.5	Basic	France	CAC40	\$14 B	Financial Services
Browse New Ratings	JKL	J.J. Sporting Inc.	9.0	Basic	USA	S&P 500	\$21 B	Retail

Refers to depth of analysis

GovernanceMetrics International	
PIONEERING ACCOUNTABILITY RATINGS	
Home > Company Ratings > Browse All Ratings > Company Detail	
XYZ Corp	
Basic	Comprehensive
100 Main Street Indianapolis, ID United States www.xyz.com	
Overall Rating* 4.5 Board Accountability 5.0 Disclosure 6.0 Shareholder Rights 4.0 Remuneration 5.0 Market for Control 3.5 Shareholder Base 3.0 Corporate Behavior 6.0	
Primary Listing: NYSE (XYZ) Market Cap: \$32.5B (as of 09/12/02) Industry: Financial Services Incorporated: Indiana Board of Directors Board Committees John Q. Doe, Corporate Secretary, +1 317 55 0000 Jane F Simpson, VP Investor Relations, +1 317 555 000	
<p>XYZ's overall governance profile suggests an emphasis on financial ties rather than traditional governance safeguards. An outside strategic investor, Thomas Watson, holds a sizable equity position in the company that represents more than seven percent of the voting power of the company. The company's stated goals and the CEO's remuneration plans are clearly focused on shareholder value.</p> <p>However, governance at the board level is meant to ensure that other checks and balances are in place besides pure financial motivation. On this count, XYZ disappoints. Shareholders face significant potential dilution from equity-based compensation plans. The board does not have a nominating or governance committee. It does not undertake director evaluations. Other than for the purposes of determining bonuses the board does not provide a formal review of CEO performance.</p> <p>Shareholders are protected by a fair price requirement in the event of a successful tender offer but may not act by written consent or call a special meeting. A "stakeholder" clause under Indiana state law allows the XYZ board wide discretion in a takeover situation.</p> <p>Last, XYZ is subject to a number of distracting and potentially expensive lawsuits involving both current and former company officers and directors.</p>	
Market for Control 3.5 XYZ does not have a shareholder rights plan ("poison pill") in place but it is covered by Indiana's stakeholder clause. This clause allows a board of directors to consider the interests of employees, the local community and other stakeholders in addition to the financial interests of company shareholders when presented with a takeover offer. As such it can act as a deterrent to a takeover even advocated by a majority of shareholders. XYZ is also covered by a fair price provision to promote equal treatment of all shareholders in the event of a successful tender offer. This is viewed as a positive protection by GMI and by most shareholders. In addition to a potent tender offer defense, XYZ's board is also well protected from a proxy contest for control. The board is divided into staggered terms, with each director serving a three-year term and shareholders have neither the ability to call a special meeting nor can they act by written consent. Written consent is allowed in theory but since it would require the consent of all shareholders it's an impossible standard as a practical matter. The size of the board is fixed between a reasonable range of five to fourteen (there are now nine directors) but since the board has the power to amend the by-laws on its own this is in effect moot should the board decide to alter its size in the event of a contested election.	
Shareholder Base 3.0 One of the most distinguishing features of XYZ's overall governance profile is its shareholder base. Two outside directors, David Harry, and Thomas Watson, control 7.8 percent of the voting power of the company via the Series F Common-Linked Convertible Preferred Stock owned by Wilson Ventures. Harry and Watson are officers of Wilson Ventures. Officers and directors as a group control 10.8 percent of the voting power of the company when warrants and options exercisable within sixty days are included in their holdings. Potential dilution from stock options outstanding is a real concern at XYZ. Potential dilution was in fact the subject of three shareholder proposals at XYZ's 2001 annual meeting. Outstanding options represent 12 percent of the weighted average number of common shares outstanding in the last fiscal year. When options and other equity-based awards approved for grant but not yet granted are included, potential dilution from option programs amount to a whopping 23.8 percent of the weighted average number of common shares outstanding in the last fiscal year.	

Provides a daily update on governance developments at the company

Red flag signifies GMI ALERT

Click through to see who directors and committee members are



GMI — PIONEERING ACCOUNTABILITY RATINGS

Investors know that enterprises that are accountable and transparent produce greater value and less risk. The simple and proven way to test whether a company meets a certain standard is through an objective rating score.

GovernanceMetrics International offers investors a new way to understand and quantify corporate governance risk. Our rating system, developed and tested over the past two and a half years, highlights companies that have poor governance attributes, identifies problem areas in companies with otherwise acceptable governance profiles and spotlights those companies that have strong governance architecture.

Our system is comprehensive and timely, it is not for a once a year proxy voting decision. Governance developments at companies are recorded daily and ratings are updated regularly.

