



## IR Strategy Series

# The Rise of Corporate Governance Ratings

## *There's a new sheriff in town*

### Introduction

In a partial but significant victory for the shareholder activists' movement, dissident shareholders nearly replaced the board of directors of El Paso Corporation at its May 2003 annual meeting by a 47.5% to 52.5% vote. In the course of this contest, the incumbent CEO was forced into retirement and management and the board adopted many of the activists' prior demands, including eliminating "poison pill" provisions from bylaws, connecting executive pay to performance, and discontinuing what was viewed as overly generous severance agreements.

Key factors in this battle were the failing grades provided by a new breed of corporate governance rating services including: **Institutional Shareholders Services (ISS)**, **Governance Metrics International (GMI)**, **The Corporate Library** and **Standard & Poor's (S&P)**. The governance and disclosure ratings of these services provided many uncommitted investors the nudge required to vote in favor of the dissident plan of action.

However, El Paso Corp. is just the most visible "tip of the iceberg" of a profound change in the relationship between public companies and their primary suppliers of capital, institutional investors. Thus far as we head into the 2005 proxy season, over 200 have been submitted for shareholder approval, more than three times as many as last year.<sup>1</sup>

The most popular shareholder proposals in 2003 that were not initiated or supported by management aimed to:

1. Link executive compensation to performance;
2. Expense stock options;
3. Enhance independence of the board;

4. Separate the roles of CEO and chairman;

5. End lucrative severance agreements.

In addition to El Paso Corporation, a number of companies have been impacted by the growing reach of governance rating services, whose recommendations have the power to influence thousands of investors holding tens of billions of dollars in corporate securities. Some of the more highly visible contests included:

- AOL Time Warner (withholding vote for Steve Case),
- Verizon (linking pay to performance), and
- Goodyear, Hasbro and PacificCare Health Systems (agreement to honor majority shareholder votes).

With new NYSE and Nasdaq rules requiring shareholder approval of nearly every stock option plan and institutional investors increasingly disposed to vote against management on a wide range of issues, these new governance rating services are poised to play a decisive role in future proxy votes and serve as a mechanism for investor oversight of self-serving management teams. ***Beyond influencing proxy voting, these ratings will increasingly impact the value of corporate reputations and the cost of capital for public companies.*** Understanding and influencing their decisions is a critical new challenge for senior management and IR practitioners.

Who are these services, and which companies are targeted for rating? What criteria do they use to rate governance and disclosure practices, and what are today's best practices for the management of public companies to navigate successfully through this complex new shareholder relations maze?

## Filling a Void in Corporate Oversight

The issues surrounding shareholder monitoring and disciplining of management were first explored in the 1932 classic, *The Modern Corporation and Private Property* (Berle and Means). Berle and Means noted that most corporate governance approaches ultimately leave professional managers unaccountable to shareholders.<sup>2</sup> Other observers have postulated that institutional investors are the group most likely to manage and resolve corporate governance issues. After all, ownership of the vast majority of public companies on the NYSE and NASDAQ (NMS) is concentrated in the hands of institutional investors, who should have a vested interest in reducing the “agency costs” that arise when management pursues interests that are at odds with those of the shareholders – such as lavish options grants or ill-starred acquisitions.

However, in conflict with this theory of investing is the reality that most institutions find it too costly to engage in “relational” investing because they risk sacrificing liquidity and squandering their time by becoming enmeshed with operational issues. Presumably such an investing style would not be “rational” unless investors were given “special benefits,” such as material non-public information or influence over corporate strategy.<sup>3</sup> Relational investing is further constrained today by Regulation FD, which prohibits providing a broad range of information to select members of the investment community without sharing it with all market participants at the same time.

