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IN FOCUS

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Introduction to Financial Services: Corporate Governance

Introduction

Broadly speaking, corporate governance is the system through which a public company's objectives and the means for obtaining them are established and monitored by the company's board of directors and management. Structurally, the system constitutes a web of relationships among a firm's management, board of directors, employees, shareholders, and other stakeholders. Two key focal points of corporate governance are the corporate board and the corporate annual meeting.

The corporate board consists of a group of individuals elected to be the company's fiduciaries acting on behalf of its shareholders. Along with company executives—such as the chief executive officer—who run the company on a daily basis, the board helps set the tone for the corporation. Overarching board mandates include assisting in setting broad corporate objectives.

The corporate annual meeting is a yearly gathering where a company's previous year's performance and future prospects are discussed; its shareholders vote to appoint board members and adopt various shareholder- and management-sponsored business proposals, advocating a particular course of action.

Congress is perennially interested in corporate governance. This In Focus introduces and examines several key corporate governance issues—proxy advisory firms, shareholder proposal submission thresholds, and environmental, social, and governance (ESG) disclosures.

The Regulation of Corporate Governance

States and the Securities and Exchange Commission (SEC) share oversight of corporate governance concerns. State-based business incorporation laws give the states substantial authority over corporate governance matters. Within the parameters of state incorporation laws and under federal securities laws, the SEC oversees the types of information that are available to shareholders voting on proposals at the annual meeting and how such information is disseminated. Notably, most shareholders do not attend corporate annual meetings. Under state incorporation laws—mainly those in Delaware, where most public companies are incorporated—shareholders have the right to appoint a *proxy*. A proxy is a written authorization that delegates the shareholder's voting power to another person or, more typically, an institution.

The Sarbanes-Oxley Act (P.L. 107-204) and the Dodd-Frank Act (P.L. 111-203) significantly broadened the federal regulatory scope in corporate governance that included expanding senior management's responsibility for the quality of a company's financial reporting; expanding the audit committee's independence from management and its responsibility over company auditors; imposing constraints on the services that auditors can provide to public companies; establishing an independent board to oversee auditing practices at public companies; authorizing nonbinding shareholder voting on executive compensation; requiring new compensation-based disclosures; and providing for clawbacks of executive compensation under certain circumstances.

Proxy Advisory Firms

Proxy advisory firms provide institutional investors with research and recommendations on management and shareholder proposals that are voted on at annual corporate meetings. Two firms—Institutional Shareholder Services (ISS) and Glass Lewis—dominate the proxy advisory business. Unlike Glass Lewis, ISS is a SEC-registered investment advisor subject to added regulations.

In early 2019, SEC Chair Jay Clayton stated that the SEC is likely to consider whether (1) institutional investors over rely on ISS and Glass Lewis for voting information and recommendations; (2) public companies (issuers) are given an opportunity to express concerns over certain of their voting recommendations; (3) ISS is properly disclosing and addressing potential conflicts of interest when it provides corporate governance consulting services to issuers; and (4) these firms require additional regulation. Various academics and business interests have criticized the advisory firms on similar grounds. Countering such criticism, the firms have argued that they have little influence over client voting and they have established firewalls that separate their proxy advisory work from the other services they offer. They also stress that the ongoing demand for their services reflects their value to clients.

In late 2018, SEC staff withdrew 2004 guidance that described how an advisory firm could be deemed an independent third party that can make recommendations to an institutional investor's investment advisor despite being compensated by that advisor (whose required to vote its client's proxies in the client's best interests). Various observers say that the guidance has helped lead to overreliance on advisory firms.

A 2016 Government Accountability Office (GAO) report (GAO-17-47) surveyed market participants and stakeholders on proxy advisory firms. GAO found that, although advisory firms influenced shareholder voting and corporate governance practices, that influence varied based on an institutional investor's size or the nature of the voting policies that were employed.

S. 3614, introduced in the 115th Congress, would have required larger proxy advisory firms to register with the SEC as investment advisors, but exempt smaller advisory firms with $5 million or less in annual gross receipts from such mandatory registration.

