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Proxy Advisory Firms and Corporate Governance Practices: One Size Does Not Fit All

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Editor's Note: The following post comes to us from Bill Libit, partner concentrating in corporate and securities and municipal finance at Chapman and Cutler LLP, and is based on a Chapman publication by Mr. Libit and Todd Freier.

The 2014 proxy season, like previous seasons, has provided shareholders of public US companies with an opportunity to vote on a number of corporate governance proposals and director elections. Throughout this proxy season, proxy advisory firms have provided shareholder vote recommendations "for" or "against" those proposals and "for" or to "withhold" votes for directors. Certain proxy advisory firms, such as Institutional Shareholders Services Inc. ("ISS") and Glass, Lewis & Co., LLC ("Glass Lewis"), have also published updated corporate governance ratings reports on public companies, including evaluations of a company's corporate governance risk profile.

Companies are experiencing increasing pressure from proxy advisory firms to conform their governance practices to the "best" practice standards established by those advisory firms. Often, however, what might be a "best" corporate governance practice for one company may not be for another, as the industries in which companies operate and their culture, management style and short- and long-term corporate strategies, as well as the best interests of a company's shareholders, may be better suited for different governance practices. In recognition of the increased influence of proxy advisory firms on corporate governance practices, the Securities and Exchange Commission (the "SEC") recently hosted a roundtable where panelists discussed, among other topics, proxy advisory firms' influence in shaping so-called "best" corporate governance practices by way of their vote recommendations and governance ratings reports (the "Proxy Advisory Services Roundtable").[1] Specifically, SEC Chair Mary Jo White, while noting that proxy advisory firms play an important role in the proxy process, stated that one goal of the

[1] A transcript of and other materials relating to the Proxy Advisory Services Roundtable can be found at http://www.sec.gov/spotlight/proxy-advisory-services.shtml (the "Proxy Roundtable Transcript").

roundtable was to better understand the process by which those firms formulate their voting positions and governance ratings, and the transparency of that process.

This post (1) discusses the influence proxy advisory firms have on establishing “best” corporate governance practices, (2) identifies select current corporate governance practices considered by proxy advisory firms as detrimental to shareholders (including classified boards, combined chief executive officer (“CEO”) and chair roles, and the limitations on shareholders to act by written consent or to convene special shareholder meetings) and examines why such practices may benefit certain companies and be in the best interests of and create long-term value for their shareholders, and (3) presents certain considerations for corporate boards of directors and management.

Proxy Advisory Firms’ Influence on Corporate Governance Practices

Proxy advisory firms provide clients with an array of proxy and corporate governance-related services, including providing investors with vote recommendations on proxy voting issues and corporate governance ratings reports. ISS and Glass Lewis currently enjoy a duopoly on providing these proxy advisory services.[2] Supporters of proxy advisory firm services note that such firms offer a valuable service, particularly to investment companies and certain institutional investors who may not have the resources or find it economical to conduct the research necessary to evaluate every director and proxy proposal prior to casting their proxy vote. Critics of proxy advisory firms, however, state that such firms encourage shareholders to vote blindly on directors and proxy proposals and have become *de facto* corporate governance regulators without being subject to significant SEC oversight.

While companies, practitioners and governance experts may disagree as to whether it has been a positive development, there is little debate as to proxy advisory firms’ influence on the proxy voting process and corporate governance practices. For example, certain studies reveal that in an effort to avoid negative vote recommendations or corporate governance ratings, many companies will implement governance policies and practices aligned with those promulgated by the proxy advisory firms.[3] A study conducted by The Conference Board revealed that 70% of companies

[2] Ninety-seven percent of proxy advisory firm business is handled by ISS and Glass Lewis. Proxy Roundtable Transcript at 27.