Why Subscribe to GMI Ratings

- GMI Ratings can help you avoid corporate governance disasters.
- After the past year investors now more fully appreciate that governance matters. According to a McKinsey Study in July 2002, investors now regard corporate governance as equal to financial performance in making an investment decision.
- Large pension funds are demanding that their managers review the governance of companies in portfolios they manage on their behalf.
- Risks still abound. New laws, regulations and listing rules are an improvement but they are not a panacea. For investors, corporate governance uncertainty equals risk. GMI's ratings reduce uncertainty.
- You may be overlooking companies with good financial performance and excellent governance. Our ratings help you identify potential out-performers as well as companies that have a reasonable governance profile overall but one or two worrisome attributes that could cause concern to investors.
- The service is flexible and easy to use and includes data from lots of sources in one place. Further, it is reasonably priced. Starting at \$18,000 per annum, it is a small price to pay if it helps you avoid even one governance failure in your portfolio.



How to Subscribe

Contact Gavin Anderson at GovernanceMetrics International, 275 Madison Avenue, Suite 3300, New York, NY 10016. Telephone: (212) 490-9266. Email at: ganderson@gmiratings.com

RATING CORPORATE GOVERNANCE

The board met 29 times in 2001 and all directors attended at least 75 percent of all board meetings and meetings of the committees on which they served. The unusually large number of meetings last year was directly related to the company's financial restructuring and management changes. However, there is no mention of director evaluations in XYZ's public filings or web-site. Other than reviews by the remuneration committee to determine annual bonuses, the board does not provide formal annual performance review of the CEO or any other member of senior management.

Board
Accountability

XYZ's audit and audit committee charter conform to normal standards. Like many companies, XYZ uses its outside auditors for non-audit services. Fees paid to PricewaterhouseCoopers for non-audit services exceeded audit fees in the last fiscal year (\$3.4M compared to \$2.6M). While this is something shareholders should be aware of, XYZ does not provide additional details concerning the fees for non-audit services. A more useful breakdown would be to compare audit and audit-related fees to fees for all other services.

Financial
Disclosure
and Internal
Controls

XYZ scores below average in this section of our analysis. The company has dual class voting: Series H Common-Linked Convertible Preferred Stock has ten votes per share. Shareholders do not have the right to call a special meeting or act by written consent. Indiana state law calls for 100 percent of the shareholders to agree in order to act by written consent, an impossible standard to meeting in practice. XYZ also does not offer confidential voting to its shareholders.

Shareholder
Rights

Starting with fiscal 2001, XYZ will move from a discretionary management bonus program to a pay-for-performance program. Each officer will have goals for the year based on a combination of corporate and individual performance. Despite clearly aligning his interests with shareholders, the sheer size of the CEO's remuneration package has generated considerable attention and criticism from some quarters. He received a \$20 million cash payment at signing, which amount was partial compensation for benefits he was for-

Executive
Compensation

XYZ does not have a shareholder rights plan ("poison pill") in place but it is covered by Indiana's stakeholder clause. This clause allows a board of directors to consider the interests of the community and other stakeholders in addition to the financial interests of shareholders when proposing a takeover offer. As such it can be seen as a positive protection to promote equal treatment of all shareholders in the event of a successful tender offer. This is viewed as a positive protection by GMI and by most shareholders.

Market for
Control

One of the most distinguishing features of XYZ's overall governance profile is its shareholder base. Two outside directors, David Harry and Thomas Watson, control 17.8 percent of the voting power of the company via the Series H Common-Linked Convertible Preferred Stock. XYZ was acquired by Wilson Ventures, O'Connell and Associates as a group control 10.8 percent of the voting power of the company when warrants and options exercisable within sixty days are included in their holding. Potential dilution from stock options outstanding is a real concern at XYZ.

Shareholder
Base

Pending litigation is both an important proxy for measuring corporate behavior and a potential source of financial business risk. XYZ Finance has been served with various class actions on behalf of persons or entities who purchased common stock or options to purchase common stock of XYZ Finance from February 1995 to January 1998. Certain current and former officers and directors of XYZ Finance are also named as defendants in one or more of the lawsuits. Plaintiffs allege that XYZ Finance and the other defendants violated federal securities laws by, among other

Corporate
Behavior
and
SRI Issues

Appendix B

**ISS Proxy Voting
Guidelines
Summary**

ISS Proxy Voting Guidelines Summary

The following is a condensed version of all proxy voting recommendations contained in The ISS Proxy Voting Manual.

The Board of Directors (Chapter 3)

Voting on Director Nominees in Uncontested Elections

Votes on director nominees should be made on a case-by-case basis, examining the following factors: composition of the board and key board committees, attendance at board meetings, corporate governance provisions and takeover activity, long-term company performance relative to a market index, directors' investment in the company, whether the chairman is also serving as CEO, and whether a retired CEO sits on the board. However, there are some actions by directors that should result in votes being withheld. These instances include directors who:

- Attend less than 75 percent of the board and committee meetings without a valid excuse
- Implement or renew a dead-hand or modified dead-hand poison pill
- Ignore a shareholder proposal that is approved by a majority of the shares outstanding
- Ignore a shareholder proposal that is approved by a majority of the votes cast for two consecutive years
- Have failed to act on takeover offers where the majority of the shareholders have tendered their shares
- Are inside directors and sit on the audit, compensation, or nominating committees

- Are inside directors and the full board serves as the audit, compensation, or nominating committee or the company does not have one of these committees

In addition, directors who enacted egregious corporate governance policies or failed to replace management as appropriate would be subject to recommendations to withhold votes.

