January 29, 2013

ISS Governance QuickScore: Back to the Future

ISS, the dominant proxy advisory firm, recently unveiled its new ISS Governance QuickScore product, which will replace its Governance Risk Indicators ("GRId") next month. ISS asserts that QuickScore is an improvement on the GRId product because it is "quantitatively driven" (with a "secondary policy-based overlay"). Using an algorithm purportedly derived from correlations between governance factors and financial metrics, QuickScore will rank companies in deciles within each of ISS' existing four pillars—Audit, Board Structure, Compensation and Shareholder Rights – and provide an overall governance rating to "provide a quick understanding of a company's relative governance risk to an index or region." While one can understand, as a business matter, ISS' desire to continually reinvent and "improve" its products, the constant shifting of goalposts creates uncertainty and inefficiency. More important, QuickScore will likely provide a no more complete or accurate assessment of corporate governance practices than its predecessors, and it may be worse.

When ISS adopted its GRId product three years ago, we cautiously noted that it offered greater transparency and granularity than the blunt one-dimensional CGQ ratings that it replaced. Unfortunately, in our view, going back to a system of opaque quantified ratings is a move in the wrong direction. After a substantial investment of management time and effort, companies have familiarity with the GRId "level of concern" approach, which at least helps them understand and address any legitimate issues or explain any divergences from ISS' "best practices." While ISS retains GRId's formulaic approach, to the extent that it does not share the weightings it assigns to the various governance factors, it reduces transparency as companies would not be able to compute their own QuickScores.

Although ISS suggests that the use of quantitative tools is "emerging as an important trend," corporate governance is not an exact science susceptible to simple statistical analysis. Trying to quantify and rate governance practices is akin to trying to rate the attractiveness of people. We will leave it to the academy to analyze ISS' purported statistical finding of a strong correlation between its governance metrics and financial performance, but note that this has historically been considered dubious at best. Investors do—and should—base their investment decisions on fundamentals and not on governance scores. In most cases, governance decisions are not made by those who make the investment decisions, and are sometimes outsourced to third parties like ISS.

Moreover, rating companies in deciles can be misleading and counterproductive. By definition, half of all companies will be below average. This is likely to be an unjustified "taint" on companies with no serious governance concerns, and a distraction as management and directors try to improve their QuickScores, rather than evaluating and selecting the best governance practices based on the real-world challenges faced by their particular organizations. Given how successful self-appointed governance activists have already been in eliminating takeover defenses and otherwise driving companies towards one-size-fits-all structures, it is likely that minor differences will separate the deciles, especially in the Board Structure and Shareholder Rights areas.

One of the most troubling aspects of the QuickScore "Overview" is that it is clear that ISS still does not fundamentally accept the director-centric corporate model that has driven the success of the American economy. From its zeal to penalize directors who are not immediately responsive to shareholder wishes (expressed in precatory resolutions which earn a majority vote), and to have directors be removable at will between annual meetings (even by "ambush" consent solicitations), it is clear that in ISS' view important decisions should be made not by directors who owe strict fiduciary duties to the corporation and its shareholders, but by institutional shareholders who owe no fiduciary duties, are themselves just intermediaries for the real owners, and generally do not hold stock positions for very long.

Because of ISS' outsize influence, companies will have to become familiar with QuickScore and learn to adapt. Corporate Secretaries can access ISS' "Data review and verification site" through the ISS website to confirm that at least ISS is working with accurate raw data as it generates its ratings. However, as before, we urge companies and boards to see QuickScore for what it is—a data point and an artfully marketed product, rather than a target or an ideal—and to consider their individual circumstances in establishing and evaluating appropriate corporate governance practices and compensation policies for their companies.

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