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November 6, 2014

ISS Introduces QuickScore 3.0

For the sixth time in six years, Institutional Shareholder Services Inc. ("ISS") has revised its corporate governance measurement system. The latest version, ISS Governance QuickScore 3.0 ("QuickScore 3.0" or the "Profile"), replaces QuickScore 2.0. The original QuickScore itself lasted only a year after replacing ISS's GRId Profile 2.0 and its predecessor, GRId Profile 1.0, which succeeded ISS's Corporate Governance Quotient ("CGQ"). As with the CGQ, the GRId Profiles and previous QuickScores, ISS claims QuickScore 3.0 will help investors identify, monitor and assess "governance risk."

Similarities. QuickScore 3.0 is very similar to QuickScore 2.0. It represents more of an adjustment to certain features than a significant revision. QuickScore 3.0 tracks 91 corporate governance factors across four broad categories – Audit & Risk Oversight, Shareholder Rights & Takeover Defenses, Board Structure and Compensation. For *each factor*, ISS assigns a score that varies according to the significance ISS attaches to the factor and according to the company's actual practice. After weighting and summing the scores of the factors in each category, ISS assigns *each category* a score of one (best) to ten (worst). Based on the scores for each of the four categories, ISS assigns an *overall* Governance QuickScore, again from one to ten, with one being the best possible score. The overall score and the category scores are relative, based on a comparison against all other U.S. public companies in a company's index. For example, a relative score of two means the company's raw score is in the second highest decile among public companies within its index.

Changes. There are four principal changes in QuickScore 3.0:

1. New factors. QuickScore 3.0 includes four new factors applicable to U.S. companies (for a total of 91, up from 87 under QuickScore 2.0):

a) Does the company disclose a policy requiring an annual board evaluation?

b) Has the board of directors recently taken action that "materially reduces" shareholders' rights?

c) If the company has an "unequal voting structure," does it have a sunset provision? (ISS does not state whether an "unequal voting structure" proportionately reflecting unequal economic rights would be considered for this factor.)

d) Is there a controlling shareholder? (This is a zero-weight factor, as discussed below.)

2. Revising "zero-weight" factors. QuickScore 2.0 included several factors that did not affect scoring and were only included for informational purposes. In QuickScore 3.0, two of those factors – number of women on the board and number of financial experts on the audit committee – are now scored. One previously-scored factor – three-year independent director evaluation ("TIDE") provisions in poison pills – is now a zero-weight factor. One new factor – whether there is a controlling shareholder – has been added as a zero-weight factor.

3. Historical scores. QuickScore 3.0 will incorporate a company's historical scores and a log of changes to the company's data.

4. Increased depth of analysis for regulatory investigations. For the Audit & Risk Oversight category, QuickScore 3.0 will incorporate a "deeper dive view" of regulatory investigations, penalties and resolutions.

Key (But Not the Only) Problems. We have identified several troubling problems in the structure of QuickScore 3.0.

First, the weights assigned to each factor continue to be subjective and opaque. For QuickScore 1.0, ISS stated that the weights were correlated with financial performance, but did not cite any data to support that assertion. For QuickScore 2.0 and 3.0, ISS has stated that weighting is also based on ISS's own subjective view of which factors are most important. Thus, a company will have no idea which factors are most heavily weighted and, consequently, which policies are hurting it the most, thereby denying the company the information necessary to address the issue. Of course, ISS is happy to sell companies its consulting service which will disclose the value of any company-proposed changes.

Second, several factors include a reference to the ISS-selected peer group. This is problematic because, in our experience, an ISS-selected peer group often contains peers with little or nothing in common with the company other than similar revenue or market cap figures. Comparing companies against these so-called peers is potentially harmful, as, given ISS's enormous influence, such comparisons can unjustly penalize a company. Moreover, a company may be a useful "peer" for one purpose, *e.g.*, executive compensation, but not for another, *e.g.*, risk mitigation.

Third, ISS has retained several factors of questionable relevance. One factor asks how many directors received less than 80% of the votes cast. The idea that stockholders have shown opposition to a nominee unless he or she receives 80% support is simply unrealistic, especially in these days of increased shareholder activism.[1] With all the various requirements that ISS has imposed – and is likely to continue to impose – on directors in order to be recommended by ISS for election (*e.g.*, implementing a shareholder-approved precatory proposal in the next year), it is more likely than ever that nominees will be elected without 80% or higher support. Given the now widespread prevalence of majority voting with a resignation policy among public companies, ISS's motivation to maintain this factor is curious. Another questionable factor is the

[1] At least QuickScore 3.0 lowers the threshold from QuickScore 2.0's even more bizarre 95%.

number of non-executive directors with nine or more years of service. Companies will be penalized for retaining quality independent directors solely because their tenure has exceeded an arbitrary period. Given the challenge of finding qualified independent men and women who are willing to serve as directors of public companies, we are disappointed that ISS has further complicated the process by concluding that all directors with nine or more years of service suddenly "support th[e] management team's decisions more willingly." This is especially troublesome because ISS, in its own request to solicit feedback on this topic last year, conceded that "[a]cademic studies on the topic offer conflicting conclusions."

