

ISS proxy voting guidelines and the audit committee

Institutional Shareholder Services (ISS), the largest and most influential proxy advisory firm, has recently taken an increased interest in the role of external auditors and the audit committee. This is an important development because many investors, as well as other stakeholders, rely on ISS to help assess corporate governance at public companies. ISS provides investors with reports on individual companies; these reports include recommendations on how to vote on proxy ballot questions. In its 2018 Governance Principles Survey, which it uses to help set its benchmark policies, ISS included new questions about auditor ratification and audit committees. While no changes to policies on these issues are planned for the US market in 2019 these questions raise the possibility of future changes in its policies and recommendations on audit.

On October 19, 2018, Audit Committee Leadership Network (ACLN) members met with Marc Goldstein, head of US research at ISS, in Washington, DC, to discuss ISS policy and its recent interest in questions on auditor ratification and audit committees. *For a biography of Mr. Goldstein, see Appendix 1 on page 11. For a list of participating members, see Appendix 2 on page 12.*

Executive summary

Mr. Goldstein and ACLN members touched on three main topics at the meeting in Washington:

- **Developing and implementing policy** (page 2)

Mr. Goldstein provided insight into how ISS develops policies and uses them when issuing proxy vote recommendations. ISS says that the policy process is comprehensive and ongoing, drawing on input from a broad range of stakeholders to finalize a set of guidelines at the end of every year. The guidelines are then supplemented with company-specific analysis to develop voting recommendations for ISS's institutional-investor clients. Mr. Goldstein noted that ISS also works with many institutional investors to develop custom guidelines that incorporate their own views of corporate governance.

- **Recommendations on the external auditor** (page 4)

ISS included several new questions about evaluating the external auditor in its 2018 policy survey. The firm wants to understand if it is missing any red flags when it assesses whether to recommend for or against audit firm ratification, Mr. Goldstein explained. Three factors

highlighted by investors in the survey were regulatory penalties for errors in the audit, audit controversies, and the identity of audit partners and their ties to the company. ACLN members urged caution in applying these factors, underscoring the importance of examining the broader context.

- **Recommendations on the audit committee** (*page 8*)

ISS is also examining whether to incorporate additional factors when recommending a vote for or against audit committee members. While ISS currently looks for certain “problematic” practices, the 2018 survey asked about a more expansive list of factors, including the skills and experience of committee members, which investors flagged as their foremost interest. Again, ACLN members called for nuance rather than a formulaic approach. An audit committee member without financial expertise, for example, can often provide valuable perspectives on audit-related issues (not to mention other areas of interest to audit committees).

For a list of discussion questions for audit committees, see Appendix 3 on page 13.

Developing and implementing policy

ISS publishes comprehensive proxy voting guidelines for each geographic region where it makes voting recommendations. These policies typically include an analysis of and guidance on dozens of different topics that could be the subject of a proxy vote at a public company. The firm explains that it follows a detailed process to set these guidelines, which it then uses as a benchmark for evaluating company proxies and, ultimately, for making voting recommendations to its institutional investor clients.

The policy-setting process

ISS has a defined outreach plan to update its policies annually. It explains its annual policy review process as follows:

The policy update process begins with an internal review of emerging issues, any regulatory changes and notable trends seen across global, regional, or individual markets. Based on information gathered throughout the year (particularly feedback from investors and issuers during and after proxy season), ISS internal policy committees examine various governance and other voting topics across global markets. As part of this process, the policy team also examines relevant academic research, other empirical studies, and commentary by market participants. To gain insights from a broad range of market participants, ISS also conducts policy surveys, convenes roundtable discussions, and posts draft policy proposals for an open review and comment period. Based on this broad input and extensive review process, ISS’s Global Policy Board reviews and approves the final policy updates for the following year. For most markets, updated policies

announced in November of each year apply to meetings held on and after February 1 of the following year.¹

At the meeting in Washington, Mr. Goldstein elaborated on the policy-setting process: *“We take a look at policies that are ripe for reformulation. New types of shareholder proposals, for example, might need a new policy, or a corporate law may change, so a policy needs to be updated. Also, our clients’ views change, and we adapt our policies to reflect those changes.”*² He added that ISS tries to avoid abrupt changes involving the board and will sometimes provide a one-year phase-in for new policies.

