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**Schroders**

# US Corporate Governance: A changing landscape

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## INTRODUCTION

US governance practices are coming under greater scrutiny in the face of a raft of new governance guidelines and increased investor engagement. As long term investors in the US market, we have reviewed governance practices and trends over the 2016 proxy season. We believe that the guidelines are a pre-cursor for further changes and we outline our expectations for US companies ahead of the 2017 voting season.

Following the 2016 proxy season, we have seen the introduction of a number of best practice guidelines for US corporate governance. From the Common Sense Corporate Governance Principles<sup>1</sup>, endorsed by company CEOs including Warren Buffet (Berkshire Hathaway), Jamie Dimon (JPMorgan Chase) and Larry Fink (BlackRock), to the multi-sector view on governance practices from the Business Roundtable<sup>2</sup>.

Globally, the Financial Stability Board (FSB) has also announced a thematic peer review of the G20/OECD Principles of Corporate Governance.

### **Common sense principles: our view**

We support the commitments around long-term value creation, opposing dual share structures and increased dialogue with investors. However, the principles still fall short of global best practice and lack clear definition in some areas. For example, there is an absence of clear guidance on board refreshment, with a simple statement that “boards should have a robust process to evaluate themselves on a regular basis, lead by the non-executive chair, lead independent director or appropriate committee chair”. Lack of clarity will make implementation a challenge. In other markets, procedures for board refreshment are more stringent, for example requiring external board evaluations every three years, supported by a “comply or explain” approach.

Finally, all of the public company CEOs who signed the principles are also chairs of their own boards; something that also defies global best practice.

### **Business roundtable guidelines**

Like the Common Sense principles, there is a clear focus on increased dialogue with shareholders. The principles from the Business Roundtable provide more detailed explanation of effective practice. We think the principles could go further and provide tangible recommendations on key issues of concern such as board tenure or number of board seats that constitute over boarding.

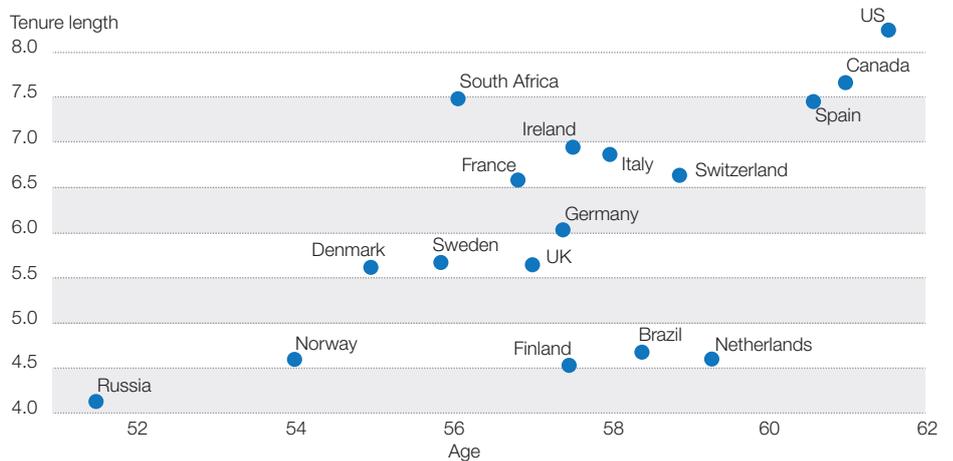
<sup>1</sup> <http://www.governanceprinciples.org/>

<sup>2</sup> <http://businessroundtable.org/corporate-governance>

# US IN THE CONTEXT OF GLOBAL BEST PRACTICE

While regulations in the US mean that investors are provided with detailed disclosure on some areas of corporate governance, the market is unique in that it does not have a national corporate governance code. The media, investors and industry bodies are frequently comparing and contrasting US governance practices against global best practice. The US comes under particular scrutiny for board structure. In the US the rate of board succession and renewal is slower, with the majority of S&P500 boards seeking re-election for directors with tenure over 15 years<sup>3</sup>. Of S&P500 boards, 354 have at least one member with over 15 years' tenure and few have mandatory retirement requirements.

