



**Are You Ready For The Ratings Game?  
The Corporate Governance Rating Phenomenon**

**By David S. Drake  
Managing Director  
Georgeson Inc.  
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Are you ready to play the corporate governance ratings game? Like it or not, if you're a company in the S&P 500, Russell 3000 or any popular market indices, your chips are probably already on the table. The field of players in the ratings game is growing quickly. The field includes familiar names like Institutional Shareholder Services (ISS) and Standard & Poor's, but the ranks are swelling with entrants like GovernanceMetrics International, Moody's, and a joint venture between IRRC and TrueCourse.

These firms have been working their way through SEC filings and other sources to ferret out everything they can about your governance practices. Once collected, the data is parsed, sliced and diced and — voila — your company's governance practices and performance may be reduced to a single number. The numbers can then be used for several purposes, ranging from making proxy voting decisions to screening portfolios for investment risks. In some cases, the ratings have already been calculated and are simply awaiting their release, either this fall or in the spring proxy season. Smile, you've just been rated.

*Who's Rating Whom?*

The ratings phenomenon might not have amounted to a hill of beans before the tumultuous year past. But then came the bursting of the market bubble: Enron, Global Crossing, Worldcom and Adelphia, and the list goes on. With their confidence in the markets shaken, institutional shareholders began questioning how well the stewards of their capital were looking after their interests. Even the major stock exchanges have raised the governance bar needed to restore confidence in Corporate America by beefing up their governance-related listing standards.

The timing of these events could not have been more perfect (or worse, depending on your perspective) for the fledgling governance rating industry. Even Treasury Secretary Paul O'Neill recently floated the idea of creating a governance scoring system for U.S. companies. As a result, companies can expect the ratings phenomenon to gain traction over the next year and perhaps become a permanent part of investment

landscape. So it makes sense for companies to familiarize themselves with the ratings systems (including the key players) how the ratings might be used by shareholders, and how to comprehensively assess your own governance, so that you can adapt to the ratings phenomenon.

In the new millennium, “corporate raiders” have been replaced by “corporate raters.” Here’s a scorecard of the major players in the governance ratings game:

#### *Standard & Poor’s Corporate Governance Services*

Standard and Poor’s already rates corporate debt securities every day, looking at almost every aspect of a company’s financial life — its income statement, cash flows, balance sheet and the impact of its strategic business decisions — in order to rate a company’s debt. Everything, that is, but the board. S&P is attempting to fill that void by rating a company’s corporate governance in much the same way it rates bond issues.

The new rating will come in the form of a Corporate Governance Score (CGS). The CGS synthesizes some 250 governance-related variables from four basic categories:

- Ownership structure and influence
- Financial stakeholder rights and relations
- Financial transparency and disclosure
- Board structure and process

Despite its good name and frequent interaction with corporations, S&P’s business model for issuing its ratings may render it the least visible. S&P is attempting to apply the “pay-to-play” model that works so well in its debt rating service to its governance rating service. If you want investors to buy your debt securities, you need an S&P rating. S&P hopes the same line of reasoning will attract institutional investors to a company’s equity.

However, in the short term, we think it’s unlikely that companies will be sufficiently convinced that good governance practices will attract investors, although that day may arrive sooner than you think. Even more problematic is that S&P is new to the governance arena and its expertise there is far from well-established. Finally, the S&P ratings are done primarily for the company, not the investor. It’s up to the company to either broadcast its rating, or bury it. So it’s highly unlikely you’ll see a newswire story announcing that Widget Industries’ governance rating has been lowered to “junk” status anytime soon. The fact that public knowledge of S&P governance ratings is controlled by the companies that are being rated may limit their acceptance by institutional investors.

As a side note, on October 16, 2002, S&P issued "Transparency and Disclosure: Overview of Methodology and Results — United States." This report included, among other things, ratings of corporate disclosure on "ownership structure and investor rights" and "board and management structure and processes." However, these ratings appear to relate to whether important governance information was adequately disclosed in the annual report and proxy statement, and not the merits of the information disclosed.

#### *Moody’s Investors Service*

Following the spate of corporate scandals that plagued corporate America in the first six months of the year, Moody’s Investors Service announced that it planned to expand its corporate credit analysis to include increased commentary on governance issues and public disclosure practices in its credit analysis. Therefore, while Moody’s is not expected to issue separate corporate governance scores for issuers, companies can expect to see increased discussion of governance issues in public and private releases. In making the

announcement, Moody's president Raymond McDaniel noted "Strong practices in these areas [governance and disclosure] may enhance creditor interests."