Proposal Resubmission Thresholds

Currently, any shareholder who holds $2,000 or 1% of a company's stock for at least one year can submit a nonbinding shareholder proposal on any subject for a vote at the annual meeting. Under 1954 securities regulations, companies can exclude a rejected and resubmitted proposal from being voted on, if

- it was not supported by at least 3% of shareholders the last time it received a vote;
- it was not supported by at least 6% of shareholders and has been voted on twice in the past five years; or
- it has not received the support of at least 10% of shareholders after being voted on three or more times during the past five years.

In 1997, the SEC voted on a never finalized proposal to raise these resubmission thresholds to 6%, 15%, and 30%, respectively. SEC officials argued that shareholder proposals unable to make the new thresholds had little chance of ultimately prevailing. In December 2018, Chair Clayton indicated that the SEC is reexamining its rules for submissions and resubmissions.

In February 2019, the NASDAQ stock exchange authored a letter to the SEC with 300 signatories—including Boeing, the U.S. Chamber of Commerce, and Chevron—recommending that the SEC reconsider instituting the proposed 1997 thresholds. The chamber has also argued that the current thresholds help fuel wasteful "zombie proposals" (often on ESG issues) submitted three or more times without earning majority shareholder support. However, supporters of the current regime, including various pension funds, caution that proposals often need time to incubate and expand their support. As such, they assert that they would be constrained by raised thresholds.

In 2018, the Council of Institutional Investors (CII, a group of pension funds, other employee benefit funds, endowments, and foundations) examined the impact of raised thresholds on ESG proposals. It first noted that nearly all shareholder proposals meet the current resubmission thresholds of 3%, 6%, and 10%. Then, using a dataset of 3,620 shareholder proposals at a wide range of 677 companies, CII examined the impact of three resubmission threshold regimes: (1) a "modest" increase of 5%, 10%, and15%; (2) a "doubling" of 6%, 12%, and 20%; and (3) the highest increase of 6%, 15%, and 30%, the same as the aforementioned 1997 SEC proposal. CII found that the actual number of ESG proposals that would have become ineligible under any of the three scenarios during a seven-year period would "not be terribly significant." The study projected that, of the 3,620 general shareholder proposals considered, 240 would have become ineligible under the modest resubmission scenario and 470 under the most stringent scenario.

Environmental, Social, and Governance Issues

There is a long running debate about what types of information public companies should disclose to potential investors and current shareholders. Currently, this debate has centered on ESG issues, such as political spending, climate change, diversity, and human rights. *Forbes Magazine* recently observed that "Responsible investing is widely understood as the integration of environmental, social and governance (ESG) factors into investment processes and decision-making. ESG factors cover a wide spectrum of issues that traditionally are not part of financial analysis, yet may have financial relevance." Investors' and the public's interests in ESG-related issues have increased in recent years. Shareholder proposals that address ESG issues increased from 40% of all shareholder proposals in 2011 to 67% of all proposals in 2016.

In general, firms discuss ESG-related issues in the Management Discussion and Analysis (MD&A) section of their annual financial reports. This section is an SEC requirement. Any ESG issues discussed in the MD&A section are, generally, not subject to an independent audit. A 2015 study found that 86% of the 100 largest companies in the United States report on ESG issues, but the information published by the companies is not standardized and can suffer from "information overload." The inconsistent disclosure makes it harder for investors to measure a firm's performance on ESG issues relative to its peers or across industries.

Firms that voluntarily disclose ESG issues could face a double-edged sword. On the one hand, additional disclosures beyond regulatory requirements could increase investor scrutiny and negatively affect firm stock prices. Additional reporting could also be time-intensive and costly for companies, and it may be of minimal use if it is not material or comparable with reporting by peer companies. On the other hand, investors might positively perceive a company that includes additional ESG disclosures. Increased disclosure could also reduce future lawsuits as investors would have greater information with which to make investing decisions.

Congress might consider several options regarding public company disclosure of ESG issues. One option is to continue to allow companies and investors to determine which ESG issues to disclose within the existing regulatory structure. Another option is to direct the SEC to require corporate disclosures modeled on financial materiality as promulgated by certain international bodies or by the Sustainability Accounting Standards Board, which is a U.S.-based entity. Requiring companies to report on ESG issues that are financially material to them might make it easier for investors to make better investment decisions. Others, however, question the financial relevance of ESG reporting.

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