**Figure 1. US Directors: Average director age and tenure length in years**



Source: Shake-up calls mount as lack of diversity on US boards laid bare, FT, 15 August 2016.

Despite the clear benefits of such experience at board level, it is of paramount importance to us as investors to strike a balance between new, fresh views and the experience and knowledge that tenure brings.

While we believe that boards benefit from directors who have a deep understanding and experience of the business, the US stands out when it comes both to average tenure and age. Despite the clear benefits of such experience at board level, it is of paramount importance to us as investors to strike a balance between new, fresh views and the experience and knowledge that tenure brings.

Looking at the same universe of US companies, there are 146 companies that have five or more directors over the age of 70 and only four company boards that have a 50/50 gender balance. Faster board refreshment, we hope, would lead to greater gender, age and knowledge diversity. Our engagement activity suggests that global boards are increasingly seeking candidates with different skillsets such as digital and data security, which further broadens the potential recruitment pool.

We suggest that after nine years of service, independent non-executive directors who still wish to serve should be classified as non-independent. We continue to believe that boards should have an overall majority of independent members.

<sup>3</sup> Schroders, ISS Data Analytics.

# TURNING TIDE: ARE GOVERNANCE PRACTICES CHANGING?

2016 saw an increase in companies engaging with investors as well as more transparency and better communications with investors.

The gap between US and global governance best practice on board structure has long been accepted. For example, it is still common to combine the roles of CEO and Chairman, with 51% of S&P 500 companies combining the two<sup>4</sup>. While industry commentary suggests that investors are seeking change, overall AGM results still show a high level of support for management. Professional services firm EY reports that in 2016 board members received average support of 96% and similarly average support for say-on-pay proposals was 92%<sup>5</sup>.

There are some signs that the tide is turning. The Business Roundtable states that along with increased regulation, another incentive for updating its governance principles is the increasing demands of its shareholders<sup>6</sup>. 2016 saw an increase in companies engaging with investors as well as more transparency and better communications with investors. EY reported that of the 287 S&P 500 companies that engaged with investors, 24% stated that board directors were involved, up from 18% the year before<sup>7</sup>.

Proxy access, the right of shareowners to place their nominees for director on a company's proxy card at a shareholder meeting, was also a success for investors in the 2016 voting season. Led by the NYC Comptroller's "Boardroom Accountability Project", a record number of shareholder proposals seeking proxy access were filed. The 2016 voting season saw a high level of support for these proposals resulting in 36% of the S&P 500 now having proxy access rules in place, up from only 20% in 2015<sup>8</sup>.

**Figure 2: Summary of governance changes in 2016**

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<p><b>What has changed</b></p> <ul style="list-style-type: none"> <li>- increased engagement between companies and their shareholders as evidenced</li> <li>- increased proxy access</li> <li>- continued improvement on board accountability – classified boards are now uncommon</li> </ul>	<p><b>What hasn't changed</b></p> <ul style="list-style-type: none"> <li>- remuneration practices, LTIPs without performance metrics</li> <li>- board refreshment and diversity</li> <li>- combined roles for CEO/Chair</li> </ul> <p>Schroders' highest level of votes against at US AGMs in 2016 were against remuneration practices and director re-elections</p>

We expect that the increase in engagement and achieving proxy access can be viewed as pre-cursors for future improvements.

