

From the Public Company Advisory Group of Weil, Gotshal & Manges LLP

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Commonsense Principles 2.0: A Blueprint for U.S. Corporate Governance?

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On October 18, 2018, over twenty prominent executives, representing some of America’s largest corporations, pension funds and investment firms, came together to sign [Commonsense Principles 2.0](#). The signatories include, among other noteworthy individuals, Warren Buffett, Jamie Dimon and Larry Fink.¹ In an [open letter](#), the signatories make “a commitment to apply the Commonsense Principles 2.0 in our businesses” and “hope others will do so as well.” Moreover, while recognizing that there is significant variation among public companies, and that not every principle will be applied in the same manner, the signatories expressed their intent to use the principles to guide their thinking, and encouraged others to do the same.²

The Commonsense Principles 2.0 are an updated version of the [Commonsense Corporate Governance Principles](#) launched in July 2016. A text comparison of the two versions is available [here](#). While many of the recommendations have remained the same, there are significant changes as well, including in the areas of director elections, shareholder engagement, shareholder rights and the role and responsibilities of investors, including in the proxy voting process. Moreover, the updated principles are not only intended for public companies and their boards of directors, but also for their *institutional* shareholders – both asset managers and asset owners. Key recommendations from the Commonsense Principles 2.0 (many of which are the same as in the 2016 principles) are as follows:

Board of Directors – Duties, Composition and Internal Governance

The Commonsense Principles 2.0 puts a spotlight on director duties of loyalty and care. Directors, who should be “shareholder-oriented,” are accountable to shareholders and owe duties of loyalty and care to the company. Moreover, a significant majority of the board (and all members of the audit, compensation and nominating and governance committees) should be independent, consistent with the New York Stock Exchange rules or similar standards. Independent directors should be “strong and steadfast . . . and willing to challenge the CEO and other directors constructively.”

The framework for director elections is expanded upon in the updated principles, providing that it is a “fundamental right of shareholders to elect directors whom they believe are best suited to represent shareholder interests.”

Additional recommendations include that: in uncontested elections, directors failing to receive majority vote should resign, which resignation the board ordinarily should accept, but if not, should clearly explain its rationale to shareholders; a director ordinarily should refrain from joining a board unless committed to serving for at least three years; one-year director terms may help promote board accountability to shareholders, but if a company chooses otherwise, the board should explain its rationale; and long-term shareholders should recommend potential directors for the board’s consideration if they know the individuals well and believe they would be additive to the board.

Shareholder Engagement

Emphasizing that it is “important that companies engage with shareholders and receive feedback about matters relevant to long-term shareholder value,” the Commonsense Principles 2.0 incorporates additional guidelines regarding shareholder engagement. In the event a company receives a shareholder proposal, it should consider engagement with the proposing shareholder early in the process, preferably before the proposal appears in the proxy. Moreover, if the proposal receives majority shareholder support, the company should consider further engagement with shareholders and either implement the proposal (or a comparable alternative) or promptly explain why doing so would not be in the best long-term interests of the company.

Similarly, in connection with a management proposal, the company should consider engagement with shareholders early in the process. If the proposal is defeated or receives significant shareholder opposition, the company should consider further shareholder engagement and formulate an appropriate response, taking into consideration how a majority of shareholders voted.

Shareholder Rights

The Commonsense Principles 2.0, unlike in the 2016 principles, takes a position on proxy access – recommending that public companies should allow for some form of proxy access, subject to reasonable requirements that do not make proxy access unduly burdensome for significant, long-term shareholders. Additionally, dual class voting is not considered best practice, but if adopted, the company ordinarily should have specific sunset provisions, based upon time or a triggering event, to eliminate it. Similarly, the principles acknowledge that the use of poison pills and other anti-takeover measures can diminish board and management accountability to shareholders. If a poison pill or other anti-takeover measure is adopted, the company should put the item to a shareholder vote and clearly explain why its adoption is in the best interests of shareholders.

