

October 22, 2018

# Corporate Governance Updates: Launch of 2019 ISS Comment Period and Release of Commonsense Principles 2.0

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**Comment Period for the ISS Benchmark Policy Opens, With No Proposed Action on Some of the Most Controversial Topics Covered by the 2019 Survey**

**“Commonsense Principles 2.0” Aim to Combat Unhealthy Short-Termism**

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## SUMMARY

On October 18, Institutional Shareholder Services Inc. (“ISS”) announced that the comment period for its 2019 benchmark voting policy is open until 5:00 PM ET on November 1, 2018. For U.S. companies, ISS is soliciting comments on proposed changes relating to board gender diversity and say-on-pay secondary screens. However, the proposed policy change relating to board gender diversity is not proposed to be in effect for 2019. ISS is not soliciting comments for tracking director controversies on other company boards or providing adjusted voting results for dual-class companies, both of which were included in ISS’s annual policy survey earlier this year.

Also, on October 18, a group of 21 executives from some of the largest U.S. public companies and asset managers, as well as public pension funds and mutual fund companies, released an updated statement of corporate governance principles for public companies, their boards of directors, and their shareholders. Referred to as “Commonsense Principles 2.0,” the new Principles are intended to update the principles published in 2016 and recognize the efforts of the Investor Stewardship Group (“ISG”), the Business Roundtable (“BRT”), the World Economic Forum, and others in the continuing dialogue regarding effective governance. In addition to recommending that asset managers and institutional asset owners

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take a more active role in encouraging long-term value creation by public companies and their boards, the revised Principles address the importance of director independence, early board engagement on important shareholder proposals, and shareholder proxy access. The group also committed to applying the Commonsense Principles 2.0 in their respective businesses and urged their peers to similarly use the Principles as a guide for their own companies. The principles also state that poison pills and other anti-takeover defenses should be put to a shareholder vote.

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### 2019 ISS BENCHMARK POLICY – U.S. PROPOSALS FOR COMMENT

As it does each year, ISS is soliciting comments from asset owners, asset managers, companies, and other market players prior to the release of its annual Benchmark Policy.<sup>1</sup> The 2019 Benchmark Policy is expected to be released in mid-November and will apply to shareholder meetings held on or after February 1, 2019.

ISS is proposing a new voting policy for directors on companies with no female directors.<sup>2</sup> Under the proposed policy, ISS would issue negative recommendations on the nomination committee chair at boards with no female directors, on a case-by-case basis, for companies in the Russell 3000 or S&P1500 beginning with shareholder meetings held on or after February 1, 2020. The policy provides that ISS will consider mitigating factors such as a firm commitment in the proxy statement of the company to appoint a female director to the board before the next annual meeting. ISS is also seeking comments on whether the proposal should be expanded to include recommending against directors other than the nominating committee chair, other mitigating factors that could temporarily excuse a company from having female representation on its board, the appropriate timeline for appointing a board's first female director, and the effective date of the new policy.

In addition to its proposal for board gender diversity, ISS is also proposing to update its secondary Financial Performance Assessment screen for evaluating the alignment between CEO pay and company performance.<sup>3</sup> In particular, ISS is proposing to replace unadjusted GAAP measures with measures based on Economic Value Added ("EVA"), which ISS states is essentially a company's Net Operating Profit After Tax less the cost of providing an acceptable return to a company's capital providers. ISS is seeking comments on the desirability of the switch to EVA-based measures, whether Total Shareholder Return ("TSR") should remain as the primary ISS pay-for-performance screen, and the utility of continuing to display GAAP performance data if a switch is made over to EVA-based measures. The use of EVA is also being proposed for Canada.

ISS is also requesting feedback for seven other voting policy areas: (1) board and gender diversity in Canada; (2) board independence and disclosure in Taiwan; (3) director independence relative to tenure in Latin America; (4) director independence in Japan; (5) auditor ratification in the United Kingdom, Ireland,

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and Europe; (6) audit committee independence in Europe; and (7) auditor fees and audit committees in India and the Asia-Pacific region.

