LJN LAW JOURNAL NEWSLETTERS

The Corporate Counselor®

An ALM Publication

July 2015

# Proxy Advisory Firms

By Jeffrey A. Scudder

Each January, our firm invites general counsel, CFOs, controllers, and other representatives of our public company clients, as well as other outside advisers to public companies, to a series of presentations focused on "hot topics" for the upcoming proxy season. For the past several years, I have been tasked with providing an update on proxy advisory firms, most notably Institutional Shareholder Services (ISS) and Glass Lewis, and the evolving policy updates they issue on an annual basis.

Some would argue that I've been "drawing the short straw." Truth be told, though, I enjoy the topic for the surprisingly animated and wide-ranging reactions it evokes (at least relative to the subject matter). Those in the audience who have significant experience dealing with ISS generally groan and shake their heads in frustration, particularly if they are seeking shareholder approval of a new equity plan at their upcoming annual meeting. Others who lack such experience typically appreciate that "ignorance is bliss" in this area, but tend to be puzzled by the influence of proxy advisory firms and the attention they command within large public companies.

**Background: The Unintentional Rise of Proxy Advisory Firms**

It wasn't always like this (or at least so I'm told). Founded in 1985, ISS is still a relatively young organization; Glass Lewis was just founded in 2003. These and other proxy advisory firms have grown in size and influence due to a variety of factors, including the proliferation of institutional ownership of U.S. public companies. According to a report issued by The Conference Board in 2010, as of the previous year, institutional investors held more than 70% of the securities of the 1,000 largest publicly traded U.S. corporations. To the extent that institutional investors have greater resources and incentive to vote their shares than individual investors, they (and, in turn, their advisers) wield greater power over the public companies in which they invest.

SEC rulemaking and no-action letters issued in the early 2000s also contributed to the rise of proxy advisory firms — not necessarily by design. In its rulemaking, the SEC endeavored to make sure that investment advisers were voting shares under their management in the best interests of their clients. To address potential conflicts of interest (since many investment advisers manage funds for multiple, sometimes interrelated, clients), the SEC allowed investment advisers to vote shares based on, among other things, the recommendations of independent third-party advis-rs (i.e., proxy advisory firms). Thus began a rapid trend toward "outsourcing" the process by which investment advisers research and make voting decisions with respect to the shares under their management. This trend continued to accelerate in the latter half of the 2000s and early 2010s, as expanded executive compensation disclosure rules, the Dodd-Frank Wall Street Reform and Consumer Protection Act, increased shareholder activism, and other developments made reviewing proxy statement disclosures and determining how to vote ever more challenging, for institutional and individual shareholders alike.

There are signs that the trend may be decelerating, and even that a change in course is possible. On June 30, 2014, the SEC's Divisions of Investment Management and Corporation Finance issued Staff Legal Bulletin No. 20 (SLB 20), which clarified guidance regarding investment advisers' discharge of their fiduciary duties to clients. Among other things, SLB 20 requires that investment advisers hold proxy advisers accountable for issuing voting recommendations based on accurate information and disclosing potential

Jeffrey A. Scudder

conflicts of interest — for example, consulting relationships with the companies covered by their voting recommendations. International regulators, including the European Securities and Market Authority and the Canadian Securities Administrators, have within the past 18 months published reports calling for reforms applicable to proxy advisory firms in their markets. The European Commission subsequently proposed a revision of its Shareholder Rights Directive that would, among other reforms, address "inadequate transparency of proxy advisors."

**Recent Trends: 2015 Policy Updates**

Setting aside the broader debate about the role and influence of proxy advisory firms, public company boards, officers and general counsel (especially in large public companies with significant institutional shareholders) generally resign themselves to reviewing ISS's and Glass Lewis' policy updates, and assessing their relevance, on an annual basis. Often, this exercise drives disclosure in the proxy statement as the company either complies with ISS's policy guidance or explains its rationale for deviating from the policy guidelines (colloquially referenced in previous ISS surveys as "comply or explain").

For the 2015 proxy season, ISS's policy updates (published in November 2014) continued an established trend in focusing on corporate governance topics relating to executive compensation, shareholder proposals, and environmental and social issues. Although it formulates and expresses policies using a different approach, Glass Lewis generally addressed similar topics in its 2015 policy updates. Focusing on ISS, notable

policy updates for 2015 were as follows:

**Equity Plan Scorecard**

To "provide for more nuanced consideration of equity plan proposals," ISS implemented an equity plan scorecard (EPSC) policy for determining whether to recommend a vote in favor of, or against, company proposals relating to equity compensation plans. (ISS' express focus on "nuance" was partially intended to address persistent criticism that its policies contemplate a "one-size-fits-all" or "cookie-cutter" approach to corporate governance.) The EPSC replaced a series of pass/ fail tests based on factors such as the reasonableness of the total cost of the company's equity plans, pay-for-performance alignment, three-year burn rate (as compared with industry peers), and problematic pay practices, with a weighted-scorecard approach considering plan cost, plan features, and actual grant practices. Absent certain overriding factors (such as repricing past awards without shareholder approval or problematic pay practices), a composite score of 53+ out of 100 on the EPSC results in a favorable recommendation with respect to the applicable equity plan proposal. ISS has also issued a set of frequently asked questions with interpretations and guidance regarding the EPSC policy.