4 ESG Spotlight: North America's board refreshment challenge, Clare Payn, LGIM, February 2016.

5 EY Center for Board Matters: Four takeaways from Proxy season 2016, EY, 2016.

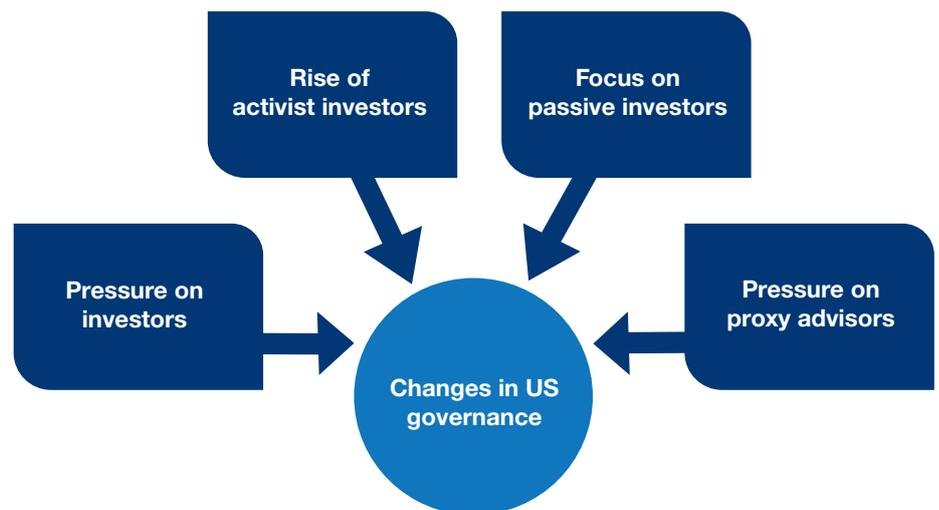
6 Principles of Corporate Governance 2016, Business Roundtable, www.businessroundtable.org

7 EY Center for Board Matters: Four takeaways from Proxy season 2016, EY, 2016.

8 2016: The Americas – Proxy Season Review Primer, ISS, 2016.

## DRIVERS OF CHANGE IN US GOVERNANCE

We believe the change witnessed in the 2016 proxy season and the publication of new governance guidelines has been driven by several factors, which are summarised in the graphic below:



### Pressure on investors to evidence role as an active owner

Governance failures have frequently been cited as the cause of several corporate scandals and the global financial crisis. However, shareholder support remained strong during the crisis, despite increasing evidence that financial institutions were being poorly managed. In 2008, at the AGMs of Wachovia, Morgan Stanley, JPMorgan Chase, Bank of America, and Lehman Brothers, all directors were elected with more than 90% support, which was comparable to support in previous years<sup>9</sup>. This has led many to question what stewardship investors exercised. There has been some response. Data from proxy voting platform ISS shows high average voting turnout rates of 86% across the S&P 500 through the 2016 voting season<sup>10</sup>. This is notably higher than the average turnout rates across the Atlantic. For example, turnout at DAX 30 companies in 2016 were 62.3%<sup>11</sup> and 72.2% in the UK<sup>12</sup>.

### Rise of activist investors

There is a noticeable media focus on the rise of activist investors, with the Wall Street Journal reporting 71 activist campaigns at US companies since 2009<sup>13</sup>. Some believe that companies with weaker governance practices are often a target for activists. Activists often mount public campaigns in their battle which will cite governance failures as a reason to adopt a new strategy. Frequently they push for a seat on the board to effect their desired short-term change.

Despite this increased media attention, we would stress that as long-term investors, we take a different approach by focusing on engagement and exercising our voting rights to fulfil our obligation as owners. We are looking for ongoing improvements in corporate governance practices across the market rather than singling out individual companies.

<sup>9</sup> 2008 Post season Report: Weathering the Storm – Investors Respond to the Global Credit Crisis, ISS, October 2008.

<sup>10</sup> Data Analytics, ISS, 2016.

<sup>11</sup> Europe: 2016 Pan-European Preliminary Voting season Review, ISS, 2016.

<sup>12</sup> United Kingdom and Ireland: 2014 Voting season review, ISS 2014.

<sup>13</sup> <http://www.wsj.com/articles/activist-investors-helping-or-hindering-1444067712>

### **Questioning of passive investors**

With the rising ubiquity of passive investing, the voting activities of passive asset managers have come under scrutiny. Three of the top ten largest global asset managers are US passive firms, according to Towers Watson<sup>14</sup>. As a result of their prominence, scale and voting power these investors are under increased pressure from media, clients, regulators and even their own shareholders to evidence how they exercise these voting rights effectively.

### **Pressure on proxy advisors**

There have been growing concerns over the significant potential influence dictated by proxy advisory firms. Some investors follow the recommendations of proxy advisors without exercising their own views and principles. In Europe, this led to an investigation by the European Securities and Markets Authority (ESMA). The result was the recommendation of a self-regulatory code of conduct<sup>15</sup>. However, this may not be enough for all global regulators and earlier this year two separate bills that would increase regulation of proxy advisory companies were passed in the US<sup>16</sup>.