The announcement of the comment period comes a month after ISS released the results of the first half of its Annual Policy Survey. In that survey, over 80 percent of investors indicated that it would be problematic for a public company board to have zero female directors, up from 69 percent in 2017, and over 60 percent of non-investors responded it would be problematic, up from 54 percent in 2017. In addition, the survey results included support for ISS to consider items such as director controversies on other company boards and provide adjusted voting results for dual-class companies, which matters are not included in the latest proposals for comment. By comparison, the proposals related to board gender diversity and say-on-pay secondary screens are significantly less controversial.

The comment period for the 2019 benchmark voting policy will be open until 5:00 PM ET on November 1, 2018.

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### COMMONSENSE PRINCIPLES 2.0

On July 21, 2016, a group of 13 executives published a report describing a set of “Commonsense Corporate Governance Principles” as part of an effort to jumpstart a dialogue on the governance of U.S. public companies.<sup>4</sup> Those principles provided a framework to support strong and lasting corporate governance and recommended, among other concepts, competent, diverse, and independent boards with appropriately aligned incentives and tenures, an emphasis on long-term strategy in public reporting, sensible use of non-GAAP measures, and greater access by asset managers to companies and their key decision makers, and vice versa.

In the two years since, groups such as the ISG, BRT, and the World Economic Forum have published their own works on the subject. In recognition of those works and after further reflection on its own principles, the group, now comprising 21 executives, has revised the principles and published “Commonsense Principles 2.0.”<sup>5</sup> The group highlights the fact that the number of public companies in the U.S. has precipitously declined in the last 20 years, and, with Commonsense Principles 2.0, takes direct aim at combatting the short-term oriented focus of public market participants that may discourage companies from going public.

The group comprised the following executives: Tim Armour, CEO of Capital Group; Mary Barra, CEO of General Motors; Ed Breen, CEO of DowDuPont; Warren Buffett, CEO of Berkshire Hathaway; Jamie Dimon, CEO of JPMorgan Chase; Mary Erdoes, CEO of JPMorgan Asset Management; Larry Fink, CEO of BlackRock; Alex Gorsky, CEO of Johnson & Johnson; Mark Machin, CEO of Canada Pension Plan Investment Board; Lowell McAdam, CEO of Verizon; Bill McNabb, CEO of Vanguard; Brian Moynihan, CEO of Bank of America; Ronald O’Hanley, CEO of State Street Global Advisors; James Quincy, CEO of Coca-Cola; Brian Rogers, Non-Executive Chairman of T. Rowe Price; Ginni Rometty, CEO of IBM;

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Charles Scharf, CEO of BNY Mellon; Randall Stephenson, CEO of AT&T; David Taylor, CEO of Procter & Gamble; Jeff Ubben, CEO of ValueAct Capital; and Theresa Whitmarsh, Executive Director of the Washington State Investment Board. Of the group, nine signatories lead large asset managers, including Blackrock, Vanguard, and State Street. In that regard, their agreement to adhere to the updated Principles could be viewed as underscoring their respective separately published voting guidelines, and could indicate how they will vote in the upcoming proxy season. The group also features nine new signatories: Ed Breen, Alex Gorsky, Brian Moynihan, James Quincy, Ginni Rometty, Charles Scharf, Randall Stephenson, David Taylor, and Theresa Whitmarsh.

The updated Principles are organized into the same eight main topics as the original Principles: (1) Board of Directors—Duties, Composition and Internal Governance; (2) Board of Directors' Responsibilities; (3) Shareholder Rights; (4) Public Reporting; (5) Board Leadership (Including the Lead Independent Director's Role); (6) Management Succession Planning; (7) Compensation of Management; and (8) Investors' Role in Corporate Governance.

