ISS Releases Responses to Governance Principles Policy Survey

While SEC's Withdrawal of Proxy Advisory Firm Guidance May Signal SEC Focus on Potential Proxy Reform

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On September 18, 2018, Institutional Investor Services ("ISS") released the results of its "2018 Governance Principles Survey,"[1] which canvassed institutional investors, corporate executives, board members and other interested constituencies[2] on a limited number of corporate governance matters. These results are expected to inform ISS's new and updated policies for the 2019 proxy season, which are usually released in November.

The key areas of focus of the survey included auditors and audit committees, director accountability and track records, board gender diversity and the principle of one-share one-vote.

Auditors and Audit Committees

In line with the Securities and Exchange Commission's ("SEC") and investors' recent focus on the expanded proxy disclosures regarding audit committee oversight and the overall process of evaluating and retaining independent auditors,[3] ISS asked respondents to identify the audit-related factors (other than fees paid to the auditor for non-audit services) that they consider in evaluating the independence and performance of external auditors. Investors cited, in order of importance, (i) regulatory fines or other penalties on the auditor for weaknesses or errors in audit practices, (ii) significant audit controversies, and (iii) the identity of the audit partner and any links to the company or its management. Non-investors most often cited links between the audit partner to the company or its management, followed by regulatory penalties on the company related to financial disclosure practices or weaknesses not identified in the audit report, and then regulatory penalties imposed on the

[1] The survey results can be found here.

[2] ISS received 669 responses from 638 different organizations: 109 individual investor representatives, 554 non-investors from 525 organizations (including corporations, consultants/advisors to companies, corporate directors, academics, trade associations and other organizations).

[3] See e.g., the SEC's concept release on possible revisions to audit committee disclosures, available here; see also Deloitte's newly released report on voluntary audit committee disclosures, available here.

auditor. It is worth noting that audit firm tenure, which has recently been an area of regulatory focus,[4] ranked fifth for investors and sixth for non-investors out of seven factors.

ISS also asked whether shareholders should consider other information in evaluating audit committees. Investors cited (i) skills and experience (such as the number of financial experts), (ii) significant financial reporting or audit controversies and (iii) the quality of the company's financial reporting (such as whether there have been restatements). Non-investors also first cited skills and experience of audit committee members, but emphasized the quality of the company's financial reporting over significant financial reporting or audit controversies.

Director Accountability and Track Records

A significant majority (84%) of investors wanted ISS to provide information in their proxy research report regarding a director's oversight failures *at other companies* that resulted in a negative recommendation. Non-investors were more evenly split on the issue and were more interested in the circumstances surrounding the oversight failure. The types of oversight shortfalls that were most relevant were risk oversight failures related to (i) fraud or other forms of corporate malfeasance, (ii) protection of shareholder rights or value, and (iii) business operations such as cybersecurity.

For investors, the most favored look-back period for such oversight shortfalls was either no time limit (39%) or five years (30%).

Board Gender Diversity

More than 80% of investors indicated that a board with no female directors would be problematic, with 37% of those investors acknowledging that their concerns may be mitigated if there is a disclosed policy or approach by the board to increase gender diversity. The most favored response to a lack of gender diversity on a board was board or management engagement, followed by support for a shareholder proposal aimed at increasing diversity and voting against the chair of the nominating/governance committee. Increased focus on gender diversity is evident in the increasing number of companies receiving shareholder proposals on board diversity over the past few proxy seasons. State Street Global Advisors announced that it voted against the chair or the entire nominating and governance committee at nearly 400 companies that lacked a single female director, BlackRock amended its proxy voting guidelines in 2018 to include an expectation of at least two women directors on each board, and the Office of the New York City Comptroller has pushed for increased transparency and comparability among companies through their Boardroom Accountability Project 2.0.

One-Share, One-Vote

For companies with multi-class share structures with unequal voting rights, 92% of investors would like to see the "adjusted" vote results (counting each share as if it has only one vote), and 72% would like the adjusted numbers to determine whether the board appropriately responded (for example, to shareholder proposals or say-on-pay votes). Some respondents felt the use of such data should be on a case-by-case basis, taking into account factors such as share structure, ownership structure and the existence of a sunset provision. In terms of sunset periods for multi-class structures, most investors thought that either one to three years, or four to six years, were appropriate. There are strong objections to perpetual multi-class stock structures in the investor community; the 2017 ISS Governance Principles Survey showed that 43% of investors considered multi-class capital structures with unequal voting rights inappropriate in all circumstances, and The Council of Institutional Investors has publicly called for an end to dual-class IPOs, and an automatic five-year sunset or "one vote per share" review mechanism. The SEC has been focused on this issue as well. In March 2018, the SEC Investor Advisory Committee unanimously approved a recommendation[5] calling for the SEC to require more disclosure from companies with dual-class shares, and SEC Commissioners Jackson[6] and Stein[7] have both spoken about their

[4] See PCAOB AS 3101, which requires disclosure of auditor tenure in the auditor's report, available here.

