VENABLE® LLP

750 E. PRATT STREET SUITE 900 BALTIMORE, MD 21202
T 410.244.7400 F 410.244.7742 www.Venable.com

January 29, 2014

Problematic Practices at ISS:
ISS Introduces Yet Another Corporate Governance Measure

For the fifth time in five years, Institutional Shareholder Services Inc. ("ISS") has revised its corporate governance measurement system. Released on Monday, January 27, 2014, the latest version, called the ISS Governance QuickScore 2.0 ("QuickScore 2.0" or the "Profile"), replaces the original QuickScore (which ISS now refers to as QuickScore 1.0), which itself lasted only a year after replacing ISS's GRId Profile 2.0 and its predecessor, GRId Profile 1.0. The GRId Profiles were themselves the successors to ISS's Corporate Governance Quotient ("CGQ"). As with the GRId Profiles and QuickScore 1.0, ISS claims QuickScore 2.0 will help investors to identify, monitor and assess "governance risk."

Similarities. QuickScore 2.0 and QuickScore 1.0 are very similar. Like QuickScore 1.0, QuickScore 2.0 tracks almost 90 corporate governance practices across four broad categories – Audit, Board Structure, Compensation and Shareholder Rights. For each factor evaluated, ISS assigns higher scores to practices that it favors and lower scores to practices it does not. After weighting and summing the scores in each category, ISS assigns each category a relative score of one through ten, with one being the best and ten being the worst. The scores are relative, based on a comparison against all other U.S. public companies in a company's applicable index. For example, a relative score of two means the company's raw score for that category is in the second highest decile among public companies within its applicable index. The score for each category is derived from the aggregate of the weightings of the factors in that category. Based on the scores of the four categories, ISS assigns an overall Governance QuickScore, again from one to ten, with one being the best possible score.

Changes. We have identified five principal changes implemented in QuickScore 2.0:

1. The addition of eight new factors[1] applicable to U.S. companies (for a total of 87, up from 79 under QuickScore 1.0), some of which are "zero-weight" factors (discussed below), including:

a) Percentage of directors receiving less than 95% support at the last annual meeting;

b) Percentage of directors serving more than nine years;

[1] We believe ISS has introduced eight new factors applicable to U.S. companies; however, in the appendix of QuickScore 2.0's technical document, ISS lists nine new factors applicable to U.S. companies, for a total of 88 factors, including a factor that measures "the aggregate level of stock ownership of officers and directors, as a percentage of shares outstanding." Based on all the information ISS has disclosed regarding QuickScore 2.0, we believe that this is an error and that this factor will only apply to companies outside the U.S.

c) Outside director compensation compared with that of the ISS-selected peer group; and

d) Whether the most recent Say-On-Pay vote received less support than the industry average.

2. Creation of “zero-weight” factors. ISS will now include data in the Profile on the following policies for information purposes only, without any effect on a company’s score – yet:

a) Number of women on the board;

b) Total number of directors; and

c) Number of financial experts on the audit committee.

Additionally, several factors that were included in QuickScore 1.0 are retained only as zero-weight factors for QuickScore 2.0, including the number of directors who are current or former employees of the company, the number of directors who are family members of major shareholders or executives and the length of the CEO’s employment agreement.

3. Elimination of one-year total stockholder return (“TSR”). Previously, ISS blended a one-year TSR and a three-year cumulative TSR when comparing a company’s TSR against that of its peers. ISS has eliminated the one-year and three-year cumulative TSR factors and will now only look at a company’s three-year annualized TSR. This is one of the few bright spots of QuickScore 2.0, as ISS has been rightly criticized for using one-year TSRs, which overemphasizes short-term performance. The old one-year and three-year cumulative TSR factors are still included as zero-weight factors.

4. Changes in the weighting of each factor. With QuickScore 1.0, each factor was weighted based on ISS’s perception of that factor’s correlation with financial performance. For QuickScore 2.0, ISS has started with its perceived financial correlation but has further overlaid its own subjective analysis of the importance of each factor to arrive at its final weighting.

5. Event-driven updates. ISS previously updated its GRIds and QuickScore 1.0 profiles only once each year, when a company released its proxy statement. Under QuickScore 2.0, ISS will review each company’s public disclosures and update the Profile as necessary. Until we see this new policy in practice, we will continue to recommend to our clients that they take the initiative by submitting a data verification request to ISS upon a policy change, because (a) changes to many of the ISS-tracked policies do not require public disclosure and (b) we have frequently noted errors by ISS in QuickScore Profiles, which has made us wary of ISS’s ability to correctly identify every new relevant disclosure by all public companies.

