MORROW SODALI

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THE INVESTOR STEWARDSHIP GROUP: AN INFLECTION POINT IN U.S. CORPORATE GOVERNANCE?

BY JOHN C. WILCOX, CHAIRMAN, MORROW SODALI

A potentially influential new organization of institutional investors has made its presence known in the U.S. corporate governance scene. On January 31, 2017, the Investor Stewardship Group (ISG), a "collective" of some of the largest U.S. and international investors, announced the launch of an ambitious program to establish a set of basic corporate governance principles for U.S. listed companies and a parallel set of stewardship principles for U.S. institutional investors.* This unprecedented event could be a turning point in the evolution of U.S. governance practice.

Here are some of the reasons why the ISG and its principles could have a significant impact on U.S. companies:

1. The formation of the ISG is noteworthy not just because of the group's size, global reach and financial clout ($17 trillion in assets under management). What is unusual is that ISG's members are the individuals within financial institutions who manage their day-to-day governance responsibilities – setting policies, engaging with portfolio companies and voting proxies. The ISG opens a door to this important but sometimes hard-to-reach audience of decision-makers whose policies companies need to understand and with whom companies should try to establish a relationship of trust through constructive dialogue and engagement. These are the individuals companies want to reach when they conduct governance road shows.
2. The ISG introduces into the U.S. a framework for the type of principles-based corporate governance that is the norm in virtually all countries outside the U.S. It is a voluntary system that relies on a "comply-or-explain" accountability mechanism rather than the rules-based, strict-compliance, liability-based governance system found in the U.S. Voluntary, principles-based governance should be welcomed by U.S. issuers because it encourages a flexible, case-by-case approach in which business strategy and financial goals are given priority over compliance with external governance standards. As the governance spotlight focuses more deeply on boardroom transparency and implementation of ESG policies rather than just a check list of best practices, the advantages of principles-based, comply-or-explain governance will become increasingly apparent to U.S. companies and investors alike.
3. The simultaneous launch of governance principles and stewardship principles conveys an implicit message that companies and institutional investors share responsibility for the economic success of portfolio companies. The idea that providers of capital and managers of business enterprises should work together for a common economic goal may seem like common-sense capitalism, but it is often forgotten in the adversarial, fight-first-ask-questions-later attitude that at times has colored relations between companies and shareholders. This is the case particularly in the U.S., where the legal system establishes formal structures for confrontation – in particular, SEC Rule 14a-8 governing shareholder proposals – and is seen as presenting obstacles to dialogue or disclosure outside regulatory guidelines.
4. The ISG initiative is focused exclusively on U.S. companies and investors. This can be taken as a sign that ISG members, all of which have portfolios of both U.S. and global stocks and are familiar with global governance practices, believe that the U.S. is where their attention is most needed. The ISG governance proposal does have roots in the U.S. – the need for a uniform U.S. governance code has been discussed intermittently for more than a decade, but consensus has not been reached largely because of two obstacles: corporate governance is deemed to be outside the remit of the SEC and a single national code seemed impractical in light of 50 separate state corporate law statutes. As ISG members clearly understand, national codes play a central role in the governance systems of countries outside the U.S. By introducing a national code of principles applicable to all U.S. listed companies, the ISG's goal, in the words of Anne Sheehan, Director of Corporate Governance at CalSTRS, "is to codify the *fundamentals* of good corporate governance and establish *baseline expectations* for U.S. corporations and their institutional shareholders." By contrast, the ISG's stewardship initiative is rooted in global practice. National stewardship codes have been adopted in the UK, Canada, Italy, Japan, Malaysia, the

Netherlands, South Africa, Switzerland and Taiwan and endorsed by the International Corporate Governance Network. The European Commission's recent amendments to the Shareholders' Rights Directive also strengthen provisions relating to engagement and stewardship. It is noteworthy that "stewardship," rather than "fiduciary," is the concept promoted by the ISG, suggesting a focus on oversight of portfolio companies in the broadest sense, including ESG and non-financial factors rather than simply financial performance and legal compliance.

5. The ISG's six governance and six engagement principles are brief, clear and succinct, drafted in general terms that allow room for flexibility in their interpretation and application. They contain no surprises, are within established guidelines, are not overly prescriptive and do not expand shareholder rights or create new obligations for either companies or institutional investors. They are designed to function as guiding principles rather than a list of do's and don'ts. The principles "reflect the common corporate governance beliefs that are embedded in each member's proxy voting and engagement guidelines" and they avoid conflict with existing legal structures and regulatory requirements. They also reflect commonplace governance standards that have already been adopted by many companies in the U.S. and abroad. The ISG framework can therefore be seen as posing no additional compliance burdens on either companies or investors.

6. ISG's condensed governance principles offer a counterpoint to proxy advisory firms' more detailed governance standards and voting guidelines based on proprietary models. Although the ISG's stated intention is not to replace or reduce the importance of proxy advisory firms, its principles-based approach reflects the continuing evolution of governance away from external standards and compliance check lists. Fundamental principles of the type proposed by the ISG are easier to apply contextually, allowing more room for substantive dialogue between companies and investors and encouraging a case-by-case approach that integrates business strategy and ESG decision-making.

7. Because the ISG governance and stewardship principles will not take effect until January 2018, the year of lead time will enable the ISG, which describes itself as a "sustained initiative," to recruit additional members, increase its public profile and answer a number of important questions that will determine its effectiveness over the long term: the group's leadership and governance; its plans for enforcing its principles; its relationship with existing governance organizations and NGOs; and, most important, the relationship of ISG's members to the leadership and investment arms of their own institutions. A number of ISG member firms' CEOs are signatories to the Commonsense Principles of Corporate Governance, published in July 2016. Are these activities coordinated or expected to achieve a common goal?

The ISG's promulgation of a governance code and stewardship principles for the United States represents a private sector initiative that has the potential to fundamentally change the relationship between U.S. companies and institutional investors and to align U.S. corporate governance more closely with global practice. The next year will tell whether this potential will be realized. In the meantime, companies and investors alike should pay attention to developments at the Investor Stewardship Group.

***APPENDIX**
ISG Corporate Governance Principles:
Principle 1: Boards are accountable to shareholders.
Principle 2: Shareholders should be entitled to voting rights in proportion to their economic interest.
Principle 3: Boards should be responsive to shareholders and be proactive in order to understand their perspectives.
Principle 4: Boards should have a strong, independent leadership structure.
Principle 5: Boards should adopt structures and practices that enhance their effectiveness.
Principle 6: Boards should develop management incentive structures that are aligned with the long-term strategy of the company.

ISG Stewardship Principles
Principle A: Institutional investors are accountable to those whose money they invest.
Principle B: Institutional investors should demonstrate how they evaluate corporate governance factors with respect to the companies in which they invest.
Principle C: Institutional investors should disclose, in general terms, how they manage potential conflicts of interest that may arise in their proxy voting and engagement activities.
Principle D: Institutional investors are responsible for proxy voting decisions and should monitor the relevant activities and policies of third parties that advise them on those decisions.
Principle E: Institutional investors should address and attempt to resolve differences with companies in a constructive and pragmatic manner.
Principle F: Institutional investors should work together, where appropriate, to encourage the adoption and implementation of the Corporate Governance and Stewardship principles.