Background on ISS

ISS was founded in 1985 and is currently owned by Genstar Capital, a private equity firm.³ It has 19 offices in 13 countries and employs about 1,200 people.⁴ In addition to its core services for institutional investors, ISS operates in other areas, including class-action securities recovery; governance-focused analytics; and environmental, social, and governance (ESG) consulting services for issuers. ISS and its leading competitor, Glass, Lewis & Co., have about 97% market share of the proxy advisory industry in the United States.⁵ Globally, ISS produces reports for over 40,000 shareholder meetings in 115 countries each year and helps its clients vote on more than 9.6 million ballots, representing 3.7 trillion shares.⁶

ISS’s provision of consulting services to issuers on whom they might also be providing voting advice has raised concerns among some ACLN members about conflicts of interest. The role of proxy advisors – including these kinds of concerns – is currently under scrutiny by the Securities and Exchange Commission as part of its review of the proxy process.⁷ The SEC will consider whether the current regulatory regime for proxy advisors is appropriate.⁸

The voting recommendation process

Once the annual policy-setting process is complete, ISS publishes its revised policy guidelines, and then uses them as a guide for making its ultimate recommendations on proxy proposals. ISS says that the process entails more than applying the stated policies to particular issues on proxy ballots. Even if a proposal is in an area where ISS has a stated policy, it conducts a company-specific analysis before making a recommendation. When clarification is needed, ISS says, its analysts will meet with corporate issuers to obtain an accurate picture of the matter in question. This dialogue can be initiated by ISS or by the issuer or shareholder. ISS states that it will usually seek input from both sides “in contested situations.”⁹ However, Mr. Goldstein

noted, *“We are not in a position to use non-public information. We need to be able to show our clients what we are basing our recommendation on.”*

A common critique of proxy voting is that investors simply follow the advisors’ recommendations, without conducting their own, independent analysis of the particularities of individual companies. Mr. Goldstein deflected this critique: *“It’s important to emphasize that our clients don’t blindly follow us. The larger and more sophisticated they are, the less likely they are to follow our benchmark recommendations, and the more likely they are to use a custom policy that reflects their own views of corporate governance.”* He added that certain political dynamics may fuel misperceptions about the influence of proxy advisors: *“Investors like to maintain independence from proxy advisors and to keep strong relationships with CEOs and management, and investors do not like confrontation with them. Often, when they disagree with management, they will lean on the fact that ISS or other proxy advisors recommended voting in a certain way on an issue like compensation, for example. It’s easier than telling an angry CEO, ‘I think you’re overpaid.’”*

Mr. Goldstein emphasized that ISS works with its institutional-investor clients to develop and implement their own custom policies, which often yield recommendations that differ from those issued under ISS benchmark policies.¹⁰ ISS further explains that “custom policies can be supported by the services of a custom research analyst who handles the end-to-end management of [an investor’s] policy and implementation of [its] voting recommendations across every company in [its] portfolio.”¹¹

A member was curious as to whether ISS goes back and evaluates the recommendations it made. Mr. Goldstein said that the impact of recommendations is evaluated both retroactively and proactively: *“We test our recommendations systematically. We will look back at prior policy. Clients will bring us concerns about our analysis. In our policy development process, we do consider how many more or fewer adverse recommendations would result from a change. If we’re hearing consistently from clients or companies, we will take it seriously. If satisfying our policy is unrealistic, we want to know.”*

Recommendations on the external auditor

ISS’s current policy addresses several aspects of the company’s relationship with the auditor, weighing several factors for each aspect:¹²

- **Annual recommendation for or against the retention of the audit firm.** ISS recommends against an audit firm in the following scenarios: the auditor has a financial interest in or association with the company and is thus not independent; the auditor issued an inaccurate opinion on the company’s financials; poor accounting practices are discovered, as in the case of fraud; or fees for non-audit services are excessive. ISS’s policy states that if the sum of audit fees, audit-related fees, and tax compliance/preparation fees are exceeded by all other fees paid to the auditor, then such non-audit or “other” fees, as they define them, are

considered excessive.¹³ Mr. Goldstein noted that their policy suggests such “non-audit” or “other” fees should be less than 50% of total fees to the auditor. Separately, ISS observes that if companies obtaining tax compliance/preparation fees from their auditor provide a footnote to the audit fees disclosure table showing a breakout of such tax fees, then ISS will use that information in the application of their policy.¹⁴