Public Reporting

The Commonsense Principles 2.0, encouraging transparency with respect to quarterly financial results, recommends that while in certain instances it may be acceptable to use non-GAAP measures, companies should provide a bridge from non-GAAP items to the most comparable GAAP items – and *all* compensation, including equity compensation, should be reflected in any non-GAAP measurement of earnings in the same way it is reflected in GAAP earnings. At the same time, a “company should not feel obligated to provide quarterly earnings guidance – and should determine whether providing quarterly earnings guidance for the company’s shareholders does more harm than good.” Moreover, a “company should take a long-term strategic view, as though the company were private, and explain clearly to shareholders how material decisions and actions are consistent with that view.”

Board of Directors Leadership

Recognizing that independent leadership of the board is “essential” for effective oversight, the Commonsense Principles 2.0 recommends that the board’s independent directors decide, based upon the circumstances, whether it is appropriate for the company to have separate or combined chair and CEO roles. If a board decides to combine the chair and CEO positions, it is critical that the board has a strong designated lead independent director and governance structure. Moreover, the board should periodically review its leadership structure and explain clearly to shareholders why it has separated or combined the roles, consistent with the board’s oversight responsibilities.

Management Compensation

The Commonsense Principles 2.0 recommends that management compensation be comprised of both current and long-term components, and companies should consider paying a substantial portion (for some companies, as much as 50% or more) of compensation for senior management in the form of stock, performance stock units or similar equity-like instruments. The principles do note, however, that compensation should not be entirely formula based, and companies should retain discretion to consider factors that may not be easily measured.

Role of Investors in Corporate Governance

The updated principles elaborates upon the role of asset managers and incorporates recommendations regarding the role of institutional asset owners. Acknowledging the ability to influence public company corporate governance practices, asset managers are encouraged to exercise their voting rights thoughtfully, actively engage early on with companies and evaluate the performance of directors.

In line with growing concerns regarding conflicts of interests on the part of proxy advisory firms when making voting recommendations, as discussed in our Alert [available here](#), the Commonsense Principles 2.0 makes specific recommendations regarding the proxy voting process. To the extent asset managers use proxy advisor recommendations in their decision-making processes, they should disclose that they do so, and should be satisfied that the information upon which they are relying is accurate and relevant. Moreover, proxy advisors whom they use should have in place processes to avoid or mitigate conflicts of interest. Asset managers should also make public their proxy voting process and voting guidelines, have clear engagement protocols and procedures and disclose their policies for dealing with potential conflicts in their proxy voting and engagement activities.

Recognizing that institutional asset owners, such as pension plans and endowments, are in a position to influence public companies either directly or through their interactions with asset managers, the updated principles recommends that they use their position to advance long-term oriented corporate governance. Examples include through the use of benchmarks and performance reports consistent with the asset owner's strategy and investment time horizon; dialogue with asset managers concerning corporate governance issues; and the evaluation of asset managers regarding how they discharge their role in corporate governance matters.

Other Recommendations

The Commonsense Principles 2.0 sets out recommendations on additional corporate governance issues not covered above, including board committee structure, director tenure, board agendas and management succession planning.

There are currently various other organizations that have put forth corporate governance principles addressing the role and responsibilities of public companies, their boards of directors and their shareholders, each with their own perspectives. Acknowledging that competing principles could impede, rather than promote, healthy corporate governance practices, the signatories ultimately hope that the many existing sets of corporate governance principles can be "harmonized and consolidated, and reflect the combined views of companies and investors."

ENDNOTES

¹ Business Roundtable and The Conference Board Governance Center have also [endorsed](#) the principles. The Council of Institutional Investors [“praised”](#) the principles.

² The signatories of the Commonsense Principles 2.0 are “calling on all companies and institutions that believe in the cause of good governance” to sign on to the principles at Columbia Law School’s Ira M. Millstein Center for Global Markets and Corporate Ownership [website](#).

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