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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 comprises 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 annual meeting of the firm's shareholders.

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 and broad corporate objectives.

The corporate annual meeting is a yearly gathering where a firm's previous year's performance and future prospects are discussed. At the meeting, a company's shareholders typically vote to appoint board members and adopt, or reject, various shareholder- and management-sponsored business proposals that direct a particular course of action by the firm.

The Regulation of Corporate Governance

States and the Securities and Exchange Commission (SEC) share oversight of corporate governance concerns. In certain sectors of the economy, such as in banking, other regulators might also share oversight. 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) significantly broadened the federal regulatory scope in corporate governance. The law expanded senior management's responsibility for the quality of a company's financial reporting, expanded the audit committee's independence from management and its responsibility over company auditors, imposed constraints on the services that auditors can provide to public companies, and established an independent board to oversee auditing practices at public companies. The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203), among its numerous other provisions, expanded the federal regulatory scope by authorizing nonbinding shareholder voting on executive compensation, requiring new compensation-based disclosures, and requiring that board compensation committees be solely composed of independent directors.

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 also a SEC-registered investment advisor subject to added regulations.

Various academics and business interests have argued that the advisory firms require additional regulation because (1) institutional investors over-rely on ISS and Glass Lewis for voting information and recommendations; (2) public companies (issuers) are not given an opportunity to express concerns over certain of their voting recommendations; and (3) ISS is not adequately disclosing and addressing potential conflicts of interest when it provides corporate governance consulting services to issuers. Countering such criticism, the advisory 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 earlier 2004 guidance that described how an advisory firm could be deemed an independent third party able to make recommendations to an institutional investor's investment advisor despite being compensated by that advisor (who is required to vote its client's proxies in the client's best interests). Some say that it has helped lead to an overreliance on the firms.

On November 5, 2019, the SEC proposed various proxy advisory firm reforms under the Securities Exchange Act of 1934 (P.L. 73-291). Among other things, it would codify controversial SEC guidelines that advisory firm voting recommendations constitute "solicitations" that are subject to antifraud rules. The firms would also be required to allow subject companies an opportunity to review and respond to their voting recommendations before being given to clients.

SEC Chair Jay Clayton said the proposal is intended to increase the accuracy of advisory firm reporting, a view shared by business interests like the U.S. Chamber of

Commerce. It, however, has been criticized by the two dissenting Democratic SEC commissioners, including Robert Jackson, who argued that it would problematically help to tilt shareholder voting toward incumbent management. A related view was expressed by the Council of Institutional Investors (CII), a large institutional investor advocacy group, who said that the reform would increase the likelihood that advisory firms took "a more management-friendly approach" to their work. Some Members of Congress echoed these views, including Senators Sherrod Brown and Christopher Van Hollen.

Shareholder Proposal Thresholds

Currently, any shareholder holding $2,000 or 1% of a company's voting stock for at least one year can submit a nonbinding shareholder proposal on any subject for a vote at the annual meeting. Under securities regulations originating in 1954, 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.

Through the years, various businesses and business interests have asked the SEC to reconsider the thresholds. The U.S. Chamber of Commerce has also argued that the current thresholds help fuel wasteful "zombie proposals" (which according to the Chamber are often related to Environmental, Social, and Governance [ESG] issues) submitted three or more times without earning majority shareholder support. However, supporters of the current regime, including various pension funds, have said that proposals often need time to gain momentum.

On November 5, 2019, the SEC proposed to raise the shareholder ownership thresholds for submitting proposals, including having at least $25,000 of a firm's voting equity for at least one year. It would also increase the resubmission thresholds from the current 3%, 6%, and 10% to 5%, 15%, and 25%, respectively.

SEC Chair Clayton said that such changes "would facilitate constructive engagement by long-term shareholders in a manner that would benefit all shareholders and ... [the] public capital market." However, one of the two dissenting Democratic commissioners, Robert Jackson, cited research conducted by his office on proxy-access proposals, which are efforts to allow larger shareholders to nominate candidates to corporate boards. The staff found that 40% of the current number of such proposals would likely be removed after three submissions and would have to wait another three years for resubmission under the current proposal, thus denying proposals that may enhance shareholder value, according to Commissioner Jackson.

Business interests like the U.S. Chamber of Commerce, many of whom have long advocated for such reforms, also praised the proposal. The CII, however, has argued that the proposal would restrict the ability of ordinary investors to submit useful shareholder ESG proposals.

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. ESG factors cover a wide spectrum of issues that traditionally are not part of financial analysis, but 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. 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 both benefit and face challenges from the additional disclosure. On the one hand, additional disclosures beyond regulatory requirements could increase investor scrutiny and negatively affect a firm's stock price. 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 because investors would have greater information with which to make investing decisions.

Members have introduced legislation to increase ESG disclosures, including H.R. 1018, H.R. 3279, and S. 592. These proposals do not necessarily require financial materiality as a consideration for disclosure, but some do, such as H.R. 4329. Other options for Congress to consider include continuing 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.

Raj Gnanarajah, Analyst in Financial Economics
Gary Shorter, Specialist in Financial Economics

IF11221

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