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Research Analyst Views of Corporate Governance

2007 NATIONAL DIRECTORS INSTITUTE

RESEARCH ANALYST VIEWS OF CORPORATE GOVERNANCE

Is corporate governance a non-factor for analysts? Or is it, in fact, an issue that analysts take into consideration, specifically when dealing with long term investors? This session led to a lively debate as to the role and importance that corporate governance plays in a research analyst's mind and covered such topics as the importance or non-importance of ISS scores, the role that Sarbanes-Oxley plays in corporate governance, corporate governance distinctions between small- and large-cap companies, short term investors vs. long term investors, and the role that hedge funds play in the world of corporate governance.

At the sixth annual Foley & Lardner LLP National Directors Institute held March 8, 2007 in Chicago, Illinois, a panel including John McGinty, advisor at UBS Securities LLC, and a former research analyst for 36 years; Beth Saunders, founding partner and chairman at Ashton Partners; Fred Bratman, president at Hyde Park Financial Communications and Richard Grubaugh, senior vice president at D.F. King & Company, Inc., addressed the issue of "Research Analyst Views of Corporate Governance."

The Importance - *or Lack Thereof* - of Corporate Governance to a Research Analyst

Generally speaking, corporate governance, at least corporate governance ratings and scores, aside from outlier cases, is a non-factor in the minds of a research analyst when deciding whether to recommend to buy or sell the stock of a company. The only important factor to consider when dealing with the management of a company is sustainability and whether or not the company will be able to operate 20 years down the road. Ashton Partners, a strategic advisory firm specializing in investor relations and corporate communications, performed a survey of 200 portfolio managers and analysts on the buy side and the information garnered from the survey supported the initial argument that corporate governance is a non-factor. According to the survey results, roughly one-third of the individuals surveyed had not even heard of a corporate governance quotient (CGQ), a score utilized by Institutional Shareholder Services, Inc. (ISS) that enables analysts and others to evaluate a company's relative success in adopting good corporate governance practices. Another one-third of the individuals surveyed stated they are aware of corporate governance, but that they do not consider corporate governance a factor in making investment decisions or recommendations. Finally, a small group of the individuals surveyed stated that corporate governance played a minimal role in their investment decisions or recommendations, but only in outlier cases, and only when corporate governance was a negative factor.

Corporate governance has always been an important topic for industry activists who want every company to have a perfect CGQ score and to be in accordance with the guidelines set forth. However, the consensus among the panelists was that as long as a company was not at the bottom of the pack with respect to its CGQ scores, analysts would not raise any red flags. In essence, associating corporate governance with obtaining a good CGQ score by checking boxes and complying with the Sarbanes-Oxley Act (SOX) is irrelevant and only a short-term indicator of the company's governance patterns. Although a CGQ score is not of importance to an analyst when investment recommendations, it is crucial that a company has good decision making processes, a competent CEO and board of directors, and adequate time to make its corporate decisions.

Sarbanes-Oxley Act (SOX) and the Role it Plays

Compliance with SOX is an obvious necessity, but in the end, the investment community is only interested in the bottom line performance of a company. In spite of this argument, investors and analysts understand that in order to have a successful company, senior management must be trusted and therefore a company's governance structure may play a role. Regarding SOX requirements, one panelist mentioned that any member of a board of directors who spends more time complying with the SOX requirements than is absolutely necessary, is in fact breaching his or her duties to the corporation. The growth and future strategy for a company is an important factor that analysts view and rely on, and a board of directors only has a finite number of hours to spend planning the long-term strategy of a company. If all of the board's time is consumed dealing with corporate formalities such as SOX and taking the necessary actions to obtain a high CGQ score, the board will in fact have failed in its most important function, namely that of guiding management and coordinating efforts to ensure the company's long term future strategic goals and plans.

Does Corporate Governance Matter?

In certain situations, corporate governance and CGQ scores are important. Long-term institutional investors are more focused on the role of corporate governance and place greater importance on it when making investment decisions. In theory, these investors are concerned with executive compensation and a split role between the chairman of the board and CEO, among other factors. However, even for institutional investors, some panelists still felt strongly that corporate governance does not play a role and that investors would not focus on splitting up the board and CEO until a problem arose. Even when dealing with executive compensation and CEO salaries, the argument was made that investors are satisfied if shareholders are seeing a profit. It is only in special circumstances, when major problems with a company arise, that questions are asked and corporate governance becomes an issue.

Some attendees disagreed and felt that many companies in today's business community are creating relationships with their institutional investors and that a part of these relationships involves a focus on the importance of a company's corporate governance. One attendee, who is employed with a company that has a market capitalization in excess of $18 billion, stated that her institutional investors are demanding that there be separation of CEO and chairman of the board and, in general, good corporate governance practices at her company. It appears that for large-cap companies, institutional investors may be putting greater importance on corporate governance, even though research analysts have not yet taken this approach.

Corporate governance, and specifically ISS ratings, may also play an integral role in certain shareholder voting situations, particularly when seeking approval of a merger transaction or option plans. If a small percentage of votes are needed in a closely contested vote, a company's CGQ score or ISS rating may well be the factor that helps push the vote in the company's favor.

For More Information

For more information on this session or the sixth annual National Directors Institute, visit Foley.com/ndi2007 or contact the panelists directly.

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Save the date! The 7th Annual National Directors Institute will be held on March 6, 2008 in Chicago. Learn more at Foley.com/ndi.