Separating Chairman and CEO

Vote on a case-by-case basis on shareholder proposals requiring that the positions of chairman and CEO be held separately.

Proposals Seeking a Majority of Independent Directors

Shareholder proposals asking that a majority of directors be independent should be evaluated on a case-by-case basis. Vote for shareholder proposals asking that board audit, compensation, and/or nominating committees be composed exclusively of independent directors.

Stock Ownership Requirements

Vote against shareholder proposals requiring directors to own a minimum amount of company stock in order to qualify as a director or to remain on the board.

Term of Office

Vote against shareholder proposals to limit the tenure of outside directors.

Age Limits

Vote against shareholder proposals to impose a mandatory retirement age for outside directors.

Director and Officer Indemnification and Liability Protection

Proposals on director and officer indemnification and liability protection should be evaluated on a case-by-case basis, using Delaware law as the standard. Vote against proposals to eliminate entirely directors' and officers' liability for monetary damages for violating the duty of care. Vote against indemnification proposals that would expand coverage beyond just legal expenses to acts, such as negligence, that are more serious violations of fiduciary obligation than mere carelessness. Vote for only those proposals providing such expanded coverage in cases when a director's or officer's legal defense was unsuccessful if: (1) the director was found to have acted in good faith and in a manner that he reasonably believed was in the best interests of the company, and (2) only if the director's legal expenses would be covered.

Charitable Contributions

Vote against proposals regarding charitable contributions.

Proxy Contests (Chapter 4)

Voting for Director Nominees in Contested Elections

Votes in a contested election of directors must be evaluated on a case-by-case basis, considering the following factors: long-term financial performance of the target company relative to its industry; management's track record; background to the proxy contest; qualifications of director nominees (both slates); evaluation of what each side is offering shareholders as well as the likelihood that the proposed objectives and goals can be met; and stock ownership positions.

Reimburse Proxy Solicitation Expenses

Voting to reimburse proxy solicitation expenses should be analyzed on a case-by-case basis. In cases where ISS recommends in favor of the dissidents, we also recommend voting for reimbursing proxy solicitation expenses.

Auditors (Chapter 5)

Ratifying Auditors

Vote for proposals to ratify auditors, unless: an auditor has a financial interest in or association with the company, and is therefore not independent; or there is reason to believe that the independent auditor has rendered an opinion which is neither accurate nor indicative of the company's financial position.

Proxy Contest Defenses (Chapter 6)

Board Structure: Staggered vs Annual Elections

Vote against proposals to classify the board.

Vote for proposals to repeal classified boards and to elect all directors annually.

Shareholder Ability to Remove Directors

Vote against proposals that provide that directors may be removed only for cause.

Vote for proposals to restore shareholder ability to remove directors with or without cause.

Vote against proposals that provide that only continuing directors may elect replacements to fill board vacancies.

Vote for proposals that permit shareholders to elect directors to fill board vacancies.

Cumulative Voting

Vote against proposals to eliminate cumulative voting.

Vote proposals to restore or permit cumulative voting on a case-by-case basis relative to the company's other governance provisions.

Shareholder Ability to Call Special Meetings

Vote against proposals to restrict or prohibit shareholder ability to call special meetings.

Vote for proposals that remove restrictions on the right of shareholders to act independently of management.

Shareholder Ability to Act by Written Consent

Vote against proposals to restrict or prohibit shareholder ability to take action by written consent.

Vote for proposals to allow or make easier shareholder action by written consent.

Shareholder Ability to Alter the Size of the Board

Vote for proposals that seek to fix the size of the board.

Vote against proposals that give management the ability to alter the size of the board without shareholder approval.

Tender Offer Defenses (Chapter 7)

Poison Pills

Vote for shareholder proposals that ask a company to submit its poison pill for shareholder ratification.

Review on a case-by-case basis shareholder proposals to redeem a company's poison pill.

Review on a case-by-case basis management proposals to ratify a poison pill.

Fair Price Provisions

Vote proposals to adopt fair price provisions on a case-by-case basis, evaluating factors such as the vote required to approve the proposed acquisition, the vote required to repeal the fair price provision, and the mechanism for determining the fair price.

Generally, vote against fair price provisions with shareholder vote requirements greater than a majority of disinterested shares.

Greenmail

Vote for proposals to adopt antigreenmail charter of bylaw amendments or otherwise restrict a company's ability to make greenmail payments.

Review on a case-by-case basis antigreenmail proposals when they are bundled with other charter or bylaw amendments.

Pale Greenmail

Review on a case-by-case basis restructuring plans that involve the payment of pale greenmail.

Unequal Voting Rights

Vote against dual-class exchange offers.