[3] See *How to Fix Our Broken Proxy Advisory System*, Mercatus Center, James K. Glassman and J.W. Verret (April 16, 2013). See also, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, David F. Larcker, Allan L. McCall and Gaizka Ormazabal (May 10, 2013).

reported that their compensation programs were influenced by the guidance received from or by the policies of proxy advisory firms.[4]

Although directors owe a fiduciary duty to shareholders, some research finds that directors may be implementing certain corporate governance practices, not to enhance shareholder value, but to appease proxy advisory firms and to receive a positive vote recommendation. A US Government Accountability Office report found that some companies have adopted corporate governance practices simply to meet a proxy advisory firm's corporate governance standards, even though such companies do not see the value of doing so.[5] Further, some studies found that shareholder value is actually being diminished by the proxy proposal recommendations of proxy advisory firms because of inadequate professional standards, conflicts of interest, a lack of properly aligned incentives, ideological bias or some combination of these factors.[6]

SEC Commissioner Daniel Gallagher recently remarked that proxy advisory firms have "gained an outsized role" in US corporate governance, while SEC Commissioner Michael Piwowar has noted that such firms may create an "unhealthy overreliance" by investors on proxy advisory firm recommendations. The SEC has refocused its attention on the role of proxy advisory firms and their influence on proxy voting and corporate governance practices.[7]

Discussion of Select Corporate Governance Practices

Corporate governance cannot be properly evaluated without in-depth knowledge and understanding of a company, its management and the industry in which the company operates. Proxy advisory firms' "one-size-fits-all" approach to corporate governance may have little or no relation to the specific strategic, competitive environment or operational and management issues confronting a particular company. In this section, we identify select current corporate governance practices considered by proxy advisory firms as detrimental to shareholders, which include classified boards, combined CEO and chair roles, and the limitation on shareholders to act by written consent or to convene special shareholder meetings, and examine why such practices may benefit certain companies and be in the best interests of and create long-term value for their shareholders.

[4] *The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions*, David F. Larcker, Allan L. McCall and Brian Tayan, *The Conference Board: Director Notes* (March 2012).

[5] *Corporate Shareholder Meetings–Issues Relating to Firms That Advise Institutional Investors on Proxy Voting*, US Government Accountability Office Report to Congressional Requesters (June 29, 2007).

[6] See *How to Fix Our Broken Proxy Advisory System*, Glassman and Verret (April 16, 2013).

[7] In 2010, the SEC sought public comment on the role of proxy advisory firms within a broad concept release on the proxy system (often referred to as the "proxy plumbing" release). See *Concept Release on the US Proxy System*, SEC (July 14, 2010).

Classified Boards	
Proxy Advisory Firms' Views	***Company Views (supporting classified boards)***
• support shareholder proposals to declassify boards • such boards are regarded negatively as they make it more difficult for shareholders to remove ineffective directors or to change control of a company through a proxy contest • studies show a negative correlation between the existence of a classified board and a company's value • such boards may adversely affect corporate risk ratings	• they provide the board with a continuity of board experience and prevent abrupt change in board composition • they lessen shareholder pressure for short-term performance and mitigate the risk of interference by shareholders with a short-term investment strategy • they serve as an anti-takeover defense and a needed tool and leverage in order to negotiate effectively with potential acquirers • research is conflicting as to whether staggered boards increase or decrease company value

Combined CEO and Chair Roles	
Proxy Advisory Firms' Views	***Company Views (supporting combined roles)***
• generally support shareholder proposals requiring an independent director serve as chair[8] • an independent chair is broadly considered a best practice as such chair curbs conflicts of interest, promotes oversight of risk, manages the relationship between the board and CEO,	• certain efficiencies are sacrificed when the roles are separated (e.g., efficiencies in decision-making and economics) • separate roles may result in additional costs; further, compensation required to be paid to an independent chair may counter the very rationale behind

[8] Proxy advisory firms, for example, may not support shareholder proposals that include overly prescriptive independence definitions or where the company makes a compelling argument for combining the CEO and chair roles (e.g., the company has a clearly defined lead independent director role and has strong performance and governance provisions).

and serves as a conduit for regular communication with shareholders • independent chairs may positively affect corporate risk ratings	splitting the roles (i.e., since the amount of pay may raise a question regarding the chair's independence) • there is potential for confusion regarding company leadership, leading to duplication and disruption between the CEO and chair • a combined CEO/chair may be better positioned to execute a company's strategic plan • separate roles do not guarantee effective independent oversight or the absence of management risk (see e.g., Enron Corp. and WorldCom, Inc.) • a company's governance structure may already rely on a strong independent lead director • SEC rules require disclosure of a company's board leadership structure and why such structure is appropriate • research is conflicting as to whether separate roles correlate positively with company performance

