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Corporate Governance Ratings Debunked

In recent years, the corporate governance ratings marketed by commercial proxy advisory and governance rating firms, particularly the Corporate Governance Quotient or "CGQ" created by Riskmetrics (formerly Institutional Shareholder Services), have become increasingly influential. These ratings are promoted – and increasingly viewed by investors and even some corporate directors – as meaningful measures of a corporation's governance practices and useful tools for shareholders to identify companies to avoid investing in. Some boards of directors have been willing to sacrifice fundamental protections to enhance their CGQ ratings. Anheuser Busch is the latest US company to fall prey to a hostile takeover shortly after repealing its classified board in the name of adherence to "best practices in corporate governance." It has been an open question whether the CGQ and similar ratings deserve the homage they have been accorded in the relatively short period since their invention or whether they are merely illusory. That question has now been answered.

A recent study by three leading independent researchers, Professors Robert Daines, Ian Gow and David Larcker of Stanford University, the first to examine the value and validity of commercial governance ratings, concludes that "the level of predictive validity for these ratings is well below the threshold necessary to support the bold claims made for them by these commercial firms." Attached are links to their full report "Rating the Ratings: How Good Are Commercial Governance Ratings?" and also our prior memorandum "There Is No Connection Between Corporate Governance and Corporate Performance" which highlights an earlier consistent academic study.

The Stanford trio examines the ratings produced by four leading ratings firms to determine whether there is any statistically valid association between the ratings and either positive future firm performance or avoidance of undesirable outcomes such as accounting restatements or shareholder litigation. Their analysis yields several important conclusions. "One especially interesting result," the authors note, "is that *CGQ* (perhaps the most visible governance rating) exhibits virtually no predictive validity. However, the level of predictive validity even for the best ratings is well below the threshold necessary to support the bold claims by the corporate governance rating firms."

The Stanford study confirms that one-size-fits-all governance ratings are of little predictive value and do not deserve the talismanic power they have assumed in today's overheated corporate governance environment. Companies and boards of directors should embrace governance structures and programs that are appropriate to their specific circumstances, taking into account generally accepted "best practices" as appropriate, but not go out of their way to raise their company's governance "scores" for their own sake. Shareholders should be skeptical of entrepreneurial self-styled authorities who peddle their creations as new standards that will increase the value of a company's stock.

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