Vote against dual-class recapitalizations.

Supermajority Shareholder Vote Requirement to Amend the Charter or Bylaws

Vote against management proposals to require a supermajority shareholder vote to approve charter and bylaw amendments.

Vote for shareholder proposals to lower supermajority shareholder vote requirements for charter and bylaw amendments.

Supermajority Shareholder Vote Requirement to Approve Mergers

Vote against management proposals to require a supermajority shareholder vote to approve mergers and other significant business combinations.

Vote for shareholder proposals to lower supermajority shareholder vote requirements for mergers and other significant business combinations.

White Squire Placements

Vote for shareholder proposals to require approval of blank check preferred stock issues for other than general corporate purposes.

Miscellaneous Governance Provisions (Chapter 8)

Confidential Voting

Vote for shareholder proposals that request companies to adopt confidential voting, use independent tabulators, and use independent inspectors of election as long as the proposals include clauses for proxy contests as follows: In the case of a contested election, management should be permitted to request that the dissident group honor its confidential voting policy. If the dissidents agree, the policy remains in place. If the dissidents do not agree, the confidential voting policy is waived.

Vote for management proposals to adopt confidential voting.

Equal Access

Vote for shareholder proposals that would allow significant company shareholders equal access to management's proxy material in order to evaluate and propose voting recommendations on proxy proposals and director nominees, and in order to nominate their own candidates to the board.

Bundled Proposals

Review on a case-by-case basis bundled or “conditioned” proxy proposals. In the case of items that are conditioned upon each other, examine the benefits and costs of the packaged items. In instances when the joint effect of the conditioned items is not in shareholders’ best interests, vote against the proposals. If the combined effect is positive, support such proposals.

Shareholder Advisory Committees

Review on a case-by-case basis proposals to establish a shareholder advisory committee.

Capital Structure (Chapter 9)

Common Stock Authorization

Review proposals to increase the number of shares of common stock authorized for issue on a case-by-case basis.

Vote against proposals to increase the number of authorized shares of the class of stock that has superior voting rights in companies that have dual-class capitalization structures.

Stock Distributions: Splits and Dividends

Vote for management proposals to increase common share authorization for a stock split, provided that the increase in authorized shares would not result in an excessive number of shares available for issuance given a company’s industry and performance in terms of shareholder returns.

Reverse Stock Splits

Vote for management proposals to implement a reverse stock split when the number of shares will be proportionately reduced to avoid delisting.

Review on a case-by-case basis on proposals to implement a reverse stock split that do not proportionately reduce the number of shares authorized for issue.

Preferred Stock

Vote against proposals authorizing the creation of new classes of preferred stock with unspecified voting, conversion, dividend distribution, and other rights (“blank check” preferred stock).

Vote for proposals to create blank check preferred stock in cases when the company expressly states that the stock will not be used as a takeover defense.

Vote for proposals to authorize preferred stock in cases where the company specifies the voting, dividend, conversion, and other rights of such stock and the terms of the preferred stock appear reasonable.

Vote case-by-case on proposals to increase the number of blank check preferred shares after analyzing the number of preferred shares available for issue given a company’s industry and performance in terms of shareholder returns.

Shareholder Proposals Regarding Blank Check Preferred Stock

Vote for shareholder proposals to have blank check preferred stock placements, other than those shares issued for the purpose of raising capital or making acquisitions in the normal course of business, submitted for shareholder ratification.

Adjustments to Par Value of Common Stock

Vote for management proposals to reduce the par value of common stock.

Preemptive Rights

Review on a case-by-case basis shareholder proposals that seek preemptive rights. In evaluating proposals on preemptive rights, consider the size of a company and the characteristics of its shareholder base.

Debt Restructurings

Review on a case-by-case basis proposals to increase common and/or preferred shares and to issue shares as part of a debt restructuring plan. Consider the following issues: Dilution—How much will ownership interest of existing shareholders be reduced, and how extreme will dilution to any future earnings be? Change in Control—Will the transaction result in a change in control of the company? Bankruptcy—Generally, approve proposals that facilitate debt restructurings unless there are clear signs of self-dealing or other abuses.

Share Repurchase Programs

Vote for management proposals to institute open-market share repurchase plans in which all shareholders may participate on equal terms.

Tracking Stock

Votes on the creation of tracking stock are determined on a case-by-case basis, weighing the strategic value of the transaction against such factors as:

- adverse governance changes
- excessive increases in authorized capital stock
- unfair method of distribution
- diminution of voting rights
- adverse conversion features
- negative impact on stock option plans
- other alternatives such as spinoff

Executive and Director Compensation (Chapter 10)

Votes with respect to compensation plans should be determined on a case-by-case basis.

Our new methodology for reviewing compensation plans primarily focuses on the transfer of shareholder wealth (the dollar cost of pay plans to shareholders instead of simply focusing on voting power dilution). Using the expanded compensation data disclosed under the SEC's new rules, ISS will value every award type. ISS will include in its analyses an estimated dollar cost for the proposed plan and all continuing plans. This cost, dilution to shareholders' equity, will also be expressed as a percentage figure for the transfer of shareholder wealth, and will be considered along with dilution to voting power. Once ISS determines the estimated cost of the plan, we compare it to a company-specific dilution cap.