So don't look for Moody's to issue governance-specific scores or to downgrade companies' debt ratings solely on the basis of perceived bad governance practices alone. But it is not out of the question that poor governance practices may find their way into a Moody's report and could be a contributing factor to a downgrade of corporate securities.

Recently, Moody's made a bold move to become a serious leader in governance analysis by hiring Ken Bertsch, TIAA-CREF's governance director, to head their governance analysis efforts.

### *GovernanceMetrics International(GMI)*

Unlike S&P, GovernanceMetrics International (GMI) will be rating companies' governance relative to a broad stock market index, at no cost to the companies themselves. That's because, according to a GMI marketing letter recently mailed to major company CEOs, "governance-minded institutions responsible for nearly \$2 trillion of assets" have already signed up to receive GMI's corporate ratings. An impressive statistic, to be sure. But companies should realize that GMI may have reached the \$2 trillion asset mark by signing up a few behemoth institutions like TIAA-CREF and CalPERS, or better yet the Council of Institutional Investors. However, unlike other governance ratings services, GMI's operations, as its name implies, are more international in scope in both its company coverage and institutional clientele. And unlike the debt-rating agencies, GMI has an excellent governance pedigree including well-known governance veterans like Jon Lukomnik, formerly of New York City Office of the Comptroller, Stephen Davis, formerly with Investor Responsibility Research Corporation (IRRC), and Howard Sherman, former president of ISS.

The GMI system rates companies on a scale of one to 10, with 10 being governance nirvana (Enron reportedly was rated a 4 according to GMI officials). The GMI rating is based on a mind-boggling 600 variables culled from securities regulations, various codes of best practice, and exchange listing requirements (including the newly revised NYSE and NASDAQ standards).

GMI asserts that its ratings are generated by a program that uses "asymmetric geometric scoring" (translation: We are professionals; do not try computing your governance rating at home). GMI doesn't require company cooperation to generate a "basic" rating, but for a fee you may request GMI's "comprehensive" rating that involves reviewing nonpublic documents and interviews with management, and even board members. Interestingly, if you do not participate in the comprehensive rating, GMI simply forwards you the data it has collected independently for an "accuracy check." Participants in the comprehensive rating get to review a draft of the ratings report before it goes out to investors.

Unlike ISS (see below), which affixes its governance scores to its proxy statement analyses prior to a shareholder meeting, GMI does not have a ready-made platform from which to broadcast its ratings. So it will be releasing its governance ratings not only to its subscribers, but also directly to the press. GMI ratings are expected to be issued sometime in Fall 2002.

### *ISS Corporate Governance Quotient (CGQ)*

ISS, the ubiquitous proxy voting advisory service with a reported audience of nearly 1,000 institutional investors, promises to become the 800-pound gorilla of governance ratings services with CGQ. ISS has a ready-made audience for its corporate governance grades. It is already affixing the scores to the front page of the proxy voting reports provided to clients.

How does CGQ work? A real life example demonstrates: ISS issued a proxy analysis two weeks prior to a highly prominent retailer's June 19, 2002 annual meeting. In a shaded box at the top of the first page of the analysis, ISS indicated the company's index ranking was 37.1, meaning it outperformed only 37.1% of the companies in the S&P 400 in terms of governance. However, the company's industry ranking fared better, outperforming 54.5% of the S&P Retailing group.

What contributed to these ratings? ISS doesn't reveal how the scores are calculated, but it does provide hints. For example, in this case, the analysis also included a table showing which factors positively or negatively influenced the scores. The table indicated some factors that influenced the ratings:

The upside factors:

- A fully independent nominating committee
- A fully independent compensation committee
- The cost or "shareholder value transfer" from the company's option plans fell within the ISS allowable cap
- Chairman and CEO positions were held by different individuals

The downside factors:

- A classified board
- Poison pill adopted without a shareholder vote
- An "affiliated outsider" sits on the audit committee
- The company has multiple classes of stock available for issue

The CGQ ranking system is based on 51 data points grouped into seven categories of governance-related issues:

1. Board structure and composition
2. Charter and bylaw provisions
3. State of incorporation issues (primarily anti-takeover statutes)
4. Executive and director compensation
5. Financial performance
6. Director and officer stock ownership
7. Director education (for accredited programs only)

As those familiar with ISS operations might have guessed, the rankings are determined by a "black box" computer model. That way, as with GMI's system, companies being rated cannot independently determine their ratings in advance. ISS does not even disclose the relative weightings of the factors in the "premium" fee-based area of its CGQ website (<http://www.isscgq.com>). However, early observations indicate that board independence issues are critical. For example, whether directors have disclosable business relationships with the companies on whose boards they sit and whether key board committees are completely free of conflicts tend to strongly influence the ratings — perhaps as much as the presence of certain anti-takeover provisions like poison pills and staggered boards. ISS also gives companies credit for sending directors back to school, but only if they attend programs accredited by — you guessed it — ISS.

