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Memorandum

ISS Updates Its Corporate Governance Rating Product and Invites Issuers to Verify Data

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On October 31, 2016, Institutional Shareholder Services Inc. ("ISS") released the latest version of its corporate governance rating product, which it has renamed "QualityScore" (from "QuickScore").[1] ISS has invited corporate issuers to verify the data ISS will use to calculate their scores; issuers have until November 11, 2016 at 8:00 p.m. Eastern Time to do so.[2] Updated QualityScore ratings will become available for subscribers on November 21, 2016 and will be included in ISS's proxy research reports as of that date.

Under QualityScore, as under its predecessor, issuers are evaluated and ranked on four independent grounds, or "pillars" – board structure, compensation/remuneration, shareholder rights and takeover defenses, and audit and risk oversight – and are also given an overall governance score, all in relation to other companies in the same geographic region. Possible scores range from one to ten, with higher scores indicating relatively higher governance risk. The most recent version of QualityScore includes several new corporate governance factors, each of which is applicable to companies in specified geographic regions, and changes the weight attributed to some of its existing factors.

I. New Corporate Governance Factors

The following are the new factors within each pillar that are applicable to companies in U.S. markets:

- **Board Structure.**
  - **What is the proportion of women on the board?** In addition to the existing factor inquiring

[1] *See* ISS QualityScore: Overview and Updates (Nov. 2016).

[2] To log onto ISS's data verification site or to obtain a log-in for the site, click here. According to ISS, its data verification site will again be available on November 21, 2016 and will continue to be open year-round, except in the period between the company's proxy filing and the issuance of ISS's proxy research report.

about the number of women on the board, QualityScore now evaluates the proportion of women on the board. Both questions explicitly acknowledge certain studies suggesting that "increasing the number of women on boards of directors correlates with better long-term financial performance."

- **What proportion of non-executive directors has been on the board less than six years?** Designed to balance "board refreshment, board stability, and the importance of some long-tenured directors to a company's success," this factor awards more credit to companies with a higher proportion of non-executive directors that have less than six years of tenure on the board as of the most recent annual meeting, "with no additional credit granted for proportions in excess of one-third."
- **Does the board have any mechanisms to encourage director refreshment?** This factor, which has a zero-weight impact on issuers' scores and is included solely for informational purposes, recognizes investors' increased focus on board refreshment, inquiring whether issuers have implemented a mandatory retirement age, term limits, or other board refreshment mechanisms.
- **Does the company disclose the existence of a formal CEO and key executive officers succession plan?** Given that well-crafted succession plans can help minimize the disruption attendant to succession events, as well as the distraction for companies and their boards, QualityScore considers "whether a company has a board-approved, periodically-evaluated succession plan for the CEO, other senior management, and key executive officers."
- **Has the board adequately responded to low support for a management proposal?** In addition to inquiring whether the board adequately responded to a majority-approved shareholder proposal, QualityScore now assesses whether the board has adequately responded to low shareholder support in director elections (i.e., less than 50% support) or in the advisory vote on executive compensation (i.e., less than 70% support). According to ISS, "[t]he company's disclosure of its shareholder outreach to determine the reasons for the low support, and the actions taken to address the issues, are key in this determination." Similarly, QualityScore considers whether the company adopted a say-on-pay frequency that received less support than the frequency preferred by a majority or plurality of shareholders. In this regard, ISS will take into account "the rationale provided by the company for its adoption, ownership structure, and any history of compensation concerns at the company."

- **Shareholder Rights and Takeover Defenses.**
  - **Does the company have an exclusive venue/forum provision?** In ISS's view, provisions that require shareholder lawsuits against the company to be initiated in a specific jurisdiction (usually, though not necessarily, in the company's state of incorporation) are "restrictions on shareholders' rights, and, in the absence of past harm, it is not always clear the restrictions are justified."
  - **Does the company have a fee shifting provision?** ISS believes that provisions requiring the

shifting of litigation expenses to the party that loses on the merits "may dissuade shareholders from pursuing meritorious legal action against the company due to the significant financial hurdles imposed." ISS recognizes that Delaware now prohibits fee-shifting bylaws for matters of Delaware law, though not for matters subject to federal jurisdiction.

  - **Does the company have a representative claim limitation or other significant litigation rights limitations?** Representative claim provisions, which require a minimum level of support for a shareholder to file a lawsuit against the company, are problematic in ISS's view because they "do not distinguish between frivolous and meritorious lawsuits, and [they] prevent small shareholders, unless banded together, from suing the company."
  - **Can the board materially modify the company's capital structure without shareholder approval?** In ISS's view, "[c]ompanies generally are required to put authorized capital increases or reduction to a shareholder vote, as such changes represent significant potential dilution of shareholder value."

- **Compensation/Remuneration.**
  - **Does the company employ at least one metric that compares its performance to a benchmark or peer group (relative performance)?** QualityScore takes into account whether the company has a "pre-established metric, in any short term or long term incentive plan" that is "set relative (measured on relative terms) to an external group, such as a peer group, an index, or competitors."

- **Audit and Risk Oversight.**
  - **What is the tenure of the external auditor?** QualityScore considers, as a zero-weight factor, the length of the auditor-client relationship, recognizing that certain academic studies have found that "limiting auditor tenure may ensure auditor independence, reduce the audit failure risks and protect audit quality."

II. Updates to the Weighting of Existing Factors

As applicable to issuers in U.S. markets, QualityScore now scores four existing factors that were previously considered on a zero-weight basis, all of which pertain to proxy access. These factors are as follows:

- **What is the ownership threshold for proxy access?** ISS supports the availability of proxy access for holders of at least three percent of the company's common stock.
- **What is the ownership duration threshold for proxy access?** ISS believes that requiring a minimum of three years of ownership for proxy access is reasonable; according to ISS, "[l]onger holding period requirements are considered excessive."

- **What is the cap on shareholder nominees to fill board seats from proxy access?** With regard to the maximum number of board seats that can be filled by proxy access nominees in any given year, ISS indicates that investors have generally "approved a range of 20% to 25% of the board." As noted by ISS, "[m]any companies have adopted a 'greater of 2 persons or 20%' standard."
- **What is the aggregation limit on shareholders to form a nominating group for proxy access?** According to ISS, "[a] limitation of no fewer than 20 shareholders has generally been considered a minimal restriction" on the number of shareholders permitted to aggregate to form a nominating group to arrive at the requisite ownership threshold for proxy access.

If you have any questions or would like additional information, please do not hesitate to contact **Yafit Cohn** at +1-212-455-3815 or yafit.cohn@stblaw.com, or any other member of the Firm's Public Company Advisory Practice.

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