Our model determines a company-specific allowable pool of shareholder wealth that may be transferred from the company to executives, adjusted for (1) long-term corporate performance (on an absolute basis and relative to a standard industry peer group and an appropriate market index), (2) cash compensation, and (3) categorization of the company as emerging, growth, or mature. These adjustments are pegged to market capitalization. ISS will continue to examine other features of proposed pay plans such as administration, payment terms, plan duration, and whether the administering committee is permitted to reprice underwater stock options without shareholder approval.

Management Proposals Seeking Approval to Reprice Options

Vote on management proposals seeking approval to reprice options on a case-by-case basis.

Director Compensation

Votes on stock-based plans for directors are made on a case-by-case basis.

Employee Stock Purchase Plans

Votes on employee stock purchase plans should be made on a case-by-case basis.

OBRA-Related Compensation Proposals

• Amendments that Place a Cap on Annual Grants or Amend Administrative Features

Vote for plans that simply amend shareholder-approved plans to include administrative features or place a cap on the annual grants any one participant may receive to comply with the provisions of Section 162(m) of OBRA.

• Amendments to Added Performance-Based Goals

Vote for amendments to add performance goals to existing compensation plans to comply with the provisions of Section 162(m) of OBRA.

• Amendments to Increase Shares and Retain Tax Deductions Under OBRA

Votes on amendments to existing plans to increase shares reserved and to qualify the plan for favorable tax treatment under the provisions of Section 162(m) should be evaluated on a case-by-case basis.

• Approval of Cash or Cash-and-Stock Bonus Plans

Vote for cash or cash-and-stock bonus plans to exempt the compensation from taxes under the provisions of Section 162(m) of OBRA.

Shareholder Proposals to Limit Executive and Director Pay

Generally, vote for shareholder proposals that seek additional disclosure of executive and director pay information.

Review on a case-by-case basis all other shareholder proposals that seek to limit executive and director pay.

Golden and Tin Parachutes

Vote for shareholder proposals to have golden and tin parachutes submitted for shareholder ratification.

Review on a case-by-case basis all proposals to ratify or cancel golden or tin parachutes.

Employee Stock Ownership Plans (ESOPs)

Vote for proposals that request shareholder approval in order to implement an ESOP or to increase authorized shares for existing ESOPs, except in cases when the number of shares allocated to the ESOP is “excessive” (i.e., generally greater than five percent of outstanding shares).

401(k) Employee Benefit Plans

Vote for proposals to implement a 401(k) savings plan for employees.

State of Incorporation (Chapter 11)

Voting on State Takeover Statutes

Review on a case-by-case basis proposals to opt in or out of state takeover statutes (including control share acquisition statutes, control share cash-out statutes, freezeout provisions, fair price provisions, stakeholder laws, poison pill endorsements, severance pay and labor contract provisions, antigreenmail provisions, and disgorgement provisions).

Voting on Reincorporation Proposals

Proposals to change a company’s state of incorporation should be examined on a case-by-case basis.

Mergers and Corporate Restructurings (Chapter 12)

Mergers and Acquisitions

Votes on mergers and acquisitions should be considered on a case-by-case basis, taking into account at least the following: anticipated financial and operating benefits; offer price (cost vs. premium); prospects of the combined companies; how the deal was negotiated; and changes in corporate governance and their impact on shareholder rights.

Corporate Restructuring

Votes on corporate restructuring proposals, including minority squeezeouts, leveraged buyouts, spinoffs, liquidations, and asset sales should be considered on a case-by-case basis.

Spinoffs

Votes on spinoffs should be considered on a case-by-case basis depending on the tax and regulatory advantages, planned use of sale proceeds, market focus, and managerial incentives.

Asset Sales

Votes on asset sales should be made on a case-by-case basis after considering the impact on the balance sheet/working capital, value received for the asset, and potential elimination of diseconomies.

Liquidations

Votes on liquidations should be made on a case-by-case basis after reviewing management's efforts to pursue other alternatives, appraisal value of assets, and the compensation plan for executives managing the liquidation.

Appraisal Rights

Vote for proposals to restore, or provide shareholders with, rights of appraisal.

Changing Corporate Name

Vote for changing the corporate name.

Mutual Fund Proxies (Chapter 13)

Election of Directors

Vote the election of directors on a case-by-case basis, considering the following factors: board structure; director independence and qualifications; and compensation of directors within the fund and the family of funds attendance at board and committee meetings.

Votes should be withheld from directors who:

- attend less than 75 percent of the board and committee meetings without a valid excuse for the absences. Valid reasons include illness or absence due to company business. Participation via telephone is acceptable. In addition, if the director missed only one meeting or one day's meetings, votes should not be withheld even if such absence dropped the director's attendance below 75 percent.
- ignore a shareholder proposal that is approved by a majority of shares outstanding
- ignore a shareholder proposal that is approved by a majority of the votes cast for two consecutive years
- are interested directors and sit on the audit or nominating committee
- are interested directors and the full board serves as the audit or nominating committee or the company does not have one of these committees.