Unlike GMI, ISS claims it will not disclose the ratings to the media and other interested outsiders (although we understand that several investment banking firms have purchased the CGQ database). But ISS proxy analyses are widely disseminated and often find their way into the public domain. For example, a recent article on Computer Associates appeared in *New York Newsday* indicating that ISS had ranked the company

within the top 5% of the S&P 500 in terms of corporate governance. (Interestingly, despite the high rating, ISS withheld votes from certain CA directors anyway because they had approved an agreement to pay dissident shareholder Sam Wyly not to proceed with a planned proxy contest.) ISS allows companies to register for a review of its CGQ on its website, which has a “free” and “premium” area. On a free basis, companies are given the opportunity to sign up for a review of the CGQ *data* 72 hours prior to the issuance of the ISS report that contains the CGQ score. However, the actual CGQ *score* is *not* revealed to the company until the analysis is released to ISS clients. ISS also encourages companies to input data on the 51 factors into a series of website screens, a task we hear is quite laborious. Many clients are left wondering why they cannot simply review and update the data ISS has presumably already collected. Paying for an annual subscription to the “premium” area of the website also requires the same tedious data-input process. But the rewards are immediately learning your current CGQ score and getting an opportunity to play around with changing different aspects of your governance to see what impact the changes have on your ranking. Fees for the premium area range from \$10,000 to \$17,000 depending on a company’s market capitalization.

### *IRRC and TrueCourse*

The latest entrant to the game is a partnership between well-known governance researcher, Investor Responsibility Research Corp. (IRRC) and TrueCourse, the developer of the anti-takeover database, [www.sharkrepellent.net](http://www.sharkrepellent.net). Details on the scoring system and its launch date are not yet known. The IRRC/TrueCourse angle is that its scoring system will be based on weightings of governance factors endorsed by a series of advisory panels that include both corporate and institutional players. Unlike ISS, IRRC/TrueCourse does not plan to charge companies to view their scores and promises “total transparency.” IRRC’s governance expertise combined with TrueCourse’s technological prowess could produce a potentially interesting service. IRRC already has a substantial governance database on the S&P Super 1500 and analyzes corporate proxy statements, while TrueCourse’s website currently publishes “Bullet Proof Ratings” that measure the strength of a company’s takeover defenses on a scale from one to 10.

### **How Will the Ratings be Used by Institutions and Others?**

#### *Proxy Voting Guidelines of Institutional Advisers and Shareholders*

So far, we have seen little evidence that institutions plan to incorporate governance ratings into their voting practices. ISS, so far the only active ratings service, has chosen not to incorporate its CGQ ratings into its proxy analysis guidelines, beyond displaying the score prominently on the analysis. Georgeson’s client’s ISS analysis disclosed a ranking of 5 on a scale of 100, meaning they underperformed 95% of their index in terms of corporate governance. But ISS recommended in favor of the re-election of its directors and auditors (and even a new stock option plan to boot).

However, it seems inevitable that at some juncture, if the ratings are well received by its clients in 2003, ISS will use the CGQ as a factor in some of its proxy voting decisions. Currently, the ISS research staff is not responsible for generating the rankings. That task falls under the direction of ISS Corporate Programs. In fact, the CGQ ranking is not affixed to the ISS proxy voting analysis until *after* the staff’s voting recommendations are completed (although we are told that analysts may access the rankings if the analyst believes a company’s score is germane to his or her voting recommendation). Possible future uses could include development of a policy to withhold votes from directors if a company’s ratings fall below a certain threshold.

The other side of the coin is that even if ISS *doesn’t* incorporate CGQ into its voting guidelines, some of its clients might. There is a certain psychological dimension to the rankings that can’t be ignored. If an institutional investor is on the fence about whether to support a management proxy proposal, might not

either a poor or an excellent rating influence an institution's decision? We inquired about this matter with several institutions. Generally, the institutions felt somewhat uncomfortable using the ratings to make voting decisions given their lack of knowledge about the ISS and GMI ratings systems and how specific governance issues are weighted.

