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**Living with the New GRId 2.0 and Maryland Law Issues**

In 2010, Institutional Shareholder Services Inc. (“ISS”) introduced Governance Risk Indicators (“GRId”), a scoring tool designed to assess levels of risk in a company’s corporate governance. We reviewed and discussed GRId at that time. ([See “RiskMetrics Introduces New Corporate Governance Rating System,” Mar. 9, 2010.](#))

As many of you know, the GRId scoring process began with approximately 60 questions for each company across four corporate governance categories – *Audit, Shareholder Rights, Compensation* and *Board*. ISS assigned higher scores to policies that it considered best practices. After weighting and summing the scores in each category, ISS assigned each of the four categories a level of concern – Low, Medium or High.

Beginning on March 5, 2012, ISS will introduce GRId 2.0 and rescore every Russell 3000 company. The basic approach will remain the same: For each of the four categories, the answers to a series of questions will be scored and tabulated, yielding a Low, Medium or High concern level for that category. Like GRId 1.0 (which is how ISS now refers to the former system), GRId 2.0 will be based *solely* on information that is filed with the Securities and Exchange Commission (other than preliminary proxy statements), included on the company’s website or contained in a press release.

There are, however, several significant changes in GRId 2.0:

First, the number of questions in GRId 2.0 for U.S. companies has increased from approximately 60 to approximately 90. Reflecting the current emphasis on compensation, 18 of the new questions are in the compensation category, and many incorporate ISS’s new Pay-for-Performance quantitative methodology and executive compensation data. Other new questions address (a) related-party transactions and board relationships and (b) takeover defenses.

Second, ISS has said that its overarching goal in the new questions is to include more of its concerns underlying its proxy voting recommendations. Thus, GRId 2.0 is likely to have more influence than GRId 1.0 on ISS’s voting recommendations on director nominees and other management proposals.

Third, the scoring and weighting methodology has been reconfigured to provide, according to ISS, more reliable and transparent “flags” of what ISS considers to be governance-related risk, together with better alignment of GRId ratings to the analytical approach of ISS proxy research. One effect of the reweighting in GRId 2.0 is that an individual question that is deemed by ISS to be most important will be weighted heavily enough to trigger a Medium or High concern by itself. This means that it may now be significantly easier for a company to receive a Medium or High concern level. In other words, if just one of a company’s governance practices within one of the four categories differs from a practice that ISS considers most

important in that category, that one practice may trigger a Medium or High concern level. This will, of course, discourage companies with such a practice from taking other measures within that category if those measures will not result in achieving a lower level of concern.

Fourth, the individual scores assigned to each question will not be released by ISS. In GRId 1.0, the range of possible scores, the score assigned to each possible answer and the weighting of each question were released by ISS. For example, for the GRId 1.0 question “What is the independent status of the compensation committee members?” ISS stated that the question was graded on a scale of -5 to 5, and an answer, for example, that 80% of the compensation committee was independent, would score 3 points. One could also determine, based on the information released by ISS, that this question was worth 5% of the total concern in the Board category. This information allowed a company to know, when considering potential governance changes, exactly how much it might gain. For GRId 2.0, ISS will not release the range of possible scores or the scores assigned to each possible answer. For the compensation committee example above, ISS now merely states that “Compensation committees with less than 100 percent independent membership will raise increasing levels of concern in the Composition of the Committees Subsection, with a moderate concern being raised for independence levels below 75 percent.” Thus, the entire scoring process for GRId 2.0 appears to be significantly more opaque, and it will be more difficult for a company to determine what it needs to do to move to the next lower level of concern.

Fifth, in addition to the current traffic lights (red, yellow, green) indicating levels of concern, ISS will display the final scores for its four surveyed categories.

In preparing for GRId 2.0, each company should consider the following actions:

First, each company should review its GRId 2.0 Profile for any inaccuracies. In our experience over the past two years, ISS sometimes makes mistakes in determining a company’s governance practices, often by simply overlooking publicly available information. Once the scores are released, companies will have an opportunity to correct any inaccuracies. We recommend that each company review and correct its Profile *before* it files its proxy statement since (1) the GRId Profile will assume much greater visibility after the proxy statement is released and (2) the amount of time available for corrections before ISS makes and releases its voting recommendations will be shorter.