Converting Closed-end Fund to Open-end Fund

Vote conversion proposals on a case-by-case basis, considering the following factors: past performance as a closed-end fund; market in which the fund invests; measures taken by the board to address the discount; and past shareholder activism, board activity, and votes on related proposals.

Proxy Contests

Vote proxy contests on a case-by-case basis, considering the following factors: past performance; market in which fund invests; and measures taken by the board to address the issues past shareholder activism, board activity, and votes on related proposals.

Investment Advisory Agreements

Vote the investment advisory agreements on a case-by-case basis, considering the following factors: proposed and current fee schedules; fund category/investment objective; performance benchmarks; share price performance as compared with peers; and the magnitude of any fee increase.

Approving New Classes or Series of Shares

Vote for the establishment of new classes or series of shares.

Preferred Stock Proposals

Vote the authorization for or increase in preferred shares on a case-by-case basis, considering the following factors: stated specific financing purpose and other reasons management gives possible dilution for common shares.

1940 Act Policies

Vote these proposals on a case-by-case basis, considering the following factors: potential competitiveness;

regulatory developments; current and potential returns; and current and potential risk.

Changing a Fundamental Restriction to a Nonfundamental Restriction

Vote these proposals on a case-by-case basis, considering the following factors: fund's target investments; reasons given by fund for change; and the projected impact of change on portfolio.

Change Fundamental Investment Objective to Nonfundamental

Vote against proposals to change a fund's fundamental investment objective to nonfundamental.

Name Rule Proposals

Vote these proposals on a case-by-case basis, considering the following factors: political/economic changes in target market; bundling with quorum requirements; bundling with asset allocation changes; and consolidation in the fund's target market.

Disposition of Assets/Termination/Liquidation

Vote this proposal on a case-by-case basis, considering the following factors: strategies employed to salvage the company; company's past performance; and terms of the liquidation.

Changes to the Charter Document

Vote changes to the charter document on a case-by-case basis, considering the following factors: degree of change implied by the proposal; efficiencies that could result; state of incorporation; and regulatory standards and implications.

Changing the Domicile of a Fund

Vote reincorporations on a case-by-case basis, considering the following factors: state regulations of both states; required fundamental policies of both states; and the increased flexibility available.

Change in Fund's Subclassification

Vote these proposals on a case-by-case basis, considering the following factors: potential competitiveness; current and potential returns; risk of concentration; and consolidation in the target industry.

Authorizing the Board to Hire and Terminate Subadvisors Without Shareholder Approval

Vote against these proposals.

Distribution Agreements

Vote these proposals on a case-by-case basis, considering the following factors: fees charged to comparably sized funds with similar objectives; proposed distributor's reputation and past performance; and competitiveness of fund in industry.

Master-Feeder Structure

Vote for the establishment of a master-feeder structure.

Changes to the Charter Document

Vote changes to the charter document on a case-by-case basis, considering the following factors: degree of change implied by the proposal; efficiencies that could result; state of incorporation; and regulatory standards and implications.

Mergers

Vote merger proposals on a case-by-case basis, considering the following factors: resulting fee structure; performance of both funds; and continuity of management personnel.

Shareholder Proposals

Establish Director Ownership Requirement

Vote against the establishment of a director ownership requirement.

Reimburse Shareholder for Expenses Incurred

Voting to reimburse proxy solicitation expenses should be analyzed on a case-by-case basis. In cases where ISS recommends in favor of the dissidents, we also recommend voting for reimbursing proxy solicitation expenses.

Terminate the Investment Advisor

Vote to terminate the investment advisor on a case-by-case basis, considering the following factors: performance of the fund's NAV and the history of shareholder relations.

Social and Environmental Issues (Chapter 14)

Energy and Environment

In most cases, ISS refrains from providing a vote recommendation on proposals that request companies to file the CERES Principles.

Generally, vote for disclosure reports that seek additional information, particularly when it appears companies have not adequately addressed shareholders' environmental concerns.

South Africa

In most cases, ISS refrains from providing a vote recommendation on proposals pertaining to South Africa.

Generally, vote for disclosure reports that seek additional information such as the amount of business that could be lost by conducting business in South Africa.

Northern Ireland

In most cases, ISS refrains from providing a vote recommendation on proposals pertaining to the MacBride Principles.

Generally, vote for disclosure reports that seek additional information about progress being made toward eliminating employment discrimination, particularly when it appears companies have not adequately addressed shareholder concerns.

Military Business

In most cases, ISS refrains from providing a vote recommendation on defense issue proposals.

Generally, vote for disclosure reports that seek additional information on military related operations, particularly when the company has been unresponsive to shareholder requests.

