ISS Announces Release of ISS Governance QuickScore 2.0

On January 8, 2014, Institutional Shareholder Services Inc. (ISS) announced that it will release ISS Governance QuickScore 2.0 (IGQ 2.0), an update to its governance risk scoring system and analytical tool, on February 18. IGQ 2.0 refines IGQ, which ISS released in March 2013. IGQ replaced ISS’s Governance Risk Indicator (GRIId), which in turn replaced ISS’s Corporate Governance Quotient.

Under IGQ 2.0, ISS will assess a company’s governance policies on an overall basis and across the same four governance areas used in IGQ: (i) Board Structure; (ii) Compensation; (iii) Shareholder Rights; and (iv) Audit Practices. Each governance area is divided into subcategories and each subcategory includes a set of questions. IGQ 2.0 will include minor revisions to the methodology, including modified weightings assigned to certain governance factors, and new governance factors (e.g., 7 new factors are added in the U.S.).

ISS will continue to develop IGQ 2.0 scores for companies in the U.S. Russell 3000 and Canadian S&P/TSX Composite indices. IGQ 2.0 will launch on February 18, when scores will be made available to institutional shareholders and all covered companies through its Governance Analytics platform. In addition, IGQ 2.0 will be presented in ISS’s proxy research reports on covered companies.

ISS is providing a data validation period during which companies may verify that ISS has collected accurate and up-to-date data for governance factors included in IGQ 2.0. This period will open on Monday, January 27 at 9 a.m. EST and will close on Friday, February 7 at 8 p.m. EST. After the February 18 launch of IGQ 2.0, the data verification site remains dynamic so companies may update and re-verify IGQ 2.0 data throughout the year.

Next Steps for Companies

To prepare for the data validation period, companies may login to Governance Analytics, a website provided by ISS Corporate Services. Companies should note the following:

- If a company already has a username and password, it does not need to request a new login and can proceed directly to the Governance Analytics Website.

- If a company does not have a username and password, North American issuers can request a user name and password through the ISS Corporate Services U.S. support desk via email (support@isscorporateservices.com) or by calling 301-556-0570.

- Once a company enters the data verification platform, ISS will ask the company to cite a company filing supporting any discrepancy in the data being verified.
Meridian comment. Contrary to its ongoing efforts to make its voting policies and analytics more transparent, IGQ methodology is somewhat opaque. A technical document on IGQ 2.0 will be released on January 27 to correspond with the beginning of the data validation period. It remains to be seen whether ISS will improve the transparency of its methodology in the upcoming technical document to afford companies the opportunity to independently determine their score by governance question or category or to determine their overall relative decile score. Such transparency would enable a company to reasonably estimate its governance score with a high degree of accuracy. A lack of transparency could potentially deter, rather than encourage, companies to evaluate their corporate governance practices against IGQ 2.0.

Perhaps the most important item to note about IGQ 2.0 is that a company’s IGQ score will not directly impact ISS’s vote recommendation on any matter (as has been the case for each of ISS’s previous scoring governance tools). Given the absence of a direct link between a company’s IGQ 2.0 score and ISS’s vote recommendations, we believe ISS’s updated governance scoring tool will continue to garner only moderate attention from corporate boards and management.

ISS Releases FAQs on Director Qualification/Compensation Bylaws

In response to compensatory arrangements between shareholder activists engaging in a proxy contest and their director candidates nominated to serve on a public company’s Board, some companies have adopted bylaws that prohibit any director nominee from serving on the Board who is party to an arrangement providing for compensation or other payments by a third party during their service as a director. Approximately 30 public companies have adopted such bylaws.

The primary rationale for such bylaws is that companies that permit such payment would essentially have two classes of directors with different compensation arrangements. Such compensation arrangements with dissident nominees following their election may present other issues, including potential conflicts of interest or breaches of their fiduciary obligations (e.g., their duty of loyalty), and differing incentives and time horizons that may influence their strategic and operational business decisions.

The issue emerged as a contentious governance practice in November 2013 when ISS recommended against all incumbent directors standing for re-election at Provident Financial Holdings, Inc. (“Provident”), because its Board of Directors adopted a bylaw amendment that any person who receives compensation or payment from a third party in connection with that person’s candidacy or service as a director of the company is disqualified from service on the Board. In ISS’s view, the bylaw unduly restricts shareholders’ ability to nominate and elect qualified individuals through a proxy contest. Furthermore, ISS expressed that companies should allow shareholders to vote on such bylaws.

In the case of Provident, ISS argues that the compensation paid to dissident nominees by a third-party was reasonable in light of the time commitment such nominees incurred in a proxy contest. Therefore, ISS viewed the Provident bylaw as potentially deterring legitimate efforts to seek board representation by a dissident, particularly efforts by dissidents that nominate independent board candidates selected for their relevant industry experience, which are characteristically recruited, but not directly employed, by the dissident shareholder.

Against this background, ISS on January 13, 2014 released an FAQ setting forth a new policy on a Board’s adoption of a bylaw that disqualifies any director nominee who receives third-party compensation (“director qualification bylaw”) without submitting such a bylaw to a shareholder vote. This policy provides that ISS may recommend a vote AGAINST or WITHHOLD from director nominees if a Board adopts a restrictive director qualification bylaw without shareholder approval. ISS views such action as a
material failure in governance. In ISS’s view, bylaws that preclude shareholders on voting on otherwise qualified candidates unnecessarily infringe on shareholders’ fundamental voting right.

ISS draws a distinction between bylaws that preclude from board service those director nominees who receive third-party compensation and those that preclude from board service those director nominees where the dissident fails to disclose the third-party compensatory payments with its nominees. ISS believes that bylaws that preclude from board service those director nominees where the dissident fails to disclose the third-party compensatory payments with its nominees may provide for greater transparency and allow shareholders to make more informed voting decisions.

If a Board submits a director qualification bylaw to a shareholder vote, ISS will formulate its vote recommendation on such a proposal on a case-by-case basis, taking into consideration factors such as the Board’s rationale for proposing the bylaw, whether the proposed bylaw materially impairs and/or delivers any off-setting improvements in shareholder rights, and any market-specific practices or views on the underlying issue.

In a proxy contest, ISS will consider compensation arrangements with director nominees as a factor in its case-by-case analysis of whether to support the election of incumbent or dissident nominees.

Meridian comment. To potentially mitigate ISS concerns, when a company’s Board unilaterally adopts a restrictive director qualification bylaw or submits such bylaw to a shareholder vote, the company should consider disclosing in its proxy statement why such a bylaw is reasonably tailored to address the concern of inappropriate compensatory arrangements between director nominees and a dissident shareholder in a proxy contest.

Although the new policy on director qualification bylaws will likely impact only a small number of companies during a given proxy season, the policy is emblematic of ISS’s ongoing efforts to increase the role of shareholders in areas traditionally reserved to company Boards. This represents a broader populist trend to tilt the balance of power on governance matters towards shareholders through the corporate ballot.

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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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