All of these drivers for change indicate an increasing pressure on corporates to demonstrate improving governance and the responsibility of investors to use their voice to raise the bar on governance practices. Schroders' view on how we will navigate this changing landscape is explained below.

<sup>14</sup> The 500 largest asset managers, The P&I/Towers Watson global 500 research and ranking, 2014, Towers Watson.

<sup>15</sup> <https://www.esma.europa.eu/press-news/esma-news/esma-publishes-report-proxy-advisors%E2%80%99-best-practice-principles>

<sup>16</sup> House committee approves bills tightening proxy firm regulation, SEC cost assessment, Pensions and Investments, 16 June 2016.

## WHAT DO WE WANT TO SEE GOING FORWARD?

There has been a sea change in the way US companies engage with investors that we have witnessed first hand. Companies are shifting their engagement focus from the “why” to the “how”. Below we outline the areas where we would like to see progress.

### **A united US view of corporate governance principles**

We acknowledge that there are different regulations across the states that companies are incorporated in. A move towards a consistent national set of principles reflecting the views of the investment chain, asset owners, managers and companies, would enhance understanding and provide a valuable framework. We hope that all key players in the investment chain will build on the current debate towards a consensus and further build on the new principles.

### **Transparent and rigorous board evaluation**

Board evaluations can be effective at improving boards’ operations, identifying skills gaps, and ensuring orderly succession planning. Using Australia as an example, recommendation 2.2 of the Third Edition of the ASX Corporate Governance Council’s Corporate Governance Principles and Recommendations states: “A listed entity should have and disclose a board skill matrix, setting out the mix of skills and diversity the board has or is looking to achieve in its membership.” Disclosure should not solely focus on a skills matrix, but also incorporate narrative on board dynamics, with detailed director biographies. Key findings and proposed changes could also be shared.

We hope that a thoughtful approach in this area will lead to increased scrutiny of over-boarding and drive a higher level of board refreshment leading to improved diversity.

### **Developing lead directors**

With 51% of S&P 500 companies continuing to combine the role of the CEO and Chairman, it is important for shareholders to have an independent voice on the board. We encourage companies with a combined role to have a lead independent director to empower shareholders and provide a forum for their questions. Both sets of the published principles support this and give guidance on how they can discharge their responsibilities, so we hope to see increased adherence to this practice.

### **Transparent remuneration**

Management remuneration should be aligned with shareholders and have a long-term structure, a clear link with performance, and be measurable and consistent over time. There should be detailed disclosure on target outcomes with boards having discretion to lower pay which appears at abnormal levels against their current performance. We acknowledge that different metrics can be used for short-term versus long-term compensation setting. Short-term objectives should align closely with the company’s strategy and encourage effective execution. Our preference is for long-term measures that provide clear alignment with shareholders and encourage disciplined capital allocation. We are not supportive of termination payments where there has been management underperformance.

### **Our responsibilities**

As highlighted by the Business Roundtable, investors also have responsibility in improving governance:

“We sense that there is a rising belief that shareholders cannot seek additional empowerment without assuming some accountability for the goal of long-term value creation for all shareholders”<sup>17</sup>.

In response to this, we can re-assure corporates that we will not vote blindly and we take our responsibilities as shareholders seriously. We have a dedicated corporate governance team who work closely with fund managers and analysts so that we can exercise voting rights on behalf of our clients, with a focus on long-term value creation. We rely on our own governance and company expertise to reach voting decisions. While we receive proxy research, this is just one piece of information influencing our voting decision. Company engagement is a core part of our responsible investment strategy and we welcome the opportunity to engage with companies on corporate governance practices.

## CONCLUSION

While many commentators are quick to criticise US corporate governance practices, we are encouraged by the evidence of increased dialogue and greater focus on best practice guidelines; the progress is evident. We are keen to build on this momentum and encourage further change. In particular we would like to see strong lead directors, greater diversity and board refreshment. We feel that this will enable companies to ensure that they have the right mix of skills to navigate what is an increasingly complex global environment.

Finally, at Schroders we are looking forward to engaging with our US holdings and debate the principles ahead of the next proxy season.



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