Simpson Thacher

# Memorandum

## ISS Details Governance QuickScore 3.0 Updates

November 5, 2014

Institutional Shareholder Services Inc. ("ISS") has released a technical document detailing the factors and scoring methodology of Governance QuickScore 3.0, which ISS plans to launch on November 24, 2014.[1] Corporate issuers may verify, update or correct the data used to calculate their scores, via ISS's data verification site, through 8:00 p.m. EST on November 14.

### I. Overview of QuickScore

QuickScore is a scoring system, "underpinned by hard data, designed to help institutional investors identify governance risk within portfolio companies."[2] QuickScore analyzes governance attributes that are specific to the company's region and categorized under four pillars: Board Structure, Shareholder Rights & Takeover Defenses, Compensation/Remuneration, and Audit & Risk Oversight. Every company is assigned a score of 1 to 10 for each pillar, as well as an overall score. Each score is "a relative measure based on the raw score calculations of the other companies in the relative index or region." The data underlying the scores is "updated on an ongoing basis as company disclosure is available."

### II. New Factors Applicable to Companies in U.S. Markets

QuickScore 3.0 includes four new factors that will be considered in scoring companies in U.S. markets:

**1) Does the company disclose a policy requiring an annual performance evaluation of the board?**

[1] *See* ISS Governance QuickScore 3.0: Overview and Updates (Oct. 2014). For a brief overview of QuickScore 3.0, *see* Memorandum of Simpson Thacher & Bartlett LLP, "ISS Announces Plan to Release Governance QuickScore 3.0" (Oct. 29, 2014).

[2] ISS Governance QuickScore 3.0: Overview and Updates.

ISS will now consider whether the company conducts board evaluations, as well as the nature and frequency of such evaluations. This factor highlights ISS's view that board evaluations measure "effective contribution and commitment of board members to their role, assessing the way the board operates, whether important issues are properly prepared as well as key competences on the board." According to ISS, the effectiveness and contribution of the entire board, board committees, and each individual director should be assessed on a regular basis. ISS provides that each assessment "should consider (a) in the case of the board or a board committee, its mandate or charter, and (b) in the case of an individual director, the applicable position description(s), as well as the competencies and skills each individual director is expected to bring to the board." It remains to be seen whether this new factor will prompt companies to make more fulsome and detailed disclosures in their proxy statements regarding their board evaluation process.

**2) Has ISS's review found that the board of directors recently took action that materially reduces shareholder rights?**

This factor, added to a new "Board Controversies" section under the Board Structure Pillar, acknowledges a finding of the ISS policy survey that investors have "little tolerance for unilateral boardroom adoption of bylaw amendments that diminish shareholder rights." According to ISS, unilateral charter or bylaw amendments that are considered material include, but are not limited to:

- diminishing shareholder rights to call a special meeting / act by written consent;
- classifying the board;
- increasing authorized capital; and
- lowering quorum requirements.

**3) Is there a sunset provision on the company's unequal voting structure?**

Where a company has an unequal voting structure, this factor will consider whether the company has set the conditions upon which such a structure will be terminated and replaced with an equal voting structure.

**4) Does the company have a controlling shareholder?** (zero-weight)

According to ISS, because the existence of a controlling shareholder could create challenges for minority shareholders, QuickScore 3.0 "will consider whether the company has a shareholder or shareholders acting in concert and holding a majority of the voting rights." This is a zero-weight factor that will not impact the scoring of companies in U.S. markets; it is included solely for informational purposes.

## III. Updates to the Weighting of Existing Factors for Companies in U.S. Markets

### A. Factors That Are Now Scored

Two existing QuickScore factors, which have heretofore been zero-weight factors, are now scored factors for companies in U.S. markets:

**1) How many women are on the board?**

This factor, introduced as a zero-weight factor in QuickScore 2.0, recognizes the results of certain studies that "increasing the number of women on boards of directors correlates with better long-term financial performance."