With large investors reluctant to adopt insider roles that might diminish the liquidity of their holdings, an opportunity was created for third-party corporate governance rating services to provide an objective, third-party analysis of corporate governance practices. Given that many institutional investors now equate poor governance with a significantly higher investment risk, there was also money to be made in providing such information to ratings to institutions. The significance and influence of these services should not be underestimated. Adverse ratings presently have the ability to:

1. Significantly influence the election of company-nominated or dissident-nominated directors,
2. Vote down executive and employee compensation plans,
3. Reject changes or expansions of stock option plans,

4. Influence credit rating services and ultimately debt ratings,
5. Increase the cost of capital in the equity markets by lowering the company’s attractiveness to institutional investors,
6. Produce a hostile environment during road shows to investors,
7. Influence capital allocation plans including the payment of dividends,
8. Increase the cost of director’s and officer’s liability insurance,
9. Discourage high-quality candidates from joining the board of directors,
10. Adversely influence the independent auditor’s certification of the company’s financial statements.<sup>4</sup>

## How Are Companies Scored?

Fundamentally, each of the services assess and benchmark corporate governance and disclosure practices, and then provide the results of to investors, credit providers, insurers and other stakeholders. The reports are paid for predominantly by institutional investors (both equity and debt), and to a lesser extent by the companies themselves. The most significant uses of the reports are to advise investors on matters being voted on, effect corporate change by recommending improved governance standards, and to serve as an evaluation tool for prospective investors. Several major brokerage houses have already begun to incorporate governance ratings into their equity research reports. Increasingly, the investment committees of many institutional investors will not invest in a company with a poor corporate governance and disclosure score due to their liability under a “fiduciary duty” legal theory. Thus companies with low governance ratings may be expected to trade at a discount to comparable companies with strong governance principles.

The rating process includes a review of both public and confidential information, as well as interviews with senior company representatives, including directors.<sup>5</sup> The survey generally covers four key areas:

- Ownership structure and external influence,
- Shareholder rights and stakeholder relations,
- Transparency, disclosure and audit,
- Board structure and effectiveness.

Following the assessment, the corporate governance rating agency will produce a “score,” which reflects the extent to which a company’s corporate governance practices and policies serve the interests of investors, shareholders and other stakeholders.

Player & Product	Scoring System	Information Sources	Who Pays & Cost	Access to Reports
<b>Governance Metrics International -- GMI</b>	1-10 (1=low, 10=high) rating relative to other companies in 7 categories plus an overall score; 600+ variables in areas of board accountability, financial disclosure & internal controls, reputational and social responsibility, executive compensation, market for control, ownership base and potential for dilution and shareholder rights.	Basic Rating: based on public data including regulatory filings, press releases, news articles, company Web site. Comprehensive Rating: public and non-public data, including company policies, confidential documents, board and management interviews provided by the company.	Institutional investors, insurers, corporations subscribe to ratings for \$18,000/year. Basic Rating scores free to corporations being rated; Comprehensive Rating paid for by company, up to \$50,000.	After their first rating, and with a signed non-disclosure agreement, GMI will send a company their full report free of charge. After the second rating period, GMI will send numerical scores, but company must pay approximately \$1,000 for report. Subscribers have access to every company's ratings.
<b>Institutional Shareholder Services -- Corporate Governance Quotient (CGQ)</b>	0-100 (0=low, 100=high) rating relative to other companies in market cap and industry peer group (2 scores); 61 variables in areas of board of directors, audit, charter and bylaw provisions, laws of the state of incorporation, executive and director compensation, qualitative factors, ownership and director education.	Public information such as regulatory filings, company Web site and press releases.	Scores are part of a larger package of subscription information sold predominantly to institutional investors; fees for institutional investors can top \$100,000/year; annual subscriptions for corporations (based on market cap), \$10,000-18,000	Access to scores available at no charge to company only (not advisers) and within reasonable limits (a couple of times per year), as well as after significant company changes. Subscribers have access to all company scores.
<b>Standard &amp; Poor's -- Corporate Governance Scores</b>	1-10 (1=low, 10=high) rating of 4 areas--ownership structure & influence, financial stakeholder rights & relations, financial & information disclosure, and board structure and process--as well as an overall company score.	Public data and confidential information provided by the company and interviews of directors, management and other key individuals.	The company that requested the review pays \$50,000-\$150,000, depending on the complexity of the company and how many researchers/analysts must go onsite.	A report is supplied to the company requesting and paying for the score and report. If the company agrees to make the score public, it is available at no cost on the S&P Web site. Otherwise, the score and report are available only to the company. <b>Note:</b> A downgraded score may not be withdrawn.

**Source: Investor Relations Update**

Ultimately, it is the intention of the major rating services to rate all public companies over \$50 million in market capitalization. Currently, ISS provides the most comprehensive coverage, producing ratings on more than 5,400 United States companies, which include virtually all of the New York Stock Exchange, NASDAQ NMS, many AMEX, and some NASDAQ small-cap companies. As these services “move down the ladder” in terms of market capitalization, these ratings will impact virtually all credible public companies.

