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# **ISS Introduces QualityScore**

Institutional Shareholder Services Inc. ("ISS") last week announced the "rebranding" of its latest "corporate governance scoring solution." The newest system, QualityScore ("QualityScore" or the "Profile"), replaces ISS Governance QuickScore 3.0. QuickScore 3.0 replaced ISS's GRId Profiles, which in turn succeeded ISS's Corporate Governance Quotient ("CGQ"). As with CGQ, GRId and QuickScore, ISS claims QualityScore will help investors identify, monitor and assess "governance risk."

**Similarities.** QualityScore is very similar to QuickScore. It represents more of an adjustment to certain features than a significant revision. QualityScore tracks 107 corporate governance factors across four broad categories – Audit & Risk Oversight, Shareholder Rights, 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 1 (best) to 10 (worst). Based on the scores for each of the four categories, ISS assigns an *overall* score, again from 1 to 10, with 1 being the best possible score. The overall score and the category scores are relative, based on a comparison with all other U.S. public companies in a company's index. For example, a relative score of 2 means the company's raw score is in the second-highest decile among public companies within its index. Because the scoring is relative, a company's score within a category or its overall score may change due to the actions of other companies in the same index, even though there has been no change in any of the company's factors.

**New Factors.** New factors in QualityScore that apply to U.S. companies include:

(a) Percentage of the board comprised of women directors;

(b) Percentage of directors who have served fewer than six years;

(c) Mechanisms to encourage director refreshment;

(d) Adequacy of the board's response to low support for any management proposal;

(e) Use of at least one metric that compares company performance to that of an external group, such as an index or peer group, in determining bonuses;

(f) Tenure of the external auditor;

(g) Exclusive forum provision, fee-shifting provision or limitation on shareholder litigation in the charter or bylaws;

(h) Certain details about proxy access policies, if the company has one;

(i) Power of the board to self-classify;

(j) Power of the shareholders to amend the bylaws; and

(k) Power of the board to modify the company's capital structure without shareholder consent.

**Key (But Not the Only) Problems.** There are several troubling problems in the structure of QualityScore.

(a) *Subjective and Opaque Weighting*. The original QuickScore stated that the weights were correlated with financial performance but did not cite any supporting data. Subsequent iterations of QuickScore acknowledged that weighting is also based on ISS's own, subjective view of which factors are most important. QualityScore gives companies even less information, as there is practically no discussion about how factors are weighted. 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 important information in addressing the issue. ISS makes this information available – at a price – as part of its consulting service.

(b) *Retention of ISS-Selected Peer Group*. The ISS-selected peer group for the company often contains peers with little or nothing in common with the company other than similar revenue or market capitalization. Comparison with these so-called peers is potentially harmful, as, given ISS's enormous influence, such comparisons may 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.

(c) *Use of Relative Score*. The broader the range of companies being compared with each other, the less in common the members of the cohort are likely to have and, therefore, the less the credibility of a single corporate governance regime. QualityScore's groups are very broad – S&P 500 companies and non-S&P Russell 3000 companies. ISS fails to appreciate that no one set of corporate governance measures is right for all public companies or even for all companies in most cohorts, certainly not ones as large as the S&P 500 and the non-S&P Russell 3000. Moreover, by using relative scores, half of all companies will receive scores in the bottom half when in fact they may have what ISS would regard as sound corporate governance practices. 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. ISS itself acknowledges the problem of using a relative score for the Audit & Risk Management category, because there are "limited … factors or controversies" to analyze. ISS confirms our suspicion that Audit scores are typically either a 1 or a 10 by stating that "Audit scores are limited to a few relevant deciles."

(d) *Dependence on Total Stockholder Return*. Based upon our experience working with ISS's various scoring systems over many years, we have observed that many factors in the Compensation category are influenced by a company's total stockholder return ("TSR") and those factors always appear to be weighted very heavily. 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 after the company's proxy statement is released. At that time, we have seen the overall scores for several companies swing widely without the companies having made any corporate governance changes. ISS claims that QualityScore measures corporate governance, but in fact it often seems to measure mainly TSR, which is (i) an economic result, not a corporate governance policy; (ii) commonly influenced by factors not entirely within the control of the board or management; and (iii) already understood by the market without being filtered through ISS's corporate governance prisms.

(e) *Potential Quality Control Problems*. QualityScore now tracks 107 factors for U.S. companies, while the original QuickScore only tracked 79, and QuickScore 3.0, in use until this year, tracked only 91. Many of the new factors, such as the metrics used in bonus programs, board refreshment efforts and the details of proxy access policies, are significantly more granular than previous ISS factors and will require a closer observation of a company's compensation program and board operations in order to ensure accuracy. As discussed in more detail below, ISS already reveals in its QualityScore Technical Document that it does not correctly understand the Maryland statute relating to one of the new factors.

(f) *Solutions in Search of a Problem*. ISS's governance Profiles continue to identify controversies where none exists. ISS's business depends on finding new problems that can be used to penalize companies, especially as most companies make an earnest effort to gradually move towards best practices. As more companies adopt last year's best practices, ISS continually "moves the goalposts" and develops its own new "best practices," which often have no relation to the actual world of corporate governance. ISS loses credibility with issuers and shareholders as they recalibrate, yet again, exactly what is "best practice" and realize that prior "best practices" were not the "best" after all. The next three factors discussed below, which focus on Maryland companies, penalize companies with corporate governance features that have benefitted Maryland companies and their shareholders for years.