#### *Investment Screening/Portfolio Management*

Perhaps the most important development in corporate governance history would be if institutions utilize any of these ratings systems to assist their portfolio managers in making investment decisions. It is probably unrealistic to expect portfolio managers and analysts to make major buy or sell decisions based solely on governance considerations. But we have heard some investors express an interest in using governance ratings to “red flag” companies in their portfolios that may have poor governance. GMI has asserted that its institutional clients might use its ratings in this manner. ISS has even gone so far as to suggest that Adelphia's exceedingly low CGQ might have signaled investors to unload the stock, or perhaps avoid it. Clearly, some institutions could consider low ratings as a risk factor and perhaps trim some positions to reduce exposure to poor governance practices.

#### *Governance Targeting*

We think it is likely that institutional shareholders, particularly the more activist pension funds, may use the ratings to screen their portfolios for “focus” or “target” companies. This is purely speculative, but it is not hard to imagine activist institutions like CalPERS or CREF, could choose their targets this way. For example, a rating that puts you in the bottom quartile of all companies rated could result in a letter requesting a meeting with the board, or perhaps submission of a shareholder proposal to change a key governance provision or practice.

#### *Proxy Fights*

Dissident shareholders have already imagined the potential importance of governance rankings in a proxy fight. For example, a dissident shareholder recently expressed interest in attempting to negatively influence the governance ranking of a potential target company in advance of a planned contest. The plan was to “sandbag” the target's rating by disclosing negative governance practices of the target, in hopes a lower rating would cause institutions to question their support of management.

Conversely, managements of companies at risk of being targeted for a proxy fight may find a positive rating from ISS or GMI could be used to counter criticisms by the dissident shareholder and perhaps win institutional votes in closely-contested director elections. We think it's logical that the CGQ, GMI and other rankings will play a role in proxy battles in coming years.

#### *Director and Officer Liability and Indemnification Applications*

Are companies with low governance ratings a risk to insurers of corporate directors and officers? That has yet to be proven, but some ratings businesses have suggested their rankings might be used to determine how much companies are required to pay for coverage. We have heard anecdotal evidence that D&O insurers are asking corporations more questions about governance issues — although not in great depth. The important questions here are whether the rating systems that are afoot will meet the needs of the insurers, and whether the insurers really plan to adjust the price of insurance premiums to reflect governance risk. What we do know is that some governance raters are actively encouraging insurers to pay attention to their scoring systems.

## **Should You Try to Improve Your Governance Score?**

### *How Should Companies Respond to the Emergence of Governance Rating Systems?*

What's the question in the forefront of everyone's thinking on governance ratings: "How do I improve my score?" So here's the simple answer: De-stagger your board, redeem your poison pill, give shareholders the right to call special meetings and act by written consent, and maintain a completely independent board other than the CEO (and for good measure, make sure the CEO is not also Chairman of the Board). Your score will rise significantly — guaranteed.

Not willing to make such dramatic changes? Given that most of the ratings organizations' business models are predicated on generating consulting fees, we are confident there are all sorts of tweaks and fixes that will improve your score, without giving up sacred cows. Yet, with four or five ratings services in existence, we fear companies will be rendered governance contortionists, rearranging all sorts of bylaws and board practices into uncomfortable governance postures that would impress Le Cirque de Soleil, all in the name of boosting their scores.

Our view is that the best response to the governance rating phenomenon is to first look inward at your governance practices, understand what they are and how they got to be that way. Your practices may not comply with a given organization's one-size-fits-all view of what constitutes good governance, but there may be ample reasons for why your governance practices are the right ones for your company and your shareholders.

Still, it would be a mistake for companies to be so arrogant as to simply ignore all the current thinking developed in the governance arena over the past few years. We recommend that companies do a comprehensive self-audit of their governance (if one has not been performed recently) and compare their governance with favored policies of major "thought leaders" that have expressed views on governance matters from both the corporate and shareholder perspectives.

Your audit should cover a broad spectrum of governance thinkers including Council of Institutional Investors, TIAA-CREF, CalPERS, ISS, the New York Stock Exchange, NASDAQ, Business Roundtable, National Association of Corporate Directors and others.

The evaluation process itself is a form of due diligence for your board of directors. The result should be a carefully considered report for your board on your governance strengths and weaknesses, and options for what changes should be made. Companies should communicate to their shareholders that they have engaged in such a process and explain the results, including any governance practices that are changed.

We believe this more reflective process will best serve companies whose objective is to improve their overall corporate governance, not just their governance score.

If you have comments or questions regarding this article, or would like more information on how to audit your company's governance practices, please contact David S. Drake at (212) 440-9800, or e-mail us at [info@georgeson.com](mailto:info@georgeson.com).

