Tax and Governance Havens:
International Incorporation Issues

Frequently Asked Questions
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Question: What does RiskMetrics Group Inc. (“RMG”) consider a “tax and governance haven,” and is that different than a “tax haven?”

Answer: A “tax and governance haven” is a market in which companies are incorporated with open and unrestricted tax and regulatory regimes. Tax and governance havens differ from what are traditionally dubbed “tax havens” in that they do not merely provide corporations shelter from taxation, but also allow said companies to qualify for corporate governance exemptions under the home market’s listing and regulatory standards.
A market is considered a tax and governance haven if it fulfills both of the following conditions:

1. There is an absence of a comprehensive or fixed corporate code of best practice; and
2. Company law and regulation is minimal and open, compared to developed markets, allowing considerable flexibility.

Most developed international markets have codes of corporate best practice. These guidelines, typically established by an association of local institutional investors and third parties in collaboration with relevant government entities, outline what is considered “best practice” regarding governance standards for corporations within a market. Tax and governance havens do not have established and concrete codes of best practice. Though some of these havens rely upon the codes of other markets, lacking established codes of their own, most of these markets have either no code of best practice or a very minimalist code. This absence of a standardized best practice code or authority gives a company incorporated in these markets great flexibility to structure itself around the codes and practices of its home market.

Similarly, corporate law and government regulation in these markets is very open and permissive, providing even further flexibility to companies. Many of these markets, like Bermuda, do not have a robust corporate law, which allows companies to adopt their home and/or listing market’s practice. Though the laws vary by market, most provide very limited corporate structure and are designed to accommodate the requirements of the often more stringent home market standards.

These two conditions provide a very malleable regulatory regime which distinguishes tax and governance havens from mere tax havens. It is this flexibility in corporate governance requirements on top of the less rigorous tax laws that make these markets appealing to major corporations.

**Question:** What markets does RMG consider tax and governance havens?

**Answer:** The following is a list of markets that RMG considers tax and governance havens:

- Anguilla
- Antigua/Barbuda
- Bahamas
- Barbados
- Bermuda
- Cayman Islands
- Guernsey
- Isle of Man
- Jamaica
- Jersey
- Liberia
- Marshall Islands
- Mauritius
- Monaco
- Netherlands Antilles
- Panama
- Virgin Islands (UK)

**Question:** What markets traditionally considered tax havens are not considered tax and governance havens listed above?

**Answer:** It should be noted that some countries that are traditionally considered tax havens are not included on this list as RMG does not consider them tax and governance havens.
The two primary examples are Switzerland and Luxembourg. These two markets do not fall into the category of tax and governance havens as they do not meet the two conditions listed above. Both Luxembourg and Switzerland have well-defined corporate laws and codes and do not offer the kind of governance flexibility that Bermuda or the Cayman Islands might. As such, these two markets fall under RMG’s international voting guidelines.

Another excluded market traditionally considered a tax haven is Ireland as this falls under the umbrella of the Combined Code on Corporate Governance of the U.K.

**Question:** What is RMG’s policy for proxy vote recommendations for these tax and governance havens?

**Answer:** In reviewing corporations within the tax and governance havens, which are often allowed various exemptions to their primary listing and disclosure standards, RMG applies a hybridized policy when evaluating proxies. This policy aims to hold companies to best practice and listing standards while still allowing foreign companies time to comply with changes in legislation. RMG relies upon home market and primary listing governance best practice standards alongside the mandatory standards to inform our analysis and vote recommendations, applying the most appropriate policy.

Given their natures as tax and governance havens, these markets are complex because they include companies that: (1) are U.S. companies incorporated offshore but which do not qualify for disclosure exemptions; (2) are Foreign Private Issuers (FPIs) but trade primarily in the United States; (3) are shipping companies that do not technically have operations or employees; (4) are U.S. listed companies with primary listings in their home country; or (5) are international companies listed in the home country but incorporated offshore.

