STYBEL PEABODY & ASSOCIATES, INC.

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INSTITUTIONAL SHAREHOLDER SERVICES (ISS): PROVE TO US THAT YOUR BOARD DIRECTORS ARE PROPERLY EDUCATED FOR THEIR GOVERNANCE ROLES.

Who is the Board's Chief Learning Officer? If Nobody Has Been Designated for this Role, Then the CEO becomes the CLO. See any Problems Here???!!

Equifax presents a cautionary governance tale for CEOs and for those who serve on Boards.

Founded in 1899, Equifax is an Atlanta-based public company with a market capitalization of US$14 billion. It employs 9,500.

Fifteen years from now the Equifax Case will be taught to aspiring business leaders as a good example of what NOT to do in a crisis. The purpose of this article is to focus on governance lessons to be learned.

While Equifax is a public company, the lessons apply to Board members of private companies and nonprofits.

It "Hits the Fan" at Equifax.

In September 2017 Equifax revealed a cybersecurity theft of the records of 143 million people living in the United States and Canada. Thieves stole names, Social Security numbers, birth dates, addresses, and driver's license numbers. The hackers also secured 209,000 credit card numbers and 182,000 documents containing personally identifying information.

It is estimated that hackers can sell this information for up to $30 per person on the black market. Over the next years, those armed with this information can open bank accounts in your name, establish lines of credit, obtain new credit cards, and steal your tax refund. (Goldman, 2017).

The quality of data stolen plus the scale of the theft made this cyber theft a signature threat for U.S. and Canadian consumers.

Equifax' Response to the Data Breach.

Looking at the individual biographies of top management and Board members, one could not help but be impressed. These people must be very intelligent. They know their business.

When "Stuff" hit the fan at Equifax, however, the Board and the top management team made the following decisions:

> Kept the data theft from the public for six weeks after discovery, thus giving the hackers a six-week jump on consumers.
>
> Some of the VP level people at Equifax sold shares of their Equifax stock during the time Equifax was keeping this data breach secret.
>
> Initially proposed that individuals whose data was compromised by Equifax be given only one year of free credit monitoring service---in return for a promise not to sue Equifax.

Where Was the Board?

In a large public company like Equifax, it is the nature of Board work to be hands-off with operations. The cliché in Board circles is, “Nose in Fingers out.” Investors have the right to question how much the Board knew and what decisions it made in response to management actions.

> It is the role of the Board of Directors to establish governance in the interests of investors. And investors have been harmed by the failure of the Equifax Board to appropriately govern Equifax management.
>
> Corporate Culture is set at the top. And the top is the Board of Directors. There must have been something about the Equifax Board culture that made the CEO believe his decisions in response to the crisis would receive Board approval.

Director and Officer Liability Insurance (D&O) will probably cover the costs of legal fees and eventual claim settlement. But D&O insurance will never recover the reputational costs that Board members must carry for the rest of their lives.

> "It is not a good day to be on the Equifax Board," says David Finke. He heads global technology at the executive search firm Russell Reynolds Associates. (Keitz, 2017)

It's About Governance:

The Merriam Webster dictionary definition of governance is "to exert a determining or guiding influence." In other words, CEOs left unchecked may mange a company so that it focuses on providing maximum short-term benefit for the CEO's personal wealth, while leaving the interests of long-term shareholders at a disadvantage.

Is such CEO behavior "disgraceful?"

We argue, that this CEO behavior is to be expected. The Board hires CEOs who are competent business leaders who wish to enhance their personal wealth. It is not in the business of hiring enlightened philosophers.

Corporate Governance is a checks and balances system.

It is the role of the Board to keep the CEO on track so that the company is being managed in the best interests of those shareholders the Board wishes to most help:

> The interests of speculators and short-term investors can be at odds with the interests of long-term investors. It is the Board's role to be clear in whose interests the Board is governing. You can never please all shareholders and Boards should not even try.

Boards should be clear which type of shareholder it is serving. If enough shareholders do not like the way the Board serves them, Board members can be defeated by appropriate shareholder votes.

