There They Go Again: ISS Introduces Yet Another Corporate Governance Measure

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Institutional Shareholder Services Inc. ("ISS") has recently introduced a new corporate governance measurement system (its fourth in the past four years), called the ISS Governance QuickScore ("QuickScore"). QuickScore replaces ISS's previous corporate governance measurement system, the GRId 2.0 Profile ("GRId 2.0"), which lasted only a year and replaced the GRId 1.0 Profile, which itself was the successor to ISS's Corporate Governance Quotient ("CGQ"). As it claimed with GRId 1.0 and GRId 2.0, ISS claims QuickScore will help investors to identify, monitor and assess "governance risk."

Similarities. QuickScore and GRId 2.0 are conceptually similar. Like GRId 2.0, QuickScore tracks a company's practices across four corporate governance categories – Audit, Board Structure, Compensation and Shareholder Rights. QuickScore measures 79 factors for U.S. companies, down from the 90 factors measured by GRId 2.0. As with GRId 2.0, ISS will assign higher scores to practices that it favors and lower scores to practices it does not.

Changes. The weighting and summing of the factors has changed. With GRId 2.0, different factors were given different weights, but ISS did not specifically state which factors were more heavily weighted than others, nor did it give much detail as to why it considered some factors more important than others. With QuickScore, each factor is weighted based on its correlation with financial performance. For example, if ISS has determined that a company's CEO stock ownership requirements tend to correlate strongly with company financial performance, that factor will be weighted heavily. The process is more opaque than GRId 2.0 because ISS has not disclosed the relative weighting of the factors, or the relative weighting of the potential answers within each factor.

With GRId 2.0, after weighting and summing the scores in each category, ISS assigned each of the four categories a level of "concern" – Low, Medium or High. With QuickScore, these concern levels are not retained; instead, each of the four categories will receive a raw score and a relative score, called the Governance QuickScore. The raw score is simply the sum of all the weighted scores in that category. The relative score will be one through ten (with one being the highest), and represents the decile ranking of the company compared to other companies. For example, a relative score of two means the company's raw score for that category is in the second decile of all companies with which ISS is comparing it. Also, ISS is grouping companies into world geographic regions; therefore, all U.S. companies will be grouped together and compared against each other. However, ISS will group the largest 500 U.S. companies separately from all other U.S. companies. ISS has also stated it will further divide U.S. companies by industry sector later this year. Furthermore, for each category, there are subcategories, each of which will have a positive or negative score to be disclosed by ISS.

Some of the most significant changes to the factors QuickScore will examine are:

- Compensation: ISS will no longer track, among other matters, (a) severance arrangements in contracts of non-CEO executives, (b) whether a company "provides" dividends on unvested performance shares or (c) whether a CEO receives tax gross-ups on perquisites.

- Shareholders Rights: If a company has a shareholders rights plan, ISS will no longer track the plan if it was approved by stockholders.

- Board Structure: ISS will no longer track whether independent directors have met without management present, or whether they can hire consultants without management approval.

(There were no changes to the Audit category.)

Additionally, ISS created a new Compensation subcategory called compensation controversies, which will track whether ISS has identified a pay-for-performance misalignment or a problematic pay practice.

Key Problems. We have identified several troubling trends in the changes made from GRId 2.0 to QuickScore. First, the introduction of a relative score, comparing a company against a range of other companies, may be problematic. Companies being compared against each other may have little in common and very different corporate governance needs. Many companies will receive lower relative scores (since there will always be a bottom half) when in fact they have sound corporate governance practices. This is a reversion to the relative scoring of the old CGQ. Second, ISS is becoming overly focused on the CEO, as indicated by the fact that several of the dropped factors examined policies that related to independent directors or non-CEO executives. This creates a corporate governance profile that is too narrow and ignores best practices that may address more than just the CEO. Third, the introduction of a controversies subcategory within Compensation is duplicative since, in order to determine if there is a pay-for performance misalignment or a problematic pay practice, ISS will have to examine the same factors already examined elsewhere in the Compensation category. This will further emphasize total shareholder return, which will still be used in determining pay-for-performance alignment, which ISS already over-emphasizes.

Key Dates. There are several important upcoming dates as ISS begins to implement QuickScore. Presently, all companies can check the data ISS has on file for them until February 15, 2013. At that point, there will be a blackout period while ISS creates the initial QuickScore for each company, which it has said will be released in late February or early March.

Recommendations. We strongly recommend that each company review the data that ISS currently has on file for any inaccuracies before the blackout period. In our experience, ISS frequently makes mistakes in assessing a company's governance practices, often by simply overlooking publicly available information. However, once the QuickScore is released, companies will again have the opportunity to correct any inaccuracies. In any event, we recommend that each company review and correct its QuickScore *before* it files its 2013 proxy statement since (1) the QuickScore may assume much greater visibility after the proxy statement is released and (2) there may be little, if any, time available for corrections before ISS makes and releases its voting recommendations.

Observations. Like GRId 2.0, QuickScore reflects ISS's own world 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 always bad at any company.

We note the depressing frequency with which ISS alters its corporate governance measurement program. With QuickScore following closely on the heels of GRId 2.0, GRId 1.0 and the CGQ, ISS has now had four corporate governance measurement programs in slightly over four years. ISS may find itself losing credibility with issuers and stockholders, at least with respect to QuickScore, as they relearn yet again another system of "best practices." Finally, we note that QuickScore is even more opaque than GRId 2.0, as ISS provides even less detail about which policies within any one factor might receive a positive or negative score.

As we have said before, 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 stockholder 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 who understand 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 CGQ, and corporate performance or stockholder 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.

Maryland Law. 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 particular stockholder (or group of stockholders), 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. In making governance choices, a board should consider the company's specific circumstances, including its financial performance, industry, competitors' governance practices and the directors' individual and collective background and experience.

Furthermore, 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, under the MGCL, as in Delaware, the charter 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 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 a much smaller percentage of the voting shares, which we believe encourages mischief by small stockholders, *e.g.*, labor unions and social activists, pursuing goals not shared by other stockholders.

As yet another example, the MGCL provides that the stockholders of a Maryland corporation may act by written consent only if all of them sign the consent, unless the charter authorizes consents by stockholders entitled to cast not less than the minimum number of votes that would be necessary to take the action at a meeting. This requirement ensures that the pros and cons of any proposed stockholder action with less than unanimous support may be debated at a meeting of stockholders. However, ISS believes stockholders should be able to act by written consent if consents are delivered representing only the bare minimum number of votes necessary to take the action at a meeting.

We would be happy to review and discuss your QuickScore 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 scores without significantly affecting company operations or policies.

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