Second, companies should review each policy that receives a neutral or negative score. We often find “low-hanging fruit” – policies that could be adopted or modified without adversely affecting normal operations or practices. For example, ISS views as substandard director stock ownership guidelines requiring ownership of shares valued at less than three times the directors’ annual retainer. If all directors already own shares valued in excess of this standard, the adoption of ISS’s policy would gain points without any change in this regard.

Third, a company should consider increased disclosure. ISS often views a lack of disclosure on a topic negatively, even if the issue is not relevant to the company. For example, for the question “Does the company disclose the performance measures, hurdle rates, and target payout thresholds for the short-term cash incentive plan that generated the awards reported?” ISS scores negatively if there is no disclosure but neutrally if the company merely discloses that there are no performance-related payments and that, therefore, the question is inapplicable.

Fourth, companies that received less than 70% support in last year’s say-on-pay vote should be sure to disclose (a) the company’s outreach to major stockholders in the past year and (b) a detailed list of actions that have been or will be taken to address the compensation issues that resulted in the significant opposition vote. ISS has stated that it may recommend voting against this year’s say-on-pay proposal, members of the compensation committee or possibly the full board if a company does not adequately respond to a say-on-pay vote that received less than 70% support.

Like GRId 1.0, GRId 2.0 reflects ISS’s own views, despite the contrary views of many serious participants in the continuing conversation about corporate governance and despite the varying benefits of particular governance practices from company to company and from time to time. ISS has decided, for example, that classified boards, executive board chairs and plurality voting are bad at any company.

In our view, the connection, if any, between various corporate governance practices and economic performance and/or enterprise risk is not at all clear. Indeed, several years ago, ISS published a study, with Georgia State University, finding that shareholder rights plans and other takeover defenses correlated *positively* with higher shareholder returns (over three, five and ten years), stronger profitability measures (return on equity, return on assets, return on investment and net profit margin), higher dividend payouts and yields and higher interest coverage and operating-cash-flow-to-liability ratios. ISS called these results a “surprise;” but they were no surprise to business people and their advisers with experience in the often destructive results of hostile takeovers and the increasing pressure for near-term performance. Similarly, more recent academic studies have found no consistent connection between corporate governance indices, including the Corporate Governance Quotient, ISS’s predecessor to GRId, and corporate performance or shareholder return.

Nevertheless, ISS is a major force in influencing the voting of institutional stockholders and its positions cannot be ignored. Many of its views have become mainstream. The ultimate goal of any for-profit enterprise, however, is wealth maximization, not a high corporate governance score. Under Maryland law, a director’s duty is to act in a manner that the director reasonably believes to be in the best interests of the *corporation*, which may or may not be the same as what a proxy adviser, even one as influential as ISS, or some other external group thinks is good corporate governance. Maryland law does not require a board to take an action known to be favored by a majority – even a significant majority – of stockholders.

The Maryland General Corporation Law (the “MGCL”) permits Maryland corporations to adopt many useful corporate governance measures, the benefit of which ISS just does not understand. For example, the charter of a Maryland corporation may authorize the issuance of blank check stock. The power to classify and issue blank check stock with company-specific terms on short notice is a vital tool for companies to access fast-moving, time-sensitive global capital markets. The overwhelming majority of public companies have this power. Yet, ISS still continues to view blank check stock negatively, seeing it primarily as an anti-takeover device. This is an outdated perception that ignores the current reality of corporate finance.

As another example, the MGCL permits a corporation to require the written request of stockholders entitled to cast a majority of the all votes entitled to be cast at the meeting before calling a special meeting. This sensible requirement prevents the calling of a special meeting by holders of a minority of shares without enough support to actually pass their proposal, which would be an unnecessary waste of time and resources. ISS thinks that special meetings should be callable by holders of not more than 15% of the voting shares, which we believe would encourage mischief by small stockholders, *e.g.* labor unions, pursuing goals not shared by other stockholders.

We would be happy to review and discuss your GRId profile with you, as we have found, in working with many clients, that there are often mistakes, opportunities for partial credit and other ways to improve a GRId rating without significantly affecting company operations or policies.

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