Shareholders' Ability to Act by Written Consent	
Proxy Advisory Firms' Views	***Company Views*** ***(supporting the limitation of such right)***
• oppose management or shareholder proposals to restrict or prohibit shareholders' ability to act by written consent • limitations on written consent are generally contrary to shareholder interests as shareholders may lose an	• such right gives hostile bidders and insurgent shareholders leverage when they are negotiating with incumbent boards • such right may permit a change of control at the board level without advance notice to the board or other

important right (e.g., the ability to remove directors or initiate a shareholder resolution without having to wait for the next scheduled meeting) • consent solicitations may be advantageous to both shareholders and management in that the process does not involve the expense of holding a physical meeting and it is easier for shareholders who can simply respond to the proposal by mail • beneficial tender offers may be precluded because of a bidder's inability to have shareholders take action by written consent • companies that do not permit such action or mandate that written consent be unanimous maintain a practice that may adversely affect corporate risk ratings	shareholders (precluding the board from any meaningful opportunity to communicate its view of the possible shareholder action to other shareholders or to the market) • such right may result in the removal of some or all of the target company's directors and replace them with directors nominated only by the activist shareholders • such right may permit activist shareholders to effectively assume control of the company without paying the control premium that would typically be expected to be paid to company shareholders to acquire a controlling interest • such right may cause significant disruption to the company and be extraordinarily burdensome in terms of financial expense, time and management resources • proxy advisory firms are unclear as to what percentage of shareholder consent is satisfactory (e.g., majority or supermajority) and do not take into consideration certain states' corporate laws requiring unanimous consent

Shareholders' Ability to Convene Special Shareholder Meetings	
Proxy Advisory Firms' Views	***Company Views (supporting the limitation of such right)***
• oppose management or shareholder proposals to restrict or prohibit	• such right may cause disruption between annual meetings of

shareholders' ability to call special meetings (but prefer a 10-15% minimum stock ownership threshold necessary to call special meetings) • ability to timely call special meetings is an important shareholder right (e.g., the ability to remove directors or initiate a shareholder resolution without having to wait for the next scheduled meeting) • shareholders could be powerless to respond to a beneficial offer if a bidder cannot call a special meeting • inability to call special meetings insulates management, which may result in the decline of corporate performance and shareholder returns • companies that permit such action with a preferred minimum stock ownership threshold maintain a practice that may positively affect corporate risk ratings	shareholders and be extraordinarily burdensome in terms of financial expense, time and management resources • such right permits a small percentage of shareholders to call a meeting that may serve their narrow purposes, rather than those of the company and the majority of shareholders • the board has a fiduciary duty to represent the best interests of *all* shareholders; therefore, the decision to call a special meeting should remain in the hands of the board, chair and/or CEO in order to ensure all shareholders' interests are taken into consideration • shareholders are encouraged to communicate with the board in ways that are more efficient and less resource intensive than convening special meetings (e.g., through periodic shareholder outreach initiatives, the shareholder proposal process, written communications by way of a company's formal board communications policy, and investor relations contacts)

Corporate Boards of Directors and Management Considerations

In light of proxy advisory firms' influence on corporate governance practices, corporate boards of directors and management may want to consider the following actions:

- ***Review and provide feedback on company reports published by proxy advisory firms and challenge (as appropriate).*** Companies should carefully review proxy and corporate governance ratings reports received from proxy advisory firms and, as appropriate, challenge those firms on their proxy voting recommendations or so-called best governance practices, particularly if a company concludes that such recommendations or practices are not in its or its shareholders' best interests, or are not accurately supported by facts applicable to the company. If proxy advisory firms do not change their recommendation, the company may want to communicate directly with shareholders (e.g., a proxy statement amendment filed with the SEC and direct shareholder outreach) in order for shareholders to better understand the company's position on a particular issue and to illustrate why the proxy advisors' viewpoint is not in the best interests of the company and its shareholders.