- **Shareholder proposals limiting non-audit services.** ISS currently conducts a case-by-case analysis when shareholder proposals ask to limit or prohibit the auditor from providing non-audit services.
- **Shareholder proposals on audit firm rotation.** ISS also conducts a case-by-case analysis in the very rare instance where a shareholder proposes an audit firm rotation. As part of this analysis, ISS currently considers “the tenure of the audit firm; the length of rotation specified in the proposal; any significant audit-related issues at the company; the number of Audit Committee meetings held each year; the number of financial experts serving on the committee; and whether the company has a periodic renewal process where the auditor is evaluated for both audit quality and competitive price.”¹⁵
- **Auditor indemnification and limitation of liability.** ISS recommends voting case-by-case on this issue as well, taking into consideration the terms of the auditor agreement, especially the degree to which it impacts shareholders’ rights; the motivation and rationale for the agreement; the quality of the company’s disclosures; and the company’s historical practices in the audit area.¹⁶

New issues raised in the 2018 survey

While ISS’s annual policy survey has focused on audit-related matters in the past, these issues were featured more prominently in this year’s survey. Recent high-profile financial reporting issues – at major companies such as GE in the US and Carillion in the UK – have drawn attention from investors and, in some cases, caused proxy advisory firms to recommend against the company’s audit firm.¹⁷ In a recent interview, Mr. Goldstein noted, “Investors are paying a bit more attention to auditors in the wake of some recent events in the US and UK. [ISS] hasn’t really changed our policy on auditors in some time, and we thought maybe it’s time to revisit this to see if anything makes sense to change.”¹⁸

At the meeting in Washington, Mr. Goldstein elaborated, citing recent financial scandals in the United Kingdom as events that have led ISS to reexamine its policies on auditor ratification. *“The Parliamentary investigation report in the Carillion matter was scathing. No one was spared—not the executives, nor the directors, nor the auditor nor the regulators. Clearly, we need to do a better job to spot red flags,”* he said. *“We have no intention of routinely recommending voting against auditor ratification. But we’re wondering if there’s something that we’re missing. Audit versus non-audit fees are only part of the story, and it’s something*

that we can easily look at. But is there something that we're missing that would help us spot the next Carillion before it happens?"

In this year's survey, ISS asked whether it should consider the following factors when evaluating audit firms:¹⁹

- Audit firm tenure
- Audit partner tenure
- Significant audit controversies
- Regulatory fines or other penalties on the company, related to financial disclosure practices or weaknesses not identified in the audit report
- Regulatory fines or other penalties on the auditor for weaknesses or errors in audit practices
- The identities of the audit partners and any links to the company or its management

The three factors that garnered the most interest from investors were, in rank order: (1) selected regulatory fines or other penalties for weaknesses or errors in the audit, (2) audit controversies, and (3) the identity of audit partners and ties to the company.²⁰

ACLN members urge caution

In pre-meeting conversations, ACLN members questioned the objective of ISS posing further audit-focused questions to stakeholders. *"What is ISS trying to accomplish? Is this an expansion of the proxy advisor's scope? There is potential for two different standards on audit matters—one from the regulators and one from the proxy advisors—if ISS goes too far,"* said one member. Another member advised against ISS overlapping its policy agenda with *"SEC and PCAOB territory."* Members said that these details, like audit partner rotation and the evaluation of the firm, are already disclosed in the audit committee report within the annual proxy statement.

Addressing these concerns, Mr. Goldstein said, *"ISS already provides voting recommendations on auditor ratification and election of audit committee members. Through this year's survey, we are trying to determine whether the criteria that we use to make our recommendations are the right ones, asking, 'Are there red flags that we're currently missing that would help our clients identify situations that pose a potential risk to their investments over the long term?'"* He also noted that, while there will be no immediate policy change, ISS's institutional investor clients are focused on these issues, causing ISS to explore whether its current policies are still the best practice.

