European Policy[1] – Director Elections - Board Independence at Non-Widely Held Companies

Background and Overview

Under the current ISS European Voting Guidelines, some smaller companies (i.e. "non-widely held" firms) are currently exempt from the main voting policy on board independence. Many European codes of best practice, however, now recommend that small companies maintain a minimum level of board independence. Many codes do not operate any distinction in terms of size, implying that all companies should be subject to the same regime. Where specific thresholds are present, board independence requirements in European codes are generally expressed either by a minimum number (ranging from one to three independent members) or by a minimum proportion (ranging from $1/6^{th}$ to 1/2 of the board).

Response to ISS' 2018 Policy Application Survey indicate that significant majorities of both investors and companies now believe that board independence should be considered when evaluating director elections at non-widely held companies.

Key Changes Under Consideration

ISS proposes a new policy on board independence at smaller companies ("non-widely held" companies.) which will be effective from February 2019, after a one-year transition period. Under the proposed policy, ISS would consider the minimum sufficient board independence to be one-third, and would generally recommend AGAINST the election or reelection of non-independent directors at non-widely held companies (excluding the CEO) if the overall level of board independence is less than one-third.

The proposed policy would come into effect in February 2019 following a one-year transition period. In 2018, warning language would appear in the analysis of director elections at non-widely held companies where the board does not meet the minimum independence threshold foreseen for 2019.

Intent and Impact

The proposed introduction of a board independence policy for non-widely held companies is intended to align with investors' views and evolving expectations in many European markets.

The proposed policy is expected to result in a meaningful increase in adverse ISS voting recommendations for board elections at non-widely held companies, if current board independence levels do not change prior to the implementation of the policy in 2019. The potential impact is particularly high in certain markets. Approximately 75 percent of non-widely held companies in France, for example, currently have less than one-third board independence, and would therefore receive negative ISS voting recommendations under the proposed policy. The policy could also have a substantial impact in some other markets, including Portugal (69 percent of non-widely held companies currently have independence levels under one-third), Norway (53 percent), Luxembourg (53 percent), and Italy (44 percent).

Request for Comment

While we appreciate any comments on this topic, ISS is specifically seeking feedback on the following:

[1] ISS' European Policy applies to companies incorporated in the following territories: Austria, Belgium, Bulgaria, Croatia, the Czech Republic, Cyprus, Denmark, Estonia, the Faroe Islands, Finland, France, Germany, Greece, Greenland, Hungary, Iceland, Italy, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, the Netherlands, Norway, Poland, Portugal, Romania, Spain, Slovakia, Slovenia, Sweden, and Switzerland.

- In light of the abovementioned impact, does your organization favor the introduction of a one-third board independence requirement at all non-widely held European companies with effect from February 2019, or do you consider that either some markets or some types of companies may warrant a longer transition period or a lower minimum limit?
- In several European markets, the local corporate governance code contains a specific recommendation for board independence at smaller companies[2]. In some cases, the recommended minimum independence guideline is lower than the one-third independence guideline foreseen in the proposed policy. For example, in France, the Middlenext Code[3] recommends that small companies have at least two independent directors on their boards. This effectively means that, if the proposed policy were to be implemented, ISS would in some cases apply negative voting recommendations to companies that comply with their local code recommendation on board independence. In light of this possibility, would your organization think it appropriate for ISS to apply voting sanctions based on the local code recommendation in markets where the code recommendation on board independence at small companies is lower than one-third?

[2] European countries whose local Code provides clear recommendations on board independence at small companies are: Austria, Belgium, Croatia, Cyprus, Denmark, Estonia, Finland, France, Greece, Iceland, Italy (hard law), Luxembourg, Malta, The Netherlands, Norway, Poland, Romania, Spain, Sweden, and Switzerland.

[3] According to recommendation 8 of the Middlenext Code: "It is recommended that the board includes at least two independent members. This number can be reduced to one member if the board is composed of five members or less. This number can also be increased if the board size is large."