As with the original principles, many of the recommendations and guidelines contained in Commonsense Principles 2.0 reflect best practices widely adopted by large-cap companies, as well as state law, Securities Exchange Commission and stock exchange requirements. Some notable updates include:

- ***Directors' Duties of Loyalty and Care.*** In accordance with law, directors owe duties of loyalty and care to the company on whose board they sit. The Principles recommend that companies evaluate the performance of their directors using the long-term performance metrics of the company, whether financial or otherwise.
- ***Election of Directors.*** In order to promote board accountability, companies should consider requiring all directors to stand for election on an annual basis and, absent such requirement, should clearly explain their rationale. Regardless of the frequency of director elections, the Principles recommend that a director refrain from joining a board unless he or she is committed to serving on the board for at least three years. In addition, the Principles recommend that an individual director who is not elected by a majority of the votes cast should tender an offer of resignation, which the board ordinarily should accept.
- ***Engagement on Shareholder Proposals.*** The Principles recommend that companies engage on shareholder proposals as early as possible, preferably before the proposal is included in the company's proxy statement. If a proposal receives majority support, the company should consider further engagement with shareholders and either implement the proposal (or a comparable alternative) or promptly explain why doing so would not be in the company's long-term best interests. The Principles also recommend, as a best practice, further engagement with shareholders on proposals that receive significant but less than majority support (but note that the board should be mindful that a majority of the shareholders did not support the proposal when considering the appropriate response).
- ***Shareholder Rights and Proxy Access.*** Companies should consider allowing for some type of reasonable proxy access for shareholders. However, the proxy access should not be unduly burdensome for significant long-term shareholders. The Principles continue to observe that larger companies with market capitalization of more than \$2 billion generally provide for a minimum 3% threshold of ownership for three years in order to nominate 20-25% of a company's board seats. For the first time, the Principles recognize that the 3% ownership threshold may not be appropriate for smaller companies. ISS has not yet recognized this concept.<sup>6</sup>

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- **Poison Pills and Anti-Takeover Measures.** As a general matter, boards should consider the potential poison pills and other anti-takeover measures have to reduce board accountability to shareholders when considering whether to adopt such measures. Should a board choose to adopt a poison pill or other anti-takeover measure, the Principles recommend that the board put the measure to a shareholder vote after clearly explaining why adopting the measure would be in the shareholders' best interests.
- **Committee Independence; Board Leadership.** The Principles specifically recommend that all members of the audit, compensation, and nominating and governance committees of the board be independent. The Principles also recommend that independent board leadership be achieved through an independent chair or the identification of a lead independent director, in each case with clearly defined, robust, and disclosed roles.
- **Long-Term Value Creation.** With respect to the role of investors in corporate governance, the Principles recommend that asset managers and institutional asset owners such as pension plans and endowments use their position and influence to encourage companies and their boards to adopt a long-term focus on value creation. By the same token, the Principles also recommend a portion of portfolio managers' compensation be tied to performance over an appropriate time horizon (typically three, or five-year, as well as a one-year, periods).
- **Disclosures by Asset Managers.** In order to promote transparency and avoid conflicts of interest, asset managers that rely on recommendations from proxy advisors in their decision-making should disclose that fact and ensure that such information relied upon is accurate and relevant. Asset managers should also publicly disclose their policies for dealing with potential conflicts of interest with respect to proxy voting and engagement.

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### ENDNOTES

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- <sup>1</sup> The 2019 ISS Benchmark Policy website can be found at <https://www.issgovernance.com/policy-gateway/2019-benchmark-policy-consultation/>.
  - <sup>2</sup> The proposed new policy with respect to U.S. Board Gender Diversity is available at <https://www.issgovernance.com/file/policy/2018/DirectorElections-BoardGenderDiversity-US.pdf>.
  - <sup>3</sup> The proposed new policy with respect to say-on-pay secondary screens for the U.S. and Canada is available at <https://www.issgovernance.com/file/policy/2018/ISSPayforPerformanceModel-FinancialPerformanceAssessmentMethodology-USandCanada.pdf>.
  - <sup>4</sup> The original Open Letter and Principles are available at <http://www.governanceprinciples.org/wp-content/uploads/2018/10/2016-Open-Letter-Principles.pdf>.
  - <sup>5</sup> The revised Governance Principles are available at <http://www.governanceprinciples.org/wp-content/uploads/2018/10/CommonsensePrinciples2.0.pdf>.
  - <sup>6</sup> US Proxy Voting Research Procedures & Policies (Excluding Compensation-Related) – Frequently Asked Questions, available at <https://www.issgovernance.com/file/policy/active/americas/US-Procedures-and-Policies-FAQ.pdf>.

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