ACLN members said that they consider many elements when assessing audit quality, but not all of these are available to ISS when it attempts a similar analysis. Specifically, members emphasized that their assessments of audit quality are highly qualitative, based not on metrics

but on factors such as the level of candor in the auditor’s communications. A member noted that *“there is a challenge if you can only rely on public information. If the company is in litigation, there may be constraints on disclosure.”* Mr. Goldstein suggested that the disclosure of critical audit matters (CAMs) could potentially be helpful as another source of information for ISS: *“We will start to see CAMs, and we’ve decided not to make policy changes until these are disclosed. Will these be boilerplate? Or will they raise red flags? We need to see the disclosures. We don’t want to change policy now and then change it again.”*

Turning to specific factors that ISS asked about, many members agreed that a material weakness or a restatement is cause for investor concern and warrants further investigation by proxy advisory firms. One member said that—in comparison to other factors like audit firm tenure—restatements provide an objective red flag: *“I would advise ISS to look at restatements and ask, ‘Why did it happen? Was it material? Did the auditor miss the problem, and if so, why?’”*

At the same time, members recommended caution in applying the proposed factors, including restatements. A member noted that ISS should carefully examine the situation surrounding a restatement: *“You don’t want to penalize the audit partner or audit committee who caught a problem that existed before they arrived.”* Another member said that regulatory fines and penalties could create a broad-brush indictment of a firm, and that direct engagement was important: *“Be careful about ruling out a firm.”*

While audit firm tenure is one possible factor in evaluating auditor independence, members were cautious about proxy advisory firms using this metric as well. Several members noted that auditor tenure is an ineffective data point that further limits competition and a company’s ability to select the best firm. Others emphasized the difficulty of changing audit firms: *“There’s turmoil when you change auditors; these are massive projects.”* On the issue of partner tenure, members generally agreed that the current five-year rotation requirement in the United States should make this a non-issue. Mr. Goldstein agreed on both auditor and partner tenure: *“We don’t expect to use tenure in our guidelines. Partner rotation already exists.”*

Mr. Goldstein sought to reassure the audit chairs by describing the factors ISS considered in making a recommendation against the ratification of KPMG as GE’s external auditor. *“Long tenure as GE’s auditor was not a reason for our recommendation,”* said Mr. Goldstein. *“KPMG had given GE a clean bill of health for many years, and then there was a surprising large write-off related to their legacy long-term care insurance business, followed by an SEC investigation. There were other concerns and enough questions for us to take what, for us, was a radical position.”* Mr. Goldstein elaborated that part of ISS’s concerns in the GE case stemmed from the criticism of KPMG’s work as the auditor of Carillion. Members again cautioned that ISS be careful before connecting a firm’s performance on one audit in a particular country with its work on another audit in another country.

Recommendations on the audit committee

ISS currently offers limited recommendations on the audit committee and its members, focused mostly on key outcomes related to the audit, and not on the characteristics of the committee members themselves. Certain “problematic audit-related practices” prompt votes against or votes withheld from audit committee members:²¹

- Non-audit fees to the auditor are excessive.
- The company receives an adverse opinion on its financial statements from the auditor.
- There is persuasive evidence that the committee entered into an agreement that limits the company or shareholders from taking legal action against the auditor.

ISS also recommends case-by-case votes on audit committee members if:

Poor accounting practices are identified that rise to a level of serious concern, such as: fraud, misapplication of GAAP, and material weaknesses identified in Section 404 disclosures. Examine the severity, breadth, chronological sequence, and duration, as well as the company’s efforts at remediation or corrective actions, in determining whether withhold/against votes are warranted.