**Independent Chair Shareholder Proposals**

Again, in an effort to create a more "holistic" framework for evaluating shareholder proposals requiring an independent board chair, ISS added new governance, board leadership, and performance factors, including the scope of the shareholder proposal (precatory vs. binding, immediate change vs. change upon next CEO transition), the presence of a lead independent director, and the company's relative performance as compared to its peers (based on total shareholder return over a five-year period). This new framework will replace ISS's old policy, which provided that ISS would generally recommend a vote for independent chair shareholder proposals unless the company satisfied all of ISS's specified countervailing governance criteria. To the extent that independent chair proposals were the most common type of shareholder proposal in 2014 (with 63 such proposals advancing to a vote), this change is noteworthy.

**Unilateral Charter/Bylaw Amendments**

ISS adopted a stand-alone policy codifying and expanding upon its historical approach to evaluating unilateral charter or bylaw amendments that materially diminish shareholders' rights or that could adversely affect shareholders. Previously, to the extent that a company's board approved such an amendment without shareholder approval or ratification, it was considered a "governance failure" that could lead to a recommendation to vote against individual directors, committee members, or in some cases the entire board. Going forward, ISS will generally recommend a "no" vote after considering various factors, including the board's rationale for approving the amendment without shareholder involvement, engagement with shareholders about the issue, the level of impairment of shareholders' rights caused by the amendment, the company's ownership structure, and the company's other existing governance provisions.

**Litigation Rights (Exclusive Venue/Fee-Shifting Bylaw Provisions)**

Finally, ISS expanded its policy to vote case-by-case on exclusive venue proposals (generally requiring shareholders to bring lawsuits against the company in its jurisdiction of incorporation), such that the policy now covers other types of bylaw provisions that limit shareholder rights to pursue litigation against the company, including fee-shifting and mandatory arbitration provisions. Beginning in 2015, ISS will determine its voting recommendation on such bylaw provisions on a case-by-case basis, taking into account factors like the company's stated rationale for the provision and the breadth of the provision (e.g., the types of lawsuits covered by it).

**Observations from 2015 Proxy Season Disclosures**

Public companies frequently review proxy statements filed by their industry peers and other companies for disclosure trends and best practices. In that regard, the following companies (some of which are known to be among the leading innovators in proxy statement disclosure practices) filed proxies in 2015 that may be instructive in various ways:

**The Coca-Cola Company**

- Coca-Cola continued its recent innovation of including a letter to shareholders signed by the full board of directors, which focused on key governance topics from the previous year, including board composition and executive compensation. The company addressed its underperformance head-on by pointing out that its executives received below-target payouts under annual incentive programs.
- The proxy statement includes a Q&A with the company's Chairman and CEO highlighting topics frequently addressed in its engagement with major shareholders.
- Includes easy-to-read tables and charts at the front of the proxy statement providing a "roadmap" of matters to be considered at the meeting, governance highlights (many of which are responsive to ISS voting policies), and key information regarding executive compensation.
- On pages 27-28, the proxy statement goes into detail in describing the board's leadership structure and the rationale for combining the chair and CEO positions, as well as the duties and responsibilities of the lead independent director.
- On pages 33-34, the proxy statement addresses several "additional governance features" of interest to ISS, including shareholder engagement, public policy matters, and sustainability.
- Coca-Cola introduced its own "equity scorecard" on pages 53-54 of the proxy statement, designed to summarize the company's performance relative to burn rate, overhang and dilution under its equity plan. The company implemented certain "equity stewardship guidelines" in late 2014 in response to shareholder criticism over its equity plan adopted earlier in 2014.

**Deere & Company**

- Includes easy-to-read tables and charts at the front of the proxy statement summarizing the matters to be considered at the meeting, board and committee composition, corporate governance highlights, and FY2014 performance and compensation highlights.
- On pages 11-12, the proxy statement goes into detail in describing the board's leadership structure and the rationale for

combining the chair and CEO positions, in part because of the significant governance role played by the independent Presiding Director.