**2) How many financial experts serve on the audit committee?**

This factor evaluates "whether the company has indicated a member of the audit committee with sufficient financial skills in audit and accounting." A person is deemed a financial expert if that person "is or was a chief financial officer, chartered accountant, certified management accountant, fellow chartered accountant (FCA), fellow certified practicing accountant (FCPA), or partner of an accounting firm." This factor is now a scored factor for companies in the U.S. that have zero, one, or two financial experts on the audit committee.

### B. Factor That Is Now Zero-Weight

ISS has also designated one of QuickScore's existing poison pill-related factors a zero-weight factor:

**Does the poison pill have a TIDE provision?**

QuickScore 3.0 will consider for informational purposes only whether a company's poison pill plan includes a Three-Year Independent Director Evaluation (TIDE) provision, requiring the company's independent directors to review the plan periodically to determine whether it is still in shareholders' best interest.

## IV. Updates to Factors Pertaining to Investigations and Enforcement Actions

The most notable substantive changes to QuickScore's existing factors pertain to investigations and enforcement actions, signaling ISS's increased focus on such regulatory action. In QuickScore 3.0, ISS expands upon each of QuickScore's three questions regarding regulatory activity:

**1) Has a regulator taken enforcement action against the company in the past two years?**

This question is no longer limited to enforcement actions initiated by securities regulators and now adds that "ISS will also analyze if the investigation was resolved with a material penalty." QuickScore 3.0 clarifies that it assesses the materiality of penalties based on "the nature of the underlying investigation(s), the size of any monetary penalties, both on an absolute basis and relative to certain financial metrics, including but not limited to, revenues, earnings, cash flows, and market value, as well as any non-monetary penalties or requirements." Furthermore, QuickScore 3.0 adds that it will consider settlement agreements with regulators as well, "even if the company denies the allegations underlying the investigation."

**2) Has a regulator taken enforcement action against a director or officer of the company in the past two years?**

Like the factor that considers enforcement action against a company, this factor now references any regulator, as opposed to a "securities regulator." QuickScore 3.0 clarifies that the enforcement actions it will consider include those "related to employment or board service at other firms." As with enforcement action taken against a company, QuickScore 3.0 adds that ISS will consider whether the investigation resulted in a material penalty. With regard to determining the materiality of the penalty, QuickScore 3.0 "will consider the nature of the underlying investigation(s), the size of any monetary penalties, as well as any non-monetary penalties or requirements." Again, this factor adds that QuickScore 3.0 will consider settlement agreements between the director/officer and the regulatory body, regardless of whether the director/officer denied the allegations.

**3) Is the company, a director or officer of the company currently under investigation by a regulatory body?**

Previously, this factor applied only to a director or officer of the company; it now applies to the company itself, as well. ISS's explanation of this factor in QuickScore 3.0 removes the statement that "[e]vidence of regulatory investigation action against U.S. companies is defined as a relevant disclosure found in one or more of the two preceding form 10-K filings."[3] Furthermore, QuickScore 3.0 adds that "ISS will categorize investigations as either routine or non-routine."[4] Expanding on this concept, QuickScore 3.0 notes that non-routine investigations include FCPA-related investigations, Wells Notices, and "investigations which raise serious ethical concerns or pose potential risk to the broader financial system (LIBOR manipulation, mortgage fraud, high frequency trading, or other serious one-off investigations)." Conversely, QuickScore 3.0 will generally consider the following investigations routine, unless there is reason to believe that they involved "major fraud or risk":

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[3] ISS Governance QuickScore 2.0: Overview and Updates (Jan. 2014).
[4] ISS Governance QuickScore 3.0: Overview and Updates.

- investigations pertaining to "promotion, marketing or sale of products" and "billing/false claims";
- investigations pertaining to accounting and tax practices; and
- civil investigation demands.

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If you have any questions or would like additional information, please do not hesitate to contact **Yafit Cohn** at (212) 455-3815 or yafit.cohn@stblaw.com, or any other member of the Firm's Public Company Advisory Practice.


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