RMG applies the most applicable hybrid policy to each type of company listed above, relying on local, home market, and listing standards and requirements. The tax and governance haven director election policy (below) best highlights the different approaches employed in evaluating these corporations.

**Director Elections**

RMG applies the most appropriate policy to these markets to hold companies to the applicable best practice and listing standards. Director elections are evaluated differently for each of the five types of companies in these markets:

- U.S. companies incorporated offshore which do not qualify for disclosure exemptions are evaluated under RMG’s U.S. policy on director elections. True U.S. companies should be held to the same standards as companies incorporated in the United States.

- Foreign Private Issuers who trade primarily in the United States are required to adhere to the following criteria:
  1. Majority independent board.
  2. Presence of Audit, Compensation, and Nominating Committees.
3. Entirely independent Audit, Compensation, and Nominating Committees.

An increasing number of companies are using the tax havens to access the United States as their exclusive trading market, and the listing standards for foreign private issuers became stricter as of July 2005. The main market indexes are increasingly considering these tax haven companies as U.S. entities.

- Shipping companies that do not technically have operations or employees are required to meet the following:
  1. Presence of Audit and Compensation Committees.*
  2. Entirely independent Audit and Compensation Committees.*

*An exception to the policy on Compensation Committees may be made if the company's disclosure is transparent about the existence and terms of third-party contracts. Disclosure regarding the operations and employees should also be provided.

- U.S. listed companies with a primary listing in their home country will be treated under RMG’s’ international director election policy. Such companies should possess:
  1. Presence of Audit and Compensation Committees.
  2. Entirely independent Audit and Compensation Committees.

Non-compliance with the outlined standards will result in a vote withheld from or against non-independent director nominees who serve on a board or committee that does not meet the above guidelines.

- International companies with a primary listing in their home country will be treated under RMG’s’ international director election policy. Such companies should possess:
  1. Presence of Audit and Compensation Committees.
  2. Entirely independent Audit and Compensation Committees.

Non-compliance with the outlined standards will result in a vote withheld from or against non-independent director nominees who serve on a board or committee that does not meet the above guidelines.

Question: How does this policy application approach differ from that applied in other markets?

Answer: RMG has a long-standing policy of analyzing companies based on their country of incorporation. A company’s country of incorporation determines the corporate law to which it must adhere, and is in most cases the primary determinate of the governance best practices and accepted market practices against which a company’s governance structure, oversight, remuneration policy, and other governance-related areas of shareholder interest may be reasonably measured. Although other factors such as industry and listing market are always considered on a case-by-case basis when analyzing companies that operate or list in multiple
jurisdictions, country of incorporation is used as the primary measure for most markets in order to assure an accurate, fair, sensible, and consistent application of policy worldwide. Please see our Web site for more information on RMG policy (www.riskmetrics.com).

The policy for tax and governance havens differs from those of other markets given the regulatory and best practice void in these havens. RMG applies a hybridized policy when evaluating proxies. This policy aims to hold companies to best practice and listing standards, while taking into consideration their special circumstances based on their country of incorporation. Please see the previous question for a detailed explanation on proxy research in these markets.

Question: Some U.S. companies are incorporated in other countries, including the tax and governance havens and those not deemed tax and governance havens by RMG, such as Switzerland. How are these companies treated?

Answer: Given increased globalization, an expanding number of companies are incorporating and listing in separate jurisdictions. For example, emerging-market companies might list in a higher-disclosure market to gain better access to capital. More recently, companies have also started to (re)incorporate away from tax and governance havens, such as Bermuda or the Cayman Islands, to markets with standalone economies and governance standards, such as Switzerland or Ireland, while maintaining their listing in another market.

Companies are required to meet the legal mandates of their country of incorporation, but many listed in other countries generally model their business around the listing standards and common practices of their home market.