[5] Available here.

[6] SEC Commissioner Jackson's speech of February 15, 2018 is available here.

[7] SEC Commissioner Stein's speech of February 13, 2018 is available here.

concerns regarding such structures. ISS and Glass Lewis both have voting policies disfavoring the creation of dual-class capital structures.

Practical Considerations: Reconsidering the Role of Proxy Advisory Firms

While companies should take note of the survey results, as they tend to be aligned with governance trends and investor focus generally and are expected to inform ISS's voting policies for the 2019 proxy season, recent regulatory developments may mitigate the impact proxy advisory firms have on institutional investor voting decisions. On September 13, 2018, the staff of the Division of Investment Management of the SEC announced[8] that it had withdrawn two no-action letters related to proxy advisory firms, *Egan-Jones Proxy Services* (May 27, 2004) and *Institutional Shareholder Services, Inc.* (Sept. 15, 2004), in order to facilitate discussion at the SEC's planned Roundtable on the Proxy Process,[9] which is expected to focus on, among other topics, whether prior staff guidance about investment advisers' responsibilities in voting client proxies and retaining proxy advisory firms should be modified, rescinded or supplemented.[10]

As fiduciaries, investment advisers owe their clients duties of care and loyalty in connection with the services they provide, including voting proxies, and are required to follow written policies and procedures that are reasonably designed to ensure that clients' proxies are voted in the clients' best interests and that outline procedures to address material conflicts of interest in voting proxies on behalf of clients.[11] The now-withdrawn letters essentially allowed the outsourcing of the fiduciary obligation of investment advisors to independent proxy advisory firms, describing the circumstances under which an investment adviser could rely on proxy advisory firms, such as ISS and Glass Lewis, as independent third parties for purposes of making proxy voting recommendations, thereby "cleansing" the vote of any conflict on the part of the investment adviser. The no-action letters noted that, generally, a proxy advisory firm could be considered an independent third party, even if the firm receives compensation from an issuer for providing advice on corporate governance issues, although they did set forth certain considerations that an investment advisor should apply in making that determination. The letters were often criticized as having "institutionalized" the role of proxy advisory firms and fueled their overall influence, resulting in an over-reliance on their recommendations.

The practical impact of the withdrawal of the letters is difficult to assess. Investment advisors are left with increased uncertainly over the extent to which they can rely on proxy advisors, although it seems unlikely that this will precipitate a fundamental shift in their practices. Notably, both ISS and Glass Lewis issued public statements indicating that they have never relied upon these no-action letters and the withdrawal has no impact on the services they are providing or how investors use their advice. The more immediate impact appears to be to further the ongoing debate about whether proxy advisors should be subject to formal regulation. The Society for Corporate Governance, which represents the interests of public companies and has advocated for registration and regulation of proxy advisory firms, welcomed the rescission.[12] Legislation to that effect passed the House in 2017 and has been submitted to the Senate for consideration.[13] While it is impossible to predict whether the SEC's Roundtable ultimately will lead to proposed rulemaking by the SEC, the withdrawal of these two no-action letters seems to indicate renewed SEC commitment to considering proxy advisory reform and regulation.

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8 The statement is available here.

9 The SEC's Statement Announcing SEC Staff Roundtable on the Proxy Process, which is scheduled for November 15, 2018, is available here.

10 In its statement, the Division of Investment Management did not withdraw Staff Legal Bulletin No. 20, issued on June 30, 2014 ("SLB 20"), which cites the letters as authority and also provides guidance about investment advisers' responsibility in voting client proxies and retaining proxy advisory firms. The statement indicated, however, that the SEC is seeking feedback on SLB 20 at the upcoming Roundtable. SLB 20 is available here.

11 Rule 206(4)-6 under the Investment Advisers Act of 1940, available here.

12 See Statement of Darla C. Stuckey, President and CEO of the Society for Corporate Governance before the Committee on Banking, Housing, and Urban Affairs US Senate, available here.

13 See here.

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