Synthesis

Who Truly Improves Corporate Governance: Boards or Proxy Advisors?

Why and how Boards can drive leading practices and create value

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Proxy advisory firms first came on the scene as a resource to help large investors handle the large volume of proxy votes they must submit annually on significant governance issues, including executive pay and board composition. However, the role and influence of proxy advisory firms have grown exponentially, leading many corporate directors to characterize them as "quasi-regulators," as the firms have turned their attention to environmental, social and governance issues. While proxy advisors and boards share the same goal of improving corporate governance in U.S. companies, there has been an ongoing debate in the business community as to whether proxy advisors have overstepped their bounds in the boardroom. The debate centers on one big question: Has the scale of proxy firms' influence and practices eroded or improved good governance?

The Evolution of Proxy Advisors

It depends who you ask. Investors certainly find proxy advisors to be helpful. Institutional investors have the increasingly difficult task of finding value and minimizing risk in a complex financial environment that continues to become more complicated as new markets and new technologies emerge. There is more data available than ever before on more issues than ever before, including sustainability and diversity. It's simply impossible for investors to review and analyze all of the available data to make informed voting decisions without assistance, which is where proxy advisors come in. They comb the data and make voting recommendations.

The two major firms most investors engage are Institutional Shareholder Services (ISS) and Glass Lewis & Co. Together, they represent more than 90 percent of proxy advisory services market—about 3.8 trillion shares, giving them a sizable influence.

In theory, proxy advisors can help to drive good governance by synthesizing information, which helps investors manage the significant time and expense of proxy voting. While large firms can dedicate numerous resources to voting, many small and mid-size firms lack these resources and rely on proxy advisors to lower their research costs. Proxy advisors also help to demystify some of the criteria that goes into the voting process, which was in direct response to regulation put into place by the Securities and Exchange Commission in the early 2000s to ensure institutional investors were acting without conflicts of interest.

While there is inherent good in the transparency that proxy advisors provide, there are also some concerns with how their recommendations are used by investors, as their recommendations have a significant impact on voting. In 2017, 713 institutional investors voted in accordance with proxy advisor recommendations, according to the Harvard Law School blog. HLS also noted that 95 percent of institutional investors vote in favor of company's say on pay when ISS recommends favorable vote compared to 68 percent who vote in favor when ISS is opposed.

Raising the Bar and Raising Eyebrows

One of the biggest concerns about the proxy advisors' recommendations is that many investors take these voting recommendations at face value without examining other research or doing deeper analysis. This "robo-voting" without review raises the question of whether investors are really fulfilling their fiduciary duties. An even bigger concern is if a proxy advisor makes an error in a recommendation, which can lead to damaging consequences for companies.

A study by the American Council for Capital Formation (ACCF) and Frank Placenti of Squire Patton Boggs, reviewed supplemental proxy filings from 2016, 2017 and part of 2018 (through Sept. 30) and found that there were 107 filings from 94 different companies that cited 139 significant problems in the proxy recommendations, including 90 factual or analytical errors. One particularly concerning example was when ISS issued a report that was critical of Willis Towers Watson's executive compensation plan—an area the firm specializes in. According to the ACCF, ISS's report was filled with errors and bad recommendations, but Willis Towers Watson had to correct those errors in a supplementary proxy filing, costing the time and money.

Another concern of companies is that proxy advisors have been baking social and political issues into their recommendations more frequently. Board composition, environmental and sustainability issues and human rights have all found their way into reports by the proxy advisors. While doing social good and promoting good governance is admirable, some in the business community have questioned the impact of these expanded categories under review. Has it actually led to companies making changes that improve our world, or have companies simply presented information in new ways to appease the proxy advisors without actually changing anything?

Additionally, there is growing evidence that some of these expanded policies have had a negative correlation with shareholder value. In a speech to the Council of Institutional Investors earlier this year, SEC Commissioner Hester Peirce said that ISS and Glass Lewis have paved the way for shareholders to "put forward proposals that incur considerable costs borne by all shareholders. Shareholders are able to submit losing proposals over and over again. In recent years, many of these proposals are not even related to core corporate governance issues, but instead promote a tiny group of shareholders' personal political and social preferences."

How Boards Can Continually Improve Governance

Given the increased influence of proxy advisors, many corporate directors have shifted from having a love/hate relationship with proxy advisors to a general distrust. They see the good the proxy firms provide, but they also have concerns about some of the firms' practices. There are several actions board members can take to help ensure that good governance is upheld and that their company's reputation does not hinge on a proxy advisor recommendation:

- **Demand transparency from proxy advisors.** Proxy advisors are not held to fiduciary responsibility with their recommendations the way directors are. Their recommendations do not fully take into account the best interests of shareholders or the corporation. There are also potential conflicts of interest. Proxy advisors often receive consulting fees from the same companies whose governance practices they evaluate. Companies can pay money for access to information about models that underlie the firms' recommendations so they can ensure their companies fall into the appropriate parameters. While the proxy advisors contend that these are separate areas of the firm and that they do not overlap with personnel, it is important that directors understand the proxy advisor business model and ask questions and for more information as appropriate.

- **Use proxy advisor recommendations as another tool, not the only tool.** The evidence is mixed as to whether the proxy advisors truly enhance company value. It's best to use them as another tool to assess company value, combined with other analysis and details. Evidence suggests that proxy advisor recommendations regarding corporate governance increased shareholder value early on. But as the proxy advisors have moved away from specific corporate considerations and real long-term value creation to broader environmental and social issues, the correlation to value creation has decreased.

- **Keep the focus on value creation.** The more companies maintain a core focus of creating and maintaining long-term value, the more flexibility and freedom they will have in making critical business decisions. As you create value, this often opens the door to more innovative ways of thinking and doing business and can lead to new-found operational efficiencies. For example, your company may want to expand into a new market, and perhaps that requires new talent who have an expertise in doing business in that region. You then may find yourself with a more diverse board and workforce stemming from the initial plan to create more value.

- **Assess the strength of your board, and be prepared to make changes.** Evaluating your board—and individual directors—on an ongoing basis is key to ensure you have the right people at the table at the right time to make the right decisions. Be certain you have a board that also serves where your company is going in the future and that the decision-making dynamics offer everyone a voice.

- **Be proactive about shareholder engagement.** While you cannot (and should not) meet with every investor, you want your shareholders to know more about your board and the decision-making processes it has than simply what the proxy firms have shared. That is only a piece of the full picture. You can also share additional information in your proxy statement—this is an opportunity to tell the story of your boardroom and why you have the talent on board that you do.

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