RMG has a long-standing policy of analyzing companies based on their country of incorporation, while taking listing standards into consideration. RMG does not evaluate companies solely on the basis of their listing market. This can cause certain differences between company practice and RMG’s international policy.

Companies incorporated in markets other than the U.S. and the tax and governance havens are treated as international companies, to which RMG’s international policy is applied. This policy holds companies to different standards than the U.S. policy, especially on compensation, director elections, and capital authorizations.

Question: How are compensation plans evaluated for these U.S. companies incorporated in other countries, including the tax and governance havens and those not deemed tax and governance havens by RMG, such as Switzerland?

Answer: Compensation is one of the areas with the most significant difference in policy.

For the U.S. policy, RMG has developed a proprietary, quantitative approach to evaluating stock-based compensation proposals that is unique in the industry, utilizing a binomial option-pricing model to estimate the cost (measured as “Shareholder Value Transfer” or “SVT”) of a company's stock-based incentive programs. The estimated cost of the proposal, in conjunction with the cost of the company's other equity plans, is compared to a company-specific allowable
The allowable cap is industry-specific, market cap-based, and pegged to the average amount paid by companies performing in the top quartile of their peer groupings.

If the SVT exceeds the allowable cap, RMG will recommend a vote against the plan. SVT is measured using the binomial model that assesses the amount of shareholders’ equity flowing out of the company to employees and executives as options are exercised. An estimated dollar value for each award is determined by factoring award features into an option pricing model to determine the potential plan cost.

The model has 12 inputs. Eight of these inputs account for the core valuation and ranked by sensitivity are:

1) dividend yield  5) risk-free interest rate
2) stock volatility  6) option term
3) stock price  7) expected stock return
4) option exercise price  8) vesting provisions

The remaining five variables result in minor adjustments to the core valuation:

8) vesting provisions  11) employee’s tax rate
9) employee’s non-option wealth  12) earnings dilution
10) employee’s risk aversion

The U.S. policy also closely examines repricing guidelines, CEO pay vs. company performance, and the three-year average burn rate of the plan relative to industry peers.

The general international policy, on the other hand, is to recommend votes against a proposed option grant if the maximum dilution level under the plan exceeds 5 percent of issued capital for a mature company and 10 percent for a growth company.

While the international policy appears “stricter” because of its emphasis on dilution, the U.S. policy is a much more balanced and in-depth examination of compensation. However, due to inconsistent disclosure issues, differing comparator groups, different governance standards, and various other obstacles, RMG cannot consistently apply the binomial model to international companies, and so does not. RMG is not willing to apply only aspects of one policy in other markets on an ad-hoc basis.

Therefore, though companies may be listed in the U.S. and have U.S.-style structures, disclosure, and compensation plans, those not incorporated in the U.S. or the tax and governance havens are held to the international policy’s standards. The tax and governance havens serve as the sole exception, due to their open nature described in question one.

**Question: Has RMG considered adopting the country of listing standard for proxy research?**

**Answer:** RMG has closely considered this issue, and compared the merits of both the listing and incorporation standards. In the 2009 annual policy survey, RMG solicited feedback through two parallel surveys, one for institutional investors and one for issuers, regarding this issue.
Of those institutions that responded, 21.4 percent favored applying requirements for the company's primary listing market, 12.2 percent favored applying requirements for the country of incorporation, 60.3 percent favored applying whichever standard is the stricter, and 6.1 percent specified another standard.

Of issuers that responded, 49.4 percent favored applying requirements for the company's primary listing market, 14.4 percent favored applying requirements for the country of incorporation, 27.3 percent favored applying whichever standard is the stricter, and 8.8 percent specified another standard.

Based on these results, there appears to be no consensus on this issue. As corporations continue to have more and more global operations, and seek to maintain profitability through advantageous domiciles, there may in the future be a need by clients for RMG’s Governance Research to adopt a new standard, whether that be a listing-market or hybridized approach. RMG will continue to research, monitor, and continually assess the situation.