Fourth, the retention of a relative score, comparing a company against a broad range of other companies, is highly questionable. The broader the range of companies being compared against each other, the less in common the cohort is likely to have and, therefore, the less credible a single corporate governance regime will be. QuickScore 3.0's groups could scarcely be broader – S&P 500 companies and non-S&P Russell 3000 companies. ISS has never understood that no one set of corporate governance measures is right for all public companies. Moreover, by using a relative score, half of all companies will receive scores in the bottom half when in fact they may have sound corporate governance practices. This problematic practice of relative scoring, pitting all companies against each other in a leap-frogging race to try to win the ISS blue ribbon, is an unhelpful reversion to ISS's old CGQ.

Fifth, the retention of a Compensation Controversies subcategory within Compensation is double jeopardy since, in order to determine whether there is a pay-for-performance misalignment or a problematic pay practice, ISS examines the same factors that it has already examined elsewhere in the Compensation category.

Sixth, in our experience with ISS, factors that are influenced by a company's total stockholder return ("TSR") are always weighted very heavily and, thus, QuickScore Profile results are heavily dependent on TSR. ISS updates a company's TSR data only once a year, when it conducts its pay-for-performance analysis at the time the company's proxy statement is released. At that time, we have seen the overall scores at several companies swing widely without the companies having made any corporate governance changes. ISS claims the QuickScore Profile measures corporate governance, but in fact it often seems to measure mainly TSR, which is an economic result, not a corporate governance policy, and is commonly influenced by factors not entirely within the control of the board or management.

Finally, perhaps our biggest concern with QuickScore 3.0 is the introduction of a new factor penalizing any board action that "materially reduces" shareholder rights. ISS states that this factor considers unilateral charter or bylaws amendments that, among other things, classify the board. ISS may be referring to the Maryland Unsolicited Takeovers Act ("MUTA"), which, among other things, permits the boards of Maryland corporations and real estate investment trusts that meet certain criteria to elect to classify themselves notwithstanding any contrary provision in the charter, declaration of trust or bylaws and without a stockholder vote. While we have addressed the utility of this statute elsewhere (see our Maryland corporation law memos on this topic, dated April 9, 2014 and September 3, 2014), we want to emphasize that the power to self-classify in the face of a hostile takeover bid can be a very useful protection for stockholders.

The purpose and effect of the MUTA is to protect Maryland corporations and real estate investment trusts from coercive takeovers by encouraging would-be acquirers to negotiate with the board, as the stockholders' elected representatives. In any event, at the most, self-classifying could defer a change of control of the board for only a year.

Key Dates. There are several important upcoming dates as ISS begins to implement QuickScore 3.0. Presently, companies can check ISS's data until November 14, 2014. At that point, there will be a blackout period while ISS creates its initial QuickScore 3.0 Profile for each company, which it has said will be released on November 24, 2014.

Recommendations. We strongly recommend that each company review ISS's data for the company for any inaccuracies before the blackout period. In our experience over many years of reviewing ISS profiles for clients, ISS frequently makes mistakes in assessing a company's governance practices, often by simply overlooking publicly available information. However, once the QuickScore 3.0 Profile 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 3.0 Profile *before* it files its 2015 proxy statement, since (1) the QuickScore 3.0 Profile may have 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 its previous corporate governance rating systems, QuickScore 3.0 reflects ISS's own singular world view, based on little disclosed empirical data, despite the contrary views of many serious participants in the continuing corporate governance conversation and despite the varying benefits of particular governance practices from company to company and from time to time. ISS long ago decided, for example, that classified boards and plurality voting are always bad at any company under any circumstances.

ISS has now had six corporate governance measurement programs in slightly over six years. ISS may find itself losing credibility with issuers and stockholders as they have to revisit, yet again, exactly what is "best practice" in the eyes of ISS (and realize that prior "best practices" were not the "best" after all).

As we have often noted 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 itself published a study, with Georgia State University, finding that takeover defenses correlated *positively* with higher stockholder returns (over three, five and ten years) and financial performance. 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 short-term performance. Other more recent studies have found little, if any, positive correlation between ISS's view of "good" corporate governance and economic performance.

Nevertheless, ISS remains a major force in influencing the voting of institutional stockholders and its positions cannot be ignored. Many of its views have become mainstream.

Of course, the ultimate goal of any for-profit enterprise, however, is wealth maximization, not a high corporate governance score.

<u>Maryland Law</u>. 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, the media or some other external group thinks is "good" corporate governance. Maryland law does *not* require a board to take an action just because it is favored by a majority – even a significant majority – of stockholders. In making governance choices, directors should consider the company's specific circumstances, including its financial performance, industry, competitors' governance practices and the directors' individual and collective backgrounds and experiences. Directors should not consider the impact of their actions on their chances for re-election.

As we have in the past, we would be happy to review and discuss your QuickScore 3.0 Profile with you as we have found, in working with many clients, that there are often mistakes, opportunities for partial credit or mitigation and other ways to improve scores without significantly affecting company operations or policies.

Finally, ISS released its 2015 policy updates today. These policy updates include the changes to how ISS will evaluate director nominees during the 2015 proxy season. We shall be writing to you separately regarding these policy changes.

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