- ***Identify and proactively engage shareholders on an ongoing basis.*** It is increasingly important for companies to be aware of shareholder concerns and to maintain good communication, particularly with large and institutional shareholders. Constructive proactive engagement, not only on traditional matters such as financial performance and corporate strategy, but also on executive compensation and governance practices, may head off shareholder proposals or "withhold" or "against" votes for company directors. To this end, companies should consider (1) monitoring the company's shareholder base and trading activities (e.g., Schedule 13D and 13G filings), (2) maintaining current profiles of the company's institutional investors and other large shareholders and gathering information on the background and specific investment strategies pursued by those entities, (3) creating an internal working team, including members from investor relations, legal, finance and human resources, to develop a dialogue with major shareholders about the company's compensation programs and corporate governance practices, and (4) preparing board and management talking points to address shareholder issues throughout the year in order to anticipate shareholder concerns and to defend the company's practices or explain the steps being taken to address certain practices or issues.
- ***Review proxy voting guidelines and corporate governance best practices of large institutional investors.*** Companies should identify their largest shareholders and determine whether they have their own set of proxy voting guidelines. A number of institutional investors report that they do not strictly rely on proxy advisory firm recommendations for proxy voting, but have instead adopted their own voting guidelines. Also, certain institutional investors have published what they view as best corporate governance practices. Companies should review those guidelines in order to evaluate how their practices align and to strategize how the company may want to address any practice that may not so align. On any potentially contentious proxy proposal, the company should consider reaching out to its largest shareholders to discuss the proposal and any related questions or governance concerns the shareholders may have.

- ***Respond to shareholder proposals receiving significant shareholder support.*** Proxy advisory firms may recommend a vote "against" individual directors, committee members or the entire board, as appropriate, if the board failed to respond to any shareholder proposal that received a certain level of shareholder support in the previous year (e.g., ISS uses a majority and Glass Lewis a 25% shareholder support threshold). Such policies are often referred to as "comply or explain" policies, pursuant to which if a board does not fully implement a shareholder proposal receiving a certain threshold of shareholder support, the board's reasoning should be fully and clearly explained in the company's proxy statement.
- ***Calculate shareholder voting results in accordance with proxy advisory firm methodologies.*** ISS and Glass Lewis exclude "abstentions" and "broker non-votes" from their calculation of shareholder voting results. Such methodology, however, may conflict with certain states' corporate law that requires companies to include "abstentions" as "against" votes in determining whether a particular proxy proposal passed or received majority shareholder support. Therefore, companies should consider utilizing two methodologies in calculating the voting outcome of a proposal: one for state law and SEC reporting purposes, and one to determine whether such proposal received a certain shareholder support threshold (e.g., majority or 25% support), which may necessitate a board response in accordance with proxy advisory firm policy.
- ***Anticipate future shareholder activism.*** In anticipating future shareholder activism, boards can implement steps to prepare for (or pre-empt) such activism, including (1) reassessing its strategic goals in light of changes in the economic climate and such impact on the company's governance practices, (2) designating an officer responsible for corporate governance who recommends best practices to the board and, if the company chooses to depart from widely accepted governance and organizational standards established within or without its peer group, explain such departure in disclosure documents, (3) revisiting any policy (e.g., classified boards) that may foster the perception of board entrenchment and stand in the way of obtaining institutional shareholder support, and (4) developing an inventory of governance practices that may single out the company as a target of shareholder activism and strategize how the company might pre-empt such activism.
- ***Provide comments to the SEC and support initiatives addressing issues involving proxy advisory firms.*** Companies are encouraged to submit comments to the SEC for its consideration in promulgating any possible future regulation on proxy advisory firms and their services.[9] Further, companies can support business organizations, such as the

[9] Public comments relating to proxy advisory services may be submitted to the SEC at http://www.sec.gov/spotlight/proxy-advisory-services.shtml. As of the date of this publication, the SEC was still accepting public comment on the topics discussed at the Proxy Advisory Services Roundtable.

US Chamber of Commerce, advocating for SEC or congressional action to require registration and regulation of those advisory firms.

- ***Remain steadfast (as appropriate).*** Although there is considerable pressure from outside forces (e.g., short-term focused shareholder activists and proxy advisory firms) to conform to the "one-size-fits-all" approach to corporate governance, directors and officers owe a duty to the company and its shareholders to implement the practices they believe, given a company's unique characteristics and circumstances, are in the best interests of the company and shareholders and will create long-term shareholder value. No rigid approach to governance practices can substitute for the informed business judgment of a well-advised board.