Maquiladora Standards and International Operations Policies

In most cases, ISS refrains from providing a vote recommendation on proposals relating to the Maquiladora Standards and international operating policies.

Generally, vote for disclosure reports on these issues, particularly when it appears companies have not adequately addressed shareholder concerns.

World Debt Crisis

In most cases, ISS refrains from providing a vote recommendation on proposals dealing with third world debt.

Generally, vote for disclosure reports on these issues, particularly when it appears companies have not adequately addressed shareholder concerns.

Equal Employment Opportunity and Discrimination

In most cases, ISS refrains from providing a vote recommendation on proposals regarding equal employment opportunities and discrimination.

Generally, vote for disclosure reports that seek additional information about affirmative action efforts, particularly when it appears companies have been unresponsive to shareholder requests.

Animal Rights

In most cases, ISS refrains from providing a vote recommendation on proposals that deal with animal rights.

Product Integrity and Marketing

In most cases, ISS refrains from providing a vote recommendation on proposals that ask companies to end their production of legal, but socially questionable, products.

Generally, vote for disclosure reports that seek additional information regarding product integrity and marketing issues, particularly when it appears companies have been unresponsive to shareholder requests.

Human Resources Issues

In most cases, ISS refrains from providing a vote recommendation on proposals regarding human resources issues.

Generally, vote for disclosure reports that seek additional information regarding human resources issues, particularly when it appears companies have been unresponsive to shareholder requests.

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Appendix C

ISS Global Proxy Voting Guidelines Summary

Financial Results/Director and Auditor Reports

Vote FOR approval of financial statements and director and auditor reports, unless:

- there are concerns about the accounts presented or audit procedures used; or
- the company is not responsive to shareholder questions about specific items that should be publicly disclosed.

Appointment of Auditors and Auditor Compensation

Vote FOR the reelection of auditors and proposals authorizing the board to fix auditor fees, unless:

- there are serious concerns about the accounts presented or the audit procedures used;
- the auditors are being changed without explanation; or
- nonaudit-related fees are substantial or are routinely in excess of standard annual audit fees.

Vote AGAINST the appointment of external auditors if they have previously served the company in an executive capacity or can otherwise be considered affiliated with the company.

ABSTAIN if a company changes its auditor and fails to provide shareholders with an explanation for the change.

Appointment of Internal Statutory Auditors

Vote FOR the appointment or reelection of statutory auditors, unless:

- there are serious concerns about the statutory reports presented or the audit procedures used;
- questions exist concerning any of the statutory auditors being appointed; or
- the auditors have previously served the company in an executive capacity or can otherwise be considered affiliated with the company.

Allocation of Income

Vote FOR approval of the allocation of income, unless:

- the dividend payout ratio has been consistently below 30 percent without adequate explanation; or
- the payout is excessive given the company's financial position.

Stock (Scrip) Dividend Alternative

Vote FOR most stock (scrip) dividend proposals.

Vote AGAINST proposals that do not allow for a cash option unless management demonstrates that the cash option is harmful to shareholder value.

Amendments to Articles of Association

Vote amendments to the articles of association on a CASE-BY-CASE basis.

Change in Company Fiscal Term

Vote FOR resolutions to change a company's fiscal term unless a company's motivation for the change is to postpone its AGM.

Lower Disclosure Threshold for Stock Ownership

Vote AGAINST resolutions to lower the stock ownership disclosure threshold below five percent unless specific reasons exist to implement a lower threshold.

Amend Quorum Requirements

Vote proposals to amend quorum requirements for shareholder meetings on a CASE-BY-CASE basis.

Transact Other Business

Vote AGAINST other business when it appears as a voting item.

Director Elections

Vote FOR management nominees in the election of directors, unless:

- there are clear concerns about the past performance of the company or the board;
or
- the board fails to meet minimum corporate governance standards.

Vote FOR individual nominees unless there are specific concerns about the individual, such as criminal wrongdoing or breach of fiduciary responsibilities.

Vote AGAINST shareholder nominees unless they demonstrate a clear ability to contribute positively to board deliberations.

Vote AGAINST individual directors if they cannot provide an explanation for repeated absences at board meetings (in countries where this information is disclosed)

Director Compensation

Vote FOR proposals to award cash fees to nonexecutive directors unless the amounts are excessive relative to other companies in the country or industry.

Vote nonexecutive director compensation proposals that include both cash and share-based components on a CASE-BY-CASE basis.

Vote proposals that bundle compensation for both nonexecutive and executive directors into a single resolution on a CASE-BY-CASE basis.

Vote AGAINST proposals to introduce retirement benefits for nonexecutive directors.

Discharge of Board and Management

Vote FOR discharge of the board and management, unless:

- there are serious questions about actions of the board or management for the year in question; or
- legal action is being taken against the board by other shareholders.

Director, Officer, and Auditor Indemnification and Liability Provisions

Vote proposals seeking indemnification and liability protection for directors and officers on a CASE-BY-CASE basis.

Vote AGAINST proposals to indemnify auditors.