Mr. Goldstein elaborated on the process: *“We do engage. For example, with GE, we spoke to the company and the audit firm. It’s always on a case-by-case basis, not an automatic adverse recommendation. We don’t want to blame the person who uncovered the issue. Perhaps the people who were responsible for the fraud have already been removed. If the board and audit committee should have spotted it and didn’t, that would cause a deep examination of the committee.”*

New considerations raised in 2018

In its 2018 survey, however, ISS asked about a lengthier list of potential factors for evaluating audit committee members, including:²²

- Skills and experience of audit committee members (including number of financial experts, if applicable)
- Quality of the company’s financial reporting (e.g. number of restatements; nature of restatements)
- Significant financial reporting or audit controversies
- The level of disclosure of factors used in the audit committee assessment of the external auditor’s independence, tenure, qualifications, and work quality
- Frequency of audit committee meetings
- Frequency of audit committee refreshment

The top three factors noted by investors, in rank order, were: (1) the skills and experience of audit committee members, (2) significant financial reporting or audit controversies, and (3) the quality of the company's financial reporting. Non-investor stakeholders reported similar results.

Members call for nuance

Mr. Goldstein noted that investors cited the skills and experience of audit committee members, including the number of financial experts, as the most important factor in evaluating an audit committee. As in their opinions on evaluating the auditor, however, ACLN members called for nuance. For example, several members challenged the notion that having more financial experts on the audit committee improves governance and oversight. One said, *"Things get so technical, it's great to have a non-financial expert ready to ask the 'dumb' questions. There's a former military leader on my audit committee who asks great questions."* Members value the diversity of perspectives on an audit committee, particularly in risk oversight matters. Mr. Goldstein agreed: *"From a risk oversight perspective, having diversity of skills and experiences, not just accounting, is very valuable."*

ACLN members cautioned ISS against ignoring these nuances by employing a checklist to evaluate committees. They noted the uniqueness of audit committees due to sector, company size, and global footprint. They expressed frustration that *"cookie cutter"* metrics could be universally applied to their companies. On an issue such as the maximum number of boards a director should join, the size of the companies is an important factor, for example, and the appropriate number might vary considerably.

As with the analysis of audit firms, members said that a restatement or other significant financial reporting controversy may warrant further evaluation of the audit committee, though they encouraged a case-by-case approach. One said, *"Among the companies in the S&P 500, there are few material weaknesses or restatements. When these do come up, there should not be a formulaic answer. ISS should follow up on those situations to understand the facts and circumstances. A failed audit comes out as a restatement."*

Conclusion

The recent interest of ISS in audit-related matters has caught the attention of audit chairs, who do not want to see formulaic requirements imposed on them. ACLN members emphasized that auditors and audit committees should be assessed in a nuanced manner that considers the particular circumstances of each company and board. Responding to these concerns, Mr. Goldstein sought to reassure the audit chairs that the policy development and recommendation process now firmly established at ISS would apply in the realm of audit as well. Careful research would support any policy changes, and case-by-case analyses would drive recommendations.

About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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Appendix 1: Biography of Marc Goldstein

Marc Goldstein is the head of US research at ISS, overseeing a team responsible for the firm's benchmark research and vote recommendations on US companies. He previously led the team responsible for proxy research on US energy and industrial sector companies, and was responsible for the ISS policy development process, coordinating the activities of the ISS policy board and policy interpretation group. Prior to that, he coordinated engagement between ISS research analysts and external constituents such as corporate issuers, activist shareholders, and business organizations. He also served as head of Japanese research for 11 years and helped open the ISS office in Tokyo. He has given presentations on US and Asian corporate governance topics at seminars and conferences in the United States, Japan, Singapore, and Taiwan.

Mr. Goldstein earned his BA in East Asian studies from Wesleyan University, his MA in economics from the University of Maryland, and his JD from the University of Michigan Law School.

Appendix 2: Participating members

Members participating in all or part of the meeting were:

- Ron Allen, Coca-Cola
- Pam Daley, BlackRock
- Dave Dillon, 3M and Union Pacific
- Bill Easter, Delta Air Lines
- David Herzog, MetLife and DXC.technology
- Lou Hughes, EACLN alumnus
- Marie Knowles, McKesson
- Mike Losh, Aon
- George Muñoz, Altria
- Helman le Pas de Sécheval, Bouygues, EACLN member
- Tom Schoewe, General Motors
- Steve West, Cisco Systems
- David Vitale, United Continental Holdings

EY was represented in all or part of the meeting by the following:

- Kelly Grier, US Chair and Americas Managing Partner
- Frank Mahoney, Americas Vice Chair of Assurance Services