(g) *Increasing Authorized Shares*. ISS now penalizes Maryland companies if the charter (or declaration of trust of a Maryland real estate investment trust) permits the board, as expressly permitted by Maryland law,[1] to increase (or decrease, but never below the number issued) the number of authorized shares without a shareholder vote (the "Authorized Shares Provision"). In our experience, the overwhelming majority of Maryland public companies formed in the past 20 years have adopted this power, and it has enabled many share-based transactions to proceed expeditiously without the delay of a shareholders meeting to obtain approval. The Authorized Shares Provision is especially useful for REITs, which must continuously access capital markets, as the provision enables the board to raise capital on market-based terms in fast-moving global capital markets. As shareholders already entrust the

[1] MD. CODE ANN. CORPS. & ASS'NS §§2-105(a)(13) & 8-203(a)(8).

board to make good business decisions on the issuance of "blank check" stock – not to mention entrusting the board with the power to issue unlimited amounts of debt – it is consistent to permit the board to determine the right amount of equity for the company. Common equity, preferred equity, secured and unsecured debt, leases and licenses are all part of the overall financing of a company, which is well within the business judgment of the board (subject, as always, to the shareholders' power to elect and remove directors).

ISS cites no data or even anecdotal evidence suggesting misuse of the Authorized Shares Provision, and we are aware of none. ISS's only stated rationale is that the existence of the Authorized Shares Provision may represent "potential dilution of shareholder value." This reveals a fundamental misunderstanding of the Authorized Shares Provision. Issuing additional equity at market price does not necessarily dilute shareholder value. If ISS is concerned about dilution of value, it should target equity issuances at less than fair market value, which may occur with or without the Authorized Shares Provision. We are not aware of any Maryland company that has ever been sued for misuse of the Authorized Shares Provision or that has ever received a shareholder proposal asking the board to remove the Authorized Shares Provision.

(h) *Board Control of Bylaw Amendments*. ISS will penalize companies if shareholders are not entitled to amend the bylaws. This is another factor solely concerned with Maryland companies, because, so far as we know, only Maryland law permits the bylaws of a Maryland corporation or real estate investment trust to give the board the sole power to amend the bylaws (the "Bylaw Provision").[2] ISS is currently raising this issue with regard to its recommendations for election of directors as well. The Bylaw Provision has been a common corporate governance feature for Maryland companies for over 20 years. Many Maryland companies have had the Bylaw Provision since their IPO without its ever creating an issue with shareholders. Giving the shareholders the concurrent power to amend the bylaws may invite mischievous and harmful proposals, such as limiting the rights of directors and officers to indemnification and advance of expenses in the event of litigation.

(i) *Subtitle 8.* ISS will no longer give full credit for an annually elected board if the board retains the power to self-classify, as permitted by Subtitle 8 ("Subtitle 8") of Title 3 of the Maryland General Corporation Law ("MGCL"), 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 shareholder vote. While we have addressed the utility of this statute elsewhere (see Opting Out of "MUTA" Is Still a Bad Idea, Green Street Takes a Wrong Turn, Board Classification in Maryland: Evaluating Section 3-803 of the MGCL, and Getting Nothing for Something), we emphasize that the power to self-classify in the face of a hostile takeover bid has proven in actual practice to be a very useful protection for shareholders as it encourages a hostile bidder to negotiate with the board, which has the power to opt out of Subtitle 8. Unlike hostile bidders, the directors have legally enforceable duties to the company and more information about the company than any single shareholder. ISS already penalizes companies that use Subtitle 8 by recommending against incumbent nominees at companies

[2] MD. CODE ANN. CORPS. & ASS'NS §2-109(b).

whose boards self-classify without shareholder approval. Now ISS will go even further and penalize companies that do not affirmatively give up the option of using Subtitle 8, no matter what the circumstances may be in the future.

**Key Dates.** There are several important upcoming dates as ISS begins to implement QualityScore. Presently, companies can check ISS's data *until November 11, 2016*. At that point, there will be a blackout period while ISS creates its initial Profile for each company, which will be released on November 21, 2016.

**Recommendations.** We strongly recommend that each company review ISS's data for the company before the blackout period. In our experience over many years of reviewing ISS profiles for clients, ISS frequently errs in assessing a company's governance practices, often by simply overlooking publicly available information or not understanding applicable state law.

We especially expect errors to occur with regard to the Authorized Shares Provision, because ISS's QualityScore Technical Document erroneously asserts that Maryland REITs have the power to increase the number of authorized shares.[3] This is incorrect. Boards at both Maryland corporations and Maryland real estate investment trusts are entitled to increase the number of authorized shares *only* if they are empowered to do so by the inclusion of such a provision in the charter or declaration.[4] Maryland companies that do not have the Authorized Shares Provision should check their Profiles for this potential inaccuracy.

Once the QualityScore Profile is released, companies will again have the opportunity to correct any inaccuracies. We recommend that each company review and correct its QualityScore Profile *before* it files its 2017 proxy statement, since (1) the QualityScore 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.

**Director Duties under Maryland Law.** Under the MGCL,[5] 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 take or fail to take any action solely because of its possible impact on his or her renomination or re-election as a director, the company's QualityScore Profile or ISS's vote recommendations.

[3] QualityScore: Overview and Updates, page 79, *available at* https://www.isscorporatesolutions.com/file/documents/QualityScore%20Techdoc%20Nov2016.pdf.
[4] See note 1 above.
[5] MD. CODE ANN. CORPS. & ASS'NS §2-405.1(c), now also applicable to Title 8 trust REITs.

**<u>Conclusions</u>.** Like its previous corporate governance rating systems, QualityScore 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 and costs of particular governance practices from company to company and from time to time. 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. Many 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 shareholders and its positions cannot be ignored, especially because many of its views have become mainstream. Of course, the ultimate goal of any for-profit enterprise is wealth maximization, not a high corporate governance score.

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

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