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INVESTOR STEWARDSHIP GROUP'S PRINCIPLES GO INTO EFFECT

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In this article, we provide an overview of the Investor Stewardship Group (the "ISG") Governance Principles and steps for public companies to consider when evaluating how the principles may be incorporated into their own disclosure and engagement priorities. The ISG's website, including a link to the ISG Governance Principles, is available at http://www.isgframework.org/corporate-governance-principles

In January 2017, the Investor Stewardship Group (the "ISG"), a collective of large U.S.-based and international institutional investors and asset managers, announced the launch of its Framework for U.S. Stewardship and Governance (the "Framework"). The measure is an unprecedented attempt to establish a set of elementary corporate governance principles for U.S. listed companies (the "ISG Governance Principles") as well as parallel stewardship principles for U.S. institutional investors. The Framework's effective date was January 1, 2018, in order to provide U.S. listed companies with time to adjust to the corporate governance principles prior to the 2018 proxy season.

As the 2018 proxy season gets into full swing, there is evidence that ISG members will be utilizing the Framework as a tool for evaluating the governance regimes at their portfolio companies, informing their engagement priorities, and potentially factoring compliance with the ISG Governance Principles into selected voting policies and decisions. In December, the ISG issued a press release "encouraging companies to articulate how their governance structures and practices align with the ISG's Corporate Governance Principles and where and why they differ in approach", leaving it to companies to determine how and where to disclose such alignment. And at least one large investor, State Street Global Advisors, has specifically highlighted that it will screen portfolio companies for compliance with the principles.
As a result, companies and their boards should continue to benchmark and understand how their specific governance practices relate to ISG Governance Principles and remain cognizant of this new regime as they prepare for engagement with investors and draft public disclosures.

BACKGROUND

The ISG's global reach and financial influence is significant; currently consisting of 50 investors representing over $22 trillion invested in the U.S. equity markets. The ISG's signatories includes some of the largest and most influential institutional investors, including BlackRock, CalSTRS, State Street Global Advisors, TIAA Investments, T. Rowe Price, ValueAct Capital and Vanguard, among others. The Framework's stewardship principles emphasize that these institutional investors have a vested interest and responsibility for the long-term economic success of their portfolio companies.

The ISG's roll-out of the Framework characterized it as a "sustained initiative" and emphasized an evolutionary view of the ability of U.S. companies and investors to work together under the Framework.

Corporate governance practices at U.S. listed companies have historically been informed by multiple regulatory and rules-based regimes. Rules and regulations of the Securities and Exchange Commission, stock exchange listing requirements, state corporate codes, case law and federal legislation adopted in the wake of past financial market crises, have been the primary dictating standards. More recently, shareholders and other stakeholders have played a larger role in influencing corporate governance norms at U.S. listed companies through engagement and various forms of shareholder activism. In contrast, the ISG Governance Principles are based substantially on U.K., Continental European and other non-U.S. frameworks that establish principles-based corporate governance standards and tend to rely on "comply-or-explain" accountability.[1] Advocates for this type of principles-based approach stress the flexibility that it gives for companies to adopt a tailored response to important tenets such as boardroom transparency, as opposed to responding more narrowly to prescriptive rules. As institutional investors continue to focus more attention on environmental and social matters, including related governance concerns, the Framework's principles-based approach will be a tool, for both institutions and companies, to promote mutually agreeable objectives, particularly given the lack of rulemaking or legislation mandating more specific disclosure on trending topics such as board diversity and environmental concerns.

THE ISG GOVERNANCE PRINCIPLES

The six ISG Governance Principles are broad principles that will not look new to those who have been following key issues in corporate governance over the past several years. Indeed, they were designed to reflect the common corporate governance principles that are already embedded in member institutions' proxy voting and engagement guidelines. The principles emphasize the importance of boardroom effectiveness and oversight, alignment of executive compensation with long-term financial results, and board accountability demonstrated in part through the adoption of governance best practices, including a one-share one-vote capital structure and independent board leadership.

