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Corporate Governance Update: Common-Sense Capitalism

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Recent developments in corporate governance indicate a welcome emphasis on common sense principles. Over the past year, leaders of prominent companies and institutional investment funds have proposed principles and a framework intended to guide U.S. corporate governance toward practices that promote the sustainable creation of long-term value. The shared goal of these two separate projects—the Investor Stewardship Group's "Corporate Stewardship and Governance Principles," released in 2017, and "Commonsense Principles of Corporate Governance," an open letter released in 2016—is to bolster companies' ability to generate prosperity for American investors. Prioritizing practicality over prescription should improve the quality and effectiveness of corporate governance, to the benefit of all market participants.

Stewardship and Governance Principles

The Investor Stewardship Group—a collective of U.S.-based institutional investors and global asset managers—launched an initiative in January 2017 to establish a framework for standards of stewardship and corporate governance to promote long-term value creation in American business. The ISG represents $17 trillion in assets under management and is led by the participating firms' senior corporate governance practitioners. The framework, set to become effective in January 2018, contains six principles for investor stewardship and six principles for corporate governance. While the framework has no legal force, it is modeled on the "comply or explain" governance frameworks that exist in the United Kingdom and elsewhere and is intended to stand as an unofficial national code of fundamental governance principles. The framework is not intended to be

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prescriptive and is expected to be revised periodically as consensus around stewardship and governance evolves. Since it lacks any enforcement or self-policing mechanism, the principles will only become meaningful through widespread adoption by market participants.

The stewardship principles highlight two positive trends in corporate governance. The first is that business leaders are uniting to promote cooperation and improve communication among companies, large investors, and shareholders. The second is that institutional shareholders may be reclaiming much of the authority they ceded to proxy advisory firms in recent decades. One of the stewardship principles is that institutional investors are responsible for proxy voting decisions and should monitor the activities and policies of proxy advisors, and another is that institutional investors should address and resolve differences with companies in a constructive and pragmatic manner. These principles are designed to increase accountability, improve communication, and create a sense of shared responsibility between investors and companies. If successful, they will go a long way toward reducing the heretofore outsized influence of proxy advisors in the corporate governance sphere. Pending legislation in Congress that would regulate proxy advisory firms may accelerate this development. Without undue pressure from proxy advisors to conform to one-size-fits-all governance practices, and with the support of their institutional investors, companies should benefit from greater flexibility to implement the practices that are most effective in their particular circumstances.

The corporate governance principles set forth by the ISG cover topics such as director independence and leadership and board responsiveness to shareholders. They also address board accountability, shareholder voting rights, and management incentive structures and are elaborated with fairly detailed guidance on each point. While the principles do advocate some policy positions, such as proportional voting and proxy access, these specifics are less important than the overarching themes of accountability, transparency, and effectiveness. Under this framework, a company with a compelling record of furthering the key governance principles, albeit through different governance practices, should find support among its investors.

The 2016 open letter, "Commonsense Principles of Corporate Governance" is a separate effort, operating at a higher level of generality than the ISG principles. The letter was signed by ten well-known corporate leaders in a range of industries, including the chief executives of General Motors, JPMorgan

Chase, Berkshire Hathaway, GE, and Blackrock. The signatories emphasized that public companies hold a public trust, and that the financial future of American families depends on the success of America's business sector and public confidence in America's financial markets. While acknowledging a diversity of opinion on corporate governance matters, the letter proposed a baseline for constructive dialogue on matters of governance. The recommendations in the letter hewed to a number of well-established principles: director independence and leadership, board diversity, financial accounting transparency, and constructive shareholder engagement. The letter also encouraged companies to provide quarterly earnings forecasts only when beneficial to shareholders and not as a matter of obligation. While not a dynamic project like the ISG framework, the letter has the potential to be significant, as it indicates that American business leaders today are focused on promoting rationally-based, prosperity-oriented corporate governance. With continued engagement between institutional investors and public companies, there is an opportunity to foster lasting change in the corporate governance paradigm.

Looking Ahead

As corporate law is a matter of state, rather than federal, law, corporate governance generally is not within the purview of the Securities and Exchange Commission. The diversity of state corporate law is a valuable feature of the U.S. business landscape. While many countries have uniform governance codes, corporate governance in the United States is a patchwork of state law, stock exchange rules, federal requirements, and prevailing norms. Nonetheless, the SEC can be a factor in encouraging the current trend toward common sense governance, a project which would seem to align with the agenda of SEC Chairman Jay Clayton. Chairman Clayton indicated this month, in his first official speech, that his tenure will prioritize "the long-term interests of the Main Street investor." The SEC is undertaking initiatives to improve the quality and utility of disclosures provided to investors through simplification, modernization, and an emphasis on readability. Chairman Clayton also intends to empower individual investors through education and information resources. As disclosures become more legible, and as shareholders become better informed, the quality of communication between companies and investors should improve significantly, producing more meaningful dialogue, more responsive boards, greater credibility between investors and management teams, and better governance overall.

In recent decades, there has been at times a counterproductively antagonistic relationship between institutional investors and corporations. Efforts such as the ISG framework may help to shift this dynamic into a constructive and cooperative one. Companies and their long-term investors should be united in their shared goals of prosperity and good governance, and both should seek governance norms that help to produce sustainable growth and success. The framework established by the ISG potentially represents a new phase in corporate governance. Inspired by the common-sense guidance of business and regulatory leaders, corporate governance is poised to move into its next phase: one in which ethical principles and good business values are implemented across the marketplace as context-driven accountability and shared economic success.