- On page 15, the proxy statement describes Deere's policy regarding voluntary disclosure of political contribution activities (another issue addressed in ISS's 2015 policy updates).
- On page 20, Deere described a board-approved proposal to amend the company's bylaws to permit stockholders holding at least 25% of the voting power to call a special meeting.
- Beginning on page 57, the proxy statement describes Deere's proposal to amend its Omnibus Equity and Incentive Plan to, among other things, increase by 13,000,000 the number of shares authorized for making awards thereunder. This disclosure highlights key features of the plan and Deere's award practices, which overlap with ISS voting policies and the EPSC criteria described above.

**Exxon Mobil Corporation**

- Although ExxonMobil's proxy statement is more traditional in format and less "flashy" than Coca-Cola's or Deere's, it nevertheless highlights many of the same governance topics, including the role of the independent Presiding Director within a board leadership structure that combines the chair and CEO positions.
- After experiencing relatively weak approval of its executive compensation programs a few years ago (in ExxonMobil's 2011 say-on-pay vote, only 67.2% of votes cast were in favor of the programs), the company includes a special "executive compensation overview" section in pages 25-36 and promotes various strategies to engage with shareholders on those and other topics, including through conference calls with institutional shareholders and a special executive compensation-related brochure distributed to all shareholders. Notably, the company's say-on-pay voting results improved to 89.8% "for" in 2014.
- ExxonMobil is a target for shareholder proposals, with eight such proposals (ranging from an independent chairman proposal to requiring a report on lobbying activities to setting greenhouse gas emissions goals) listed in the proxy statement for 2015. The company devotes considerable space in the proxy statement to responding to these proposals.

**Looking Ahead: The Fall of Proxy Advisory Firms?**

As we emerge from the 2015 proxy season and look to the future, those responsible for facilitating annual meetings, drafting proxy statement disclosures and "rounding up the vote" ought to view SLB 20 as a step in the right direction, toward greater accountability for ISS, Glass Lewis and other proxy advisory firms. If nothing else, the SEC's guidance acknowledged two well-known, arguably pervasive problems with the existing system: 1) basing voting recommendations on inaccurate information, frequently over the objection of the subject company; and 2) conflicts of interest. Time will tell how effective SLB 20 is in terms of actually addressing those problems.

In any event, several policymakers and observers argue that SLB 20 does not go far enough. SEC Commissioner Daniel M. Gallagher is perhaps the most vocal advocate for additional reforms, having spoken and written several times on the issue. In his August 2014 article, "Outsized Power & Influence: The Role of Proxy Advisors," published in the Washington Legal Foundation's Critical Legal Issues Working Paper Series, Commissioner Gallagher invited public companies disputing the accuracy of information used by proxy advisory firms to develop their voting recommendations to engage directly with institutional investors and copy his office. He also suggested further SEC guidance to replace existing no-action relief and wrote that "the Commission should fundamentally review the role and regulation of proxy advisory firms and explore possible reforms, including, but not limited to, requiring them to follow a universal code of conduct, ensuring that their recommendations are designed to increase shareholder value, increasing the transparency of their methods, ensuring that conflicts of interest are dealt with appropriately, and increasing their overall accountability." Commissioner Gallagher stopped short of calling for comprehensive SEC regulation of proxy advisory firms, however, noting that similar attempts have been ineffective in the past.

Meanwhile, proxy advisory firms have taken incremental steps to increase transparency in their policy development processes, ostensibly to avoid more intrusive SEC regulation. ISS describes its policy formulation process as using a "bottom-up" approach, in which it conducts an annual survey of institutional investors and public companies, holds roundtables with industry groups, and invites comments on its draft policy updates before finalizing them in November each year. In early 2014, ISS also launched a "benchmark consultation period" focused on specified corporate governance topics as part of an ongoing effort to shift from a seasonal to a continual policy formulation process. The efficacy of these initiatives in helping ISS shape voting policies that are both transparent and reflective of the nuances inherent in corporate governance policies and practices is debatable. And, regardless, the initiatives do not bear on ISS's willingness to correct factual or other inaccuracies in its reports.

So, where do we go from here? While the jury is still out on SLB 20 and additional SEC reforms may be forthcoming, there is little doubt that proxy advisory firms are here to stay and will continue to be influential. As in years past, I am sure there will be developments to talk about when we convene to discuss "hot topics" in January 2016 … whether the New Year's developments will be cause for celebration — or evince more groans — remains to be seen.

Reprinted with permission from the July 2015 edition of the LAW JOURNAL NEWSLETTERS. © 2015 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 877.257.3382 or reprints@alm.com. #081-07-15-02

Snell & Wilmer
LAW OFFICES