<u>Key (But Not the Only) Problems</u>. We have identified several troubling trends in the changes made to QuickScore 2.0, as well as in the structure of the QuickScore program as a whole.

First, the weights assigned to each factor are now even more subjective. Previously, ISS had stated that the weights were correlated with financial performance but did not cite any data to back up that assertion. With QuickScore 2.0, ISS has taken the original weights and changed them based on its 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. Of course, ISS is happy to sell companies its consulting service, which will give insight into the value of any company-proposed changes, for a fee.

Second, one of the new factors includes a reference to the ISS-selected peer group. This is problematic because, in our experience, the 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 at best useless and at worst harmful, as, given ISS's enormous influence, such comparisons may unjustifiably penalize a company.

Third, one of the new factors asks how many directors received less than 95% of the vote. Aside from the fact that ISS does not say whether it is 95% of votes cast or votes entitled to be cast, this is a ridiculous figure. The idea that stockholders have shown opposition to a nominee unless he or she receives 95% support is absurd. With all the various requirements that ISS has historically imposed on directors – and is likely to continue to do so – in order to be recommended by ISS (*e.g.*, implementing a shareholder-approved precatory proposal) it is more difficult than ever for a nominee to get 95% approval. When corporate governance stakeholders have already been so successful at introducing majority voting with a resignation policy across public companies, ISS's motivation to introduce this factor seems dubious.

Fourth, although it is currently a zero-weight factor, the analysis of whether an audit committee member is a "financial expert" is problematic because ISS uses a definition of "financial expert" that is both more complex and more limiting than the definitions the SEC and the major stock exchanges use. For example, ISS considers a much narrower range of employment experience relevant when determining whether an audit committee member is a financial expert. ISS already uses a more complex and challenging definition for "independence," and this new factor is a first step toward ISS making boards' determinations for audit committee members needlessly more muddled and more challenging.

Fifth, the new factor regarding board tenure of more than nine years is highly problematic. Companies will now be penalized for retaining quality directors solely because they have exceeded an arbitrary period of service. Given the challenge public companies face in finding experienced, high-quality, independent men and women who are willing to serve as directors, we are disappointed that ISS has further complicated the process by coming to the unsupported conclusion that after serving nine years, all directors 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, conceded that "[a]cademic studies on the topic offer conflicting conclusions."

Sixth, 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 the cohort is likely to have in common and, therefore, the less credible any adoption of a single corporate governance regime will be. And ISS's groups could scarcely be broader: QuickScore 2.0 only uses two pools of companies: those in the S&P 500, and those that are not, but are in the Russell 3000. 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. Attempts at relative scoring (including the QuickScore Profiles and ISS's old CGQ) are problematic because they pit all companies against each other in a leap-frogging race to try to win the ISS blue ribbon.

Finally, the retention of a Compensation Controversies subcategory within the Compensation category 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 TSR, which will still be used in determining pay-for-performance alignment, which ISS already over-emphasizes.

Key Dates. There are two important upcoming dates as ISS begins to implement QuickScore 2.0. Presently, all companies can check ISS's data for it until February 7, 2014. At that point, there will be a blackout period while ISS creates its initial QuickScore 2.0 Profile for each company, which it has said will be released on February 18, 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 2.0 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 *before* it files its 2014 proxy statement, since (1) the QuickScore 2.0 Profile 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 its previous corporate governance rating systems, QuickScore 2.0 reflects ISS's own 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, 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 2.0 following only a year after the much-heralded QuickScore 1.0, GRId 2.0, GRId 1.0 and the CGQ, ISS has now had five corporate governance measurement programs in slightly over five years. ISS may find itself losing credibility with issuers and stockholders, at least with respect to QuickScore 2.0, as they have to relearn, yet again, another system of "best practices" (and that the prior "best practices" were not the "best" after all). Indeed, QuickScore 2.0 is even more opaque than its predecessors, as ISS provides even less guidance about which factors are weighted most heavily. QuickScore 2.0 contains new factors which appear to be implemented solely to give ISS new things to criticize without any clear or demonstrable relation to corporate outcomes and with no end in sight.

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 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.

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. 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 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.

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, which may have been true 20 years ago but is no longer the case.

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, thus avoiding 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.

Further still, 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 2.0 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.

Jim Hanks
Mike Sheehan