Principle 1: Boards are accountable to shareholders

- This principle encompasses the annual election of directors, majority voting, proxy access and more robust disclosure surrounding board practices and corporate governance. Companies are also asked to explain how any anti-takeover measures are in the best long-term interest of the company.
- Interestingly, BlackRock's CEO Larry Fink recently published a letter to the CEOs at the world's largest public companies in which he argued explicitly that boards are accountable to other stakeholders, such as employees and customers, in addition to shareholders.

[1] See in particular the UK Investor Stewardship Code, on which the US ISG Principles are largely based. The UK Code "sets out a number of areas of good practice to which . . . institutional investors should aspire." https://www.frc.org.uk/investors/uk-stewardship-code

Principle 2: Shareholders should be entitled to voting rights in proportion to their economic interest

- This principle sets a base line of one-share one-vote and encourages companies with existing multi-class share structures to review and consider phasing out control shares.
- In 2017, this issue became national news when Snap Inc. filed for an IPO of non-voting shares. Many large investors were vehemently opposed and at the urging of the Council for Institutional Investors and other investor advocates, the stock index provider FTSE Russell refused to include these shares in its indices.

Principle 3: Boards should be responsive to shareholders and be proactive in order to understand their perspectives

- Under this principle, companies are expected to implement shareholder proposals that receive "significant" support or explain why they have not done so. Independent directors are encouraged to participate in engagement on matters that are meaningful to investors, and directors may be held accountable with "against" votes in instances where investors do not feel that their concerns have been adequately addressed.

Principle 4: Boards should have a strong, independent leadership structure

- There are two common independent leadership structures at U.S. companies – an independent chairperson and an independent lead director (where the role of Chairman and CEO are combined) – and the principles acknowledge that signatory investors have differing opinions on whether they provide adequate independent oversight.
- The overarching position under the principles is that the role of the independent board leader should be "clearly defined and sufficiently robust to ensure effective and constructive leadership."

Principle 5: Boards should adopt structures and practices that enhance their effectiveness

- This principle encompasses an array of board structure and effectiveness issues, including: strong board composition and board diversity; board and committee responsibilities; director attentiveness, preparedness and time commitments; and board refreshment.
- Board diversity, in particular gender diversity, has emerged as a high priority for most of the largest institutional investors. There has also been a focus on screening for long-tenured directors and directors that are over-boarded or have poor attendance records as a proxy for identifying directors that may not be adequately engaged or independent.

Principle 6: Boards should develop management incentive structures that are aligned with the long-term strategy of the company

- This principle emphasizes that the board, in particular the compensation committee, is responsible for ensuring that drivers and performance goals that underpin the company's long-term strategy are adequately reflected in a company's management incentive structure.

STEPS TO CONSIDER

As noted, the ISG Governance Principles are intended to provide a framework of broad, high-level principles. The individual investors that comprise the ISG have their own voting guidelines and engagement priorities that are tailored to their own investment philosophy and strategy. Even on current hot button issues, such as board diversity, investors have differing views and companies should consider the practices they adopt depending upon their specific facts and circumstances. There are, however, general steps that we recommend companies take to address the growing influence of the Framework. These include:

- Understand how the company's corporate governance structure and practices relate to the six ISG Governance Principles.
- Review the company's public disclosure regarding corporate governance structure and practices; consider enhancements to be responsive to the ISG's request that companies disclose how their governance aligns or differs from the ISG Governance Principles.
  - As with other corporate governance benchmarking exercises, companies should be particularly cognizant of how and why their practices may differ from the ISG Governance Principles and whether these differences are adequately explained in public disclosures. As investors screen their portfolio companies' governance practices, they will often consider valid explanations, but in the absence of effective disclosure the company may be unnecessarily penalized.
- Management and the board should be informed and prepared to respond to questions about the company's alignment with the ISG Governance Principles during shareholder engagements. Companies can also consider proactively addressing the issue in written materials or prepared remarks during investor presentations.
- In preparing for shareholder engagements with ISG signatories, understand how and if they are explicitly incorporating the ISG Governance Principles into engagement and voting priorities and continue to screen their individual voting and engagement policies.

Companies should determine whether, and how, they wish to address and incorporate the ISG Governance Principles based upon their own specific governance profile, disclosure regime and approach to shareholder engagement.

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