Board Structure

Vote FOR proposals to fix board size.

Vote AGAINST the introduction of classified boards and mandatory retirement ages for directors.

Vote AGAINST proposals to alter board structure or size in the context of a fight for control of the company or the board.

Capital Systems

Companies have one of two main types of capital systems: authorized and conditional. Both systems provide companies with the means to finance business activities, but they are considerably different in structure. Which system is used by a company is determined by the economic and legal structure of the market in which it operates.

Share Issuance Requests

General Issuances:

Vote FOR issuance requests with preemptive rights to a maximum of 100 percent over currently issued capital.

Vote FOR issuance requests without preemptive rights to a maximum of 20 percent of currently issued capital.

Specific Issuances:

Vote on a CASE-BY-CASE basis on all requests, with or without preemptive rights.

Increases in Authorized Capital

Vote FOR nonspecific proposals to increase authorized capital up to 100 percent over the current authorization unless the increase would leave the company with less than 30 percent of its new authorization outstanding.

Vote FOR specific proposals to increase authorized capital to any amount, unless:

- the specific purpose of the increase (such as a share-based acquisition or merger) does not meet ISS guidelines for the purpose being proposed; or
- the increase would leave the company with less than 30 percent of its new authorization outstanding after adjusting for all proposed issuances.

Vote AGAINST proposals to adopt unlimited capital authorizations.

Reduction of Capital

Vote FOR proposals to reduce capital for routine accounting purposes unless the terms are unfavorable to shareholders.

Vote proposals to reduce capital in connection with corporate restructuring on a case by case basis

Capital Structures

Vote FOR resolutions that seek to maintain or convert to a one share, one vote capital structure.

Vote AGAINST requests for the creation or continuation of dual class capital structures or the creation of new or additional supervoting shares

Preferred Stock

Vote FOR the creation of a new class of preferred stock or for issuances of preferred stock up to 50 percent of issued capital unless the terms of the preferred stock would adversely affect the rights of existing shareholders.

Vote FOR the creation/issuance of convertible preferred stock as long as the maximum number of common shares that could be issued upon conversion meets ISS's guidelines on equity issuance requests.

Vote AGAINST the creation of a new class of preference shares that would carry superior voting rights to the common shares.

Vote AGAINST the creation of blank check preferred stock unless the board clearly states that the authorization will not be used to thwart a takeover bid.

Vote proposals to increase blank check preferred authorizations on a CASE-BY-CASE basis.

Debt Issuance Requests

Vote nonconvertible debt issuance requests on a CASE-BY-CASE basis, with or without preemptive rights.

Vote FOR the creation/issuance of convertible debt instruments as long as the maximum number of common shares that could be issued upon conversion meets ISS's guidelines on equity issuance requests.

Vote FOR proposals to restructure existing debt arrangements unless the terms of the restructuring would adversely affect the rights of shareholders.

Pledging of Assets for Debt

Vote proposals to approve the pledging of assets for debt on a CASE-BY-CASE basis.

Increase in Borrowing Powers

Vote proposals to approve increases in a company's borrowing powers on a CASE-BY-CASE basis.

Share Repurchase Plans

Vote FOR share repurchase plans, unless:

- clear evidence of past abuse of the authority is available; or
- the plan contains no safeguards against selective buybacks

Reissuance of Shares Purchased

Vote FOR requests to reissue any repurchased shares unless there is clear evidence of abuse of this authority in the past

Capitalization of Reserves for Bonus Issues/Increase In Par Value

Vote FOR requests to capitalize reserves for bonus issues of shares or to increase par value.

Reorganizations/Restructurings

Vote reorganizations and restructurings on a CASE-BY-CASE basis.

Mergers and Acquisitions

Vote FOR mergers and acquisitions, unless:

- the impact on earnings or voting rights for one class of shareholders is disproportionate to the relative contributions of the group
- the company's structure following the acquisition or merger does not reflect good corporate governance
-

Vote AGAINST if the companies do not provide sufficient information upon request to make an informed voting decision

ABSTAIN if there is insufficient information available to make an informed voting decision

Mandatory Takeover Bid Waivers

Vote proposals to waive mandatory takeover bid requirements on a CASE-BY-CASE basis

Reincorporation Proposals

Vote reincorporation proposals on a CASE-BY-CASE basis

Expansion of Business Activities

Vote FOR resolutions to expand business activities unless the new business takes the company into risky areas

Related-Party Transactions

Vote related-party transactions on a CASE-BY-CASE basis

Compensation Plans

Vote compensation plans on a CASE-BY-CASE basis

Antitakeover Mechanisms

Vote AGAINST all antitakeover proposals unless they are structured in such a way that they give shareholders the ultimate decision on any proposal or offer

Shareholder Proposals

Vote all shareholder proposals on a CASE-BY-CASE basis

Vote FOR proposals that would improve the company's corporate governance or business profile at a reasonable cost

Vote AGAINST proposals that limit the company's business activities or capabilities or result in significant costs being incurred with little or no benefit