

NOT YOUR GRANDFATHER'S CGQ: INTRODUCING VERSION 3.0 OF THE INSTITUTIONAL SHAREHOLDER SERVICES CORPORATE GOVERNANCE QUOTIENT AND ITS IMPLICATION'S FOR NOMINATING & GOVERNANCE COMMITTEES.

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CGQ is a “pain in the rear” for many corporate Directors, a justifiable source of anger, and a governance point of reference that Boards dare not be ignored.

Version 3.0 of CGQ stands for Corporate Governance Quotient, a service of Institutional Shareholder Services (ISS). It is constructed differently from Versions 1 and 2 and it has a far wider distribution. This gives Version 3.0 broader implications for Board members.

Each year, ISS reviews the governance practices of 7500 companies in the North America, Europe, and Asia. The resulting CGQ score is used by ISS to justify its recommendations to institutional investors to vote for against the re-election of the Board as well as other votes brought before shareholders at annual meetings.

CGQ scores are typically viewed by a subscriber base or institutional investors. It is a risk management tool. Low scores are predictive of shareholder law suits. High scores are not necessarily predictive of anything.

In this article, I seek to demonstrate that the above summary is both correct and too limiting. Version 3.0 of CGQ is fundamentally different than Version 1.0 and 2.0. CGS distribution channels are wider than many Board members and CEOs are aware of. The CGS tool has broader uses that need to be taken into account.

As Boards begin to grasp the new distribution and statistical implications of Ver 3 of CGQ, I believe that this will cause some changes in the charter of Nominating & Governance Committees of Boards of Directors in the direction of explicitly monitoring CGQ scores annually and recommending a course of action to the Board of Directors.

WHAT IS CGQ?

Institutional Shareholder Services (ISS) is a division of a public company called Risk Metrics Group, Inc. The Corporate Governance Quotient (CGQ) was a tool to provide institutional investors with a measurement tool to evaluate governance risk. Low scores would be associated with low shareholder performance and a high probability of shareholder class action lawsuits. I want to stress that the tool was designed for institutional investors and the focus was on identification of investment risks.

It has two popular uses: (1) CGQ is used to justify ISS recommendations to recommend votes for or against Board of Director candidates at annual meetings. These recommendations are given to institutional investors who sign up for ISS services (2) institutional investors use CGQ scores as a factor in determining risk. Low scores are correlated with high potential of class action shareholder law suits. But high scores do not have predictive validity.

Is this popular view correct or is it too limiting?

CCQ Ver. 1.0

The original CGQ was developed in 2002 after an 18 month review with a panel of outside governance experts. Its basis was more the intuition of good governance experts than statistical analysis. Version 2.0 was created in 2003 to conform to the new Sarbanes Oxley laws.

VERSION 3 was created in 2005 by statistically examining the universe of CGQ ranked companies. Between 2003 and 2004 ISS performed more than 4,000 statistical tests. Each of the 77 factors making up CGQ measurement from 2002-2004 was statistically tested against 16 performance measures (P/E, beta, ROI, ROE, ROA, etc.).

Version 3.0 is different from Versions 1 and 2 in two respects. It is statistically driven and it looks at the correlation between positive performance on CGQ and positive things happening for shareholders like ROA.

The Correlation between Corporate Governance and Company Performance

This is a summary of research conducted by Professor Lawrence D. Brown, Ph.D .
Distinguished Professor of Accountancy Georgia State University

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Firms in the bottom decile of industry-adjusted CGQ (Corporate Governance Quotient) have 5-year return on investment that are 5% below the industry average, while firms in the top decile of industry-adjusted CGQ have 5-year returns that are 19% above the industry-adjusted average.' The difference in performance between these two groups is 24%.

You see similar dramatic data when you look at price volatility over a 3 to five year period; return on assets; and return on investment.

What CGQ factors are driving this trend? The most important factor is Board Composition. This puts CGQ within the jurisdiction of Nominating & Governance Committees.

CGQ scores are available to anyone with access to the Internet. Go to your favorite search engine and type "yahoo finance profile (name of company or stock symbol). The CGQ scores appear on the lower right side of the screen.

IMPLICATIONS

If I want to elevate a public company CEOs blood pressure or spoil a convivial dinner together, just ask "What do you think of ISS?"

They will say that managing a complex corporation can't be reduced to a simplistic score like CGQ.

They will say that scores are arbitrary and capricious and don't make sense. They will say that ISS sets itself up as the score keeper and then sells consulting services to Boards seeking to improve their ISS scores. That is a clear conflict. Some feel it is extortion.

As if that wasn't enough, Risk Metrics Group is a public company that owns ISS. ISS has not evaluated itself.

**FUTURE USES OF CGQ
BASED ON THE NEW DISTRIBUTION CHANNELS
AND NEW STATISTICAL ANALYSIS.**

CEOs and Board members may dislike ISS but they ought not to ignore it.

The CGQ mission has expanded from identification is high risk investment for a small group of investors to a tool available to everyone with access to the Internet. It will identify public companies correlated with good investment potential while retaining its original mission of putting a spotlight on companies that are high risk.

New uses for CGQ available through yahoo finance will be as a tool for M&A planners to decide if they want to make an acquisition or be acquired. It will be a factor in strategic alliances. Companies with high scores will use their scores to attract talent to join the company.

I predict that the Nominating & Governance Committees of Boards of Directors will be tasked with the role of annually looking at their ISS scores and make a recommend to the full Board whether to accept these ISS scores or seek to improve on the scores. Seeking to improve ISS scores by hiring ISS to consult on the improvement is a dicey road for Boards to take and a dicey road for ISS if it wishes to improve his reputation within the business community. If ISS continues down the road it is traveling, it could be vulnerable to competing rating services such as The Corporate Library.

ABOUT LARRY STYBEL

Founded in 1980, Board Option's mission is to provide critical talent management resources to Nominating & Governance Committees of Boards of Directors. Board Options, Inc. is independent of ISS.

Google ranks boardoptions.com #1 on the Internet in the category "board talent."

Larry Stybel is Vice President of Board Options, Inc. and Executive in Residence at the Sawyer School of Business at Suffolk University. He has served on a variety of Boards, including the National Association of Corporate Directors New England Chapter, COMPENSATION & BENEFITS MANAGEMENT, and a variety of venture backed

technology companies. His clients include a number of prominent Fortune 500 company Boards.

As a thought leader in leadership and governance, Larry is frequently interviewed on leadership and governance in THE WALL STREET JOURNAL. He was a contributor to THE HARVARD BUSINESS REVIEW ON CAREER MANAGEMENT. (Boston: Harvard Business School Publishing, 2003) and THE HARVARD BUSINESS REVIEW ON HUMAN RESOURCE MANAGEMENT (Boston: Harvard Business School Publishing, 2002). His articles about leadership and governance have been published in CALIFORNIA MANAGEMENT REVIEW, DIRECTORSHIP, HARVARD BUSINESS REVIEW, and MIT SLOAN MANAGEMENT REVIEW. Larry's work has been profiled in BUSINESS WEEK, FORTUNE, FORBES, INVESTOR'S BUSINESS DAILY, THE NEW YORK TIMES, and THE WALL STREET JOURNAL.

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