

Meridian Client Update

ISS Updates QualityScore Methodology

Institutional Shareholder Services (ISS) recently announced that it has updated its Governance QualityScore (“QualityScore”) methodology, its governance-scoring tool. The key changes to the methodology include new factors related to board and C-Suite gender diversity and the levels of shareholder support for director elections and Say on Pay proposals.

Overview of ISS Governance QualityScore

ISS applies its QualityScore methodology solely to S&P 500 and Russell 3000 companies. According to ISS, QualityScore is intended to aid institutional investors in monitoring and evaluating portfolio company governance by providing such investors insights into a company’s relative governance risk profile on an overall company level and across four governance categories (i.e., (i) board structure, (ii) compensation, (iii) shareholder rights and (iv) audit and risk oversight). ISS develops a company’s QualityScore by first evaluating over 100 factors underlying the four governance factors. Based on this evaluation, ISS will determine a company’s raw score under each governance category. This raw score is then ranked, on a decile basis, against companies in the same index (e.g., Russell 3000 or S&P 500) as the subject company. A score in the 1st decile indicates higher governance quality and relatively lower governance risk, and, conversely, a score in the 10th decile indicates relatively lower governance quality and higher governance risk.

ISS uses the four governance category scores to develop the overall governance score for a company (this score is also expressed on a decile basis).

ISS publishes a company’s governance score in Yahoo! Finance.

Updates to Scoring Methodology and New Governance Factors

ISS has updated its methodology for scoring certain governance factors and has added new governance factors. These updates and additions are summarized below by governance category.

Board Structure

- **Number of women who serve in leadership roles on the board.** Under this factor, ISS will determine the number of women who serve in board leadership positions, including board chair, chair of key committees, senior independent director, non-employee chair or lead director. ISS has not set forth its methodology for scoring this factor.
- **Number of women who serve as named executive officers (NEOs).** Under this factor, ISS will determine the number of NEOs who are women. ISS will assign a negative score for a company with no women NEOs. ISS will assign maximum score for a company with more than two women NEOs.
- **Director ages.** Under this factor, ISS will undertake a statistical evaluation of the range of director ages present on a company’s board relative to ages of directors who sit on boards of companies within the

applicable ISS coverage universe.¹ A company with *greater* variation or dispersion from the average director age within the applicable ISS coverage universe will have a *higher* percentile rank, while a company with a *less* variation or dispersion from average director age within the ISS coverage universe will have a *lower* percentile rank. ISS will score this factor based on a company's percentile ranking relative to the applicable ISS coverage universe: (i) a company at or below the 25th percentile will receive a score of zero, (ii) a company between the 25th and 75th percentiles will receive a score based on a sliding scale and (iii) a company at or above the 75th percentile will receive the maximum score.

- **Director tenure (in years).** Under this factor, ISS will evaluate a company's director tenure in the same manner in which it evaluates a company's director ages. For 2019, this factor will not be scored, but will be used for informational purposes.
- **The level of shareholder support for management-nominated director who also serves as a company's CEO, at the most recent annual meeting.** Under this factor, ISS will evaluate the level of shareholder support for a management-nominated director who also serves as a company's CEO. ISS has not set forth its methodology for scoring this factor.
- **The level of shareholder support for the Board Chair at the most recent annual meeting.** Under this factor, ISS will evaluate the level of shareholder support for a management nominated Board Chair. ISS has not set forth its methodology for scoring this factor.
- **The level of shareholder support received by management-nominated directors at the most recent annual meeting.** Under this factor, ISS will identify companies where investors might have governance concerns, as evidenced by relatively low support for one or more management-nominated directors at the most recent annual meeting. For classified boards, ISS will report the lowest level of shareholder support for any sitting management-nominated director at their most recent election, regardless if the election was at a company's most recent annual meeting. ISS has not set forth its methodology for scoring this factor.

Compensation

- **The level of shareholder support for the most recent Say on Pay proposal.** Under this factor, ISS will display the actual percentage level of shareholder support on the most recent Say on Pay proposal. Less than 75% shareholder support for the most recent Say on Pay proposal will yield a negative score on this factor.

ISS's technical document provides extensive detail on changes to the QualityScore scoring methodology, factors underlying each category and the standards or criteria for evaluating certain factors. ISS's technical document on QualityScore is available at the following link: <https://www.issgovernance.com/solutions/iss-analytics/qualityscore/#download>. The new governance factors under each QualityScore category are listed in the Appendix.

Meridian Comment. As we have stated in previous client updates, QualityScore (and its predecessor governance scoring tools) is an arbitrary method for evaluating a company's governance practices that rests on ISS's proprietary analytical foundation. This may be the reason that ISS governance risk tools have gained little to no coverage in the press. Further, we have seen little evidence that it is influencing public debate on corporate governance or pay practices.

¹ If a subject company is a constituent company of the S&P 500 index, then that index would be the applicable ISS coverage universe. Similarly, if a subject company is a constituent company of the Russell 3000 index, then that index would be the applicable ISS coverage universe.

From an individual company perspective, it is important to note that QualityScore does not directly affect ISS vote recommendations on Say on Pay proposals, director elections or on any other matter subject to a shareholder vote.

Despite the lack of broader visibility in the marketplace, directors should still possess at least a high-level understanding of QualityScore methodology and their company's overall rating, given that a company's QualityScore is published and made available to its large institutional investors.

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The *Client Update* is prepared by Meridian Compensation Partners' Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.

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