**Making the Grade: Managing Your Corporate Governance Rating**

Governance ratings services are becoming a very powerful (if somewhat subjective) source of information

on a company’s commitment to excellence in its governance practices. The following best practices are recommended in order to effectively deal with this new force in the investor relations landscape.

- 1. Appoint an executive to monitor rating services.** Given the broad potential impact of these ratings and the fact that rating methodologies are still in flux, companies would be well advised appoint a point person to accumulate rating information, understand the basis for each rating service score, communicate such information to senior management and the board of directors, and act as a catalyst for improving ratings. This role could be filled by a CFO, controller, general counsel or investor relations counsel. An important task for this officer is to monitor the agencies for mistakes

and correct such mistakes as quickly as possible. It has been reported that many companies have had their ratings lowered due to mistakes contained in various outside reporting services such as Bloomberg, which are then reflected in the rating service analysis.

**2. Develop a benchmark analysis of your 2004 rating, compare it to peers and target 2005 goals.**

It is likely that the 2003 proxy season will produce the first comprehensive rating on most public equities by the principal agencies. As shareholders learn to use such ratings for voting purposes, it will be important for management to set goals and develop a plan to improve company ratings relative to peers. Included in this analysis should be a comparison of the scores versus closest peers, and an analysis of the basis for any differential between the company and its peers. A separate analysis should be made regarding potential matters that may require shareholder approval for the next three years and issues that may be targets for future shareholder activism, such as poison pills or other bylaw issues. Following this assessment, a determination should be made of the benefits of adjusting governance and disclosure standards in advance of future ratings issuance.

**3. Develop a robust corporate governance section on Web site and in periodic reports.**

Equally important as adopting progressive policies is to provide investors with comprehensive governance information in an easy-to-access manner. The trend among high-quality companies is to separate such information in a corporate governance section of its Web site as opposed to simply providing a link to required information on the SEC's EDGAR system. Among the key elements included in the corporate governance section are: bylaws, code of conduct and ethics, board of directors information, board committee mandates, basis for executive compensation, and information on insider purchases and sales. Relevant corporate governance and disclosure data should be woven into the company's 10-K and proxy statement. These filings are important source documents for the rating agencies, and can serve to reduce the number of mistakes by such services.

**4. Model various governance structures to determine potential rating changes.**

Positive ratings will become increasingly important as large investors learn how to integrate these

recommendations into their investment analysis. Management can develop "what if" scenarios to determine the benefit of changing bylaws, compensation structure, or stock option plans. If a positive rating change can be used to lower the cost of capital in connection with a financing or other transaction, which requires stockholder approval, such change may be worth it.

**5. Publicize the ratings.**

During the 2003 proxy season, Aetna, Inc. received a very positive rank from ISS and a below-average rank from Corporate Library. Aetna chose to publicize the ISS ranking as more representative of their overall approach to corporate governance and disclosure.<sup>6</sup> Increasingly shareholders will be asking about a company's ranking, and it would be appropriate to discuss governance policies and philosophy in investor presentations and publicize the company's governance rating in a press release.

## Conclusion

Rating services are increasingly wielding significant power in advising investors with respect to issuers' corporate governance and disclosure practices. Low ratings can increase the company's cost of capital by reducing the share price and encouraging shareholder activism. A proactive approach to integrating the new ratings dynamic into shareholder relations planning and execution will go a long way toward maintaining the highest sustainable shareholder value.



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<sup>1</sup> “Shareholders Wield Proxies to Effect Change,” *Corporate Governance*, June 2003

<sup>2</sup> Macey, Jonathan, “Measuring the Effectiveness of Different Corporate Governance Systems: Toward a More Scientific Approach,” *Journal of Applied Corporate Finance*, December 1999

<sup>3</sup> *ibid*

<sup>4</sup> “Corporate Governance and Shareholder Activism,” *A Symposium*, December 2002

<sup>5</sup> “Corporate Governance Scores and Evaluations,” Standard & Poor’s, 2003

<sup>6</sup> “Want to Lift Your Firm’s Rating on Governance? Buy The Test,” *Wall Street Journal*, June 6 2003