The Nominating & Governance Committee:

Every Board of Directors has a Nominating & Governance Committee.

> It is the job of this Committee to ensure that the right talent is on the Board and that the Board is educated to execute on its responsibilities.

In Equifax' website, there is a document outlining 12 duties of the Governance Committee.

> There is no specific requirement that the Governance Committee will provide Board members with the appropriate education so that Board members can execute their responsibilities to shareholders.

This is the issue of concern to the Institutional Shareholder Services (ISS). And the Equifax case shows that this concern is appropriate.

In the Equifax case, since the Nominating & Governance Committee failed to explicitly take the initiative to educate Board members, then who has had that responsibility?

> At the Board level, power vacuums will be filled by the CEO. In the Equifax case, the CEO became the Board of Director’s Chief Learning Officer. And yet the Board is responsible for hiring/compensating/firing the CEO.
>
> See anything wrong here??

We do not have direct access to Board members at Equifax, but the Board's own published documents suggest this was indeed the framework.

Equifax Board of Directors: insufficiently curious.

We submit that the Equifax Board was insufficiently curious.

Another diagnostic sign of insufficient curiosity comes from the Institutional Shareholder Services itself.

The Institutional Shareholder Services (ISS) evaluates the quality of board of director governance so that institutional investors can assess the risk of class action shareholder lawsuits. ISS will also advise their clients to vote for/against specific Board members or entire Board candidate slates proposed for election.

ISS has been evaluating the quality of Boards of Directors for more than thirty years. It covers 20,000 public companies around the world.

The ISS ratings are a useful, impartial clue about the quality of governance in a public company.

For an in-depth discussion about what goes into the ISS Governance Quality Score:

https://www.issgovernance.com/solutions/iss-analytics/qualityscore/

ISS Governance Quality Scores range from 1-10. The higher the number the higher the probability that the company will be hit with shareholder class action lawsuits.

On September 1, 2017 the ISS overall ranking for Equifax was “5.”

Consistent with our thesis of “insufficiently curious, an ISS rating of 5 is like a “Gentleman’s C:” it does not ring alarm bells nor is it reason to celebrate.

An insufficiently curious Board would have viewed 5 as “good enough.”

When thinking about joining the Board of a public company, investing in a public company, or being an employee at a public company, beware of ISS ratings of 5 or less. One can have a company producing excellent Return on Investment with an ISS score of 5 or less. But it gives a diagnostic signal about the corporate culture at the top.

Summary and Conclusions:

The Equifax break in of September 2017 is the financial equivalent of a Class Five Hurricane. Its impact will be felt for years. Management’s response to the disaster will educate generations of business leaders about how not to respond during a crisis.

We also suggest that there are governance lessons to be learned from the Equifax case.

All Boards of Directors have Nominating & Governance Committees. That includes profit, non-profit, public, and private.

The Governance Committee's role is to ensure that there is the right talent on the Board and the right education of Board members. If it fails to take the lead on Board education, then it implicitly is saying the "CEO will tell us what we need to know so that we can appropriately evaluate the CEO's performance."

We recommend the following:

> Once a year, the members of the Nominating & Governance Committee should sit down with the CEO and a third party to discuss industry, regulatory, and governance issues that will impact the company over the next twelve months. Based on that discussion, a list of twenty-four topics should be created.

Someone hired by the Nominating & Governance Committee should be tasked with finding "best in class" articles, webinars, and podcasts for each topic. Board members will receive two online education briefings a month. Two articles a month respect the limitations of Board member time, but it does raise the bar on excellence.

The ISS score is a diagnostic tool to understand the dynamics of the Board. Numbers range from 1-10. When you see scores in the 8-10 range, you should worry about shareholder class action lawsuits and whether the Board is powerful enough to manage the CEO. When you see numbers in the 5-6 range, you should worry that this Board is insufficiently curious.

No Board would ever describe itself as "insufficiently curious." Many Boards do describe themselves as "collegial."

Collegiality has a dark side.

References:

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