Appendix 3: Discussion questions for audit committees

- ? What are your thoughts on ISS's policy development process?
- ? How does your board or management team engage in the ISS policy-setting process? Is ISS sufficiently open to input from key stakeholders?
- ? What experience do you have with ISS's voting recommendation process? Is ISS sufficiently open to input from the companies it covers?
- ? What influence do you believe proxy advisory firms have, either directly on a proxy vote or on management and the board before a vote?
- ? How could ISS better understand the performance of external auditors?
- ? Should ISS consider a broader set of factors than it currently does when making recommendations on auditor ratification? What factors?
- ? How could ISS better understand the work of audit committees?
- ? Should ISS consider a broader set of factors than it currently does when evaluating audit committee performance? What factors?
- ? Are your companies and boards hearing from investors about gender diversity on the board? How is this consideration incorporated into the board's succession plan?
- ? How should ISS evaluate directors' performance on other companies' boards?

Endnotes

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- ¹ Institutional Shareholder Services, *Executive Summary—Global Proxy Voting Guidelines Updates and Process: 2018 ISS Benchmark Policy Changes* (Rockville, MD: Institutional Shareholder Services, 2017), 3.
- ² PreView reflects the network’s use of a modified version of the Chatham House Rule whereby comments are not attributed to individuals or corporations. Quotations in italics are drawn directly from conversations with network members and other participants in connection with the meeting.
- ³ “[ISS history](#),” Institutional Shareholder Services, accessed September 10, 2018.
- ⁴ “[About ISS](#),” Institutional Shareholder Services, accessed September 10, 2018.
- ⁵ James R. Copland, David F. Larcker, and Brian Tayan, *Proxy Advisory Firms: Empirical Evidence and the Case for Reform* (New York: Manhattan Institute, 2018), 5.
- ⁶ “[About ISS](#),” Institutional Shareholder Services, accessed September 10, 2018.
- ⁷ Securities and Exchange Commission, “SEC Announces Agenda, Panelists for Staff Roundtable on the Proxy Process,” press release, November 8, 2018.
- ⁸ Chairman Jay Clayton, “[Statement Announcing SEC Staff Roundtable on the Proxy Process](#),” public statement, July 30, 2018.
- ⁹ “[FAQs: Engagement on Proxy Research](#),” Institutional Shareholder Services, accessed September 15, 2018.
- ¹⁰ ISS, *Executive Summary—Global Proxy Voting Guideline Updates and Process*, 3.
- ¹¹ “[Custom Policy & Research](#),” Institutional Shareholder Services, accessed September 20, 2018.
- ¹² Institutional Shareholder Services, *United States Proxy Voting Guidelines: Benchmark Policy Recommendations*, (Rockville, MD: Institutional Shareholder Services, January 4, 2018), 21.
- ¹³ ISS, *United States Proxy Voting Guidelines*, 21.
- ¹⁴ Institutional Shareholder Services, *U.S. Proxy Voting Research Procedures and Policies (Excluding Compensation-Related): Frequently Asked Questions* (Rockville, MD: Institutional Shareholder Services, August 13, 2018), 33.
- ¹⁵ ISS, *United States Proxy Voting Guidelines*, 22.
- ¹⁶ ISS, *United States Proxy Voting Guidelines*, 21.
- ¹⁷ Institutional Shareholder Services, *2018 Governance Principles Survey: Summary of Results* (Rockville, MD: Institutional Shareholder Services, September 18, 2018), 5.
- ¹⁸ Lindsay Frost, “[ISS Examining Auditors, Audit Committees After Scandals](#),” *Financial Times Agenda*, August 3, 2018.
- ¹⁹ Institutional Shareholder Services, *ISS Governance Principles Survey*, (Rockville, MD: Institutional Shareholder Services, 2018).
- ²⁰ Institutional Shareholder Services, *2018 Governance Principles Survey: Summary of Results* (Rockville, MD: Institutional Shareholder Services, September 18, 2018), 9.
- ²¹ ISS, *United States Proxy Voting Guidelines*, 15.
- ²² ISS, *ISS Governance Principles Survey*.