

The Role of the Proxy Advisory Firm

What Directors Need to Know

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Institutional investors hold the vast majority of the shares of most public companies. They are knowledgeable shareholders and are well aware of the power of their votes. They have clear views about executive compensation and a wide range of other corporate governance and strategic issues and will spend the time necessary to engage actively with boards and management when they believe changes are necessary. They are also prepared to hold directors directly accountable for the decisions in which they have participated and are demanding the tools to do so. This has led to a steady trend towards majority voting and say-on-pay resolutions.

Public companies are conscious of the need to communicate with and listen to their institutional shareholders. However, unless they also have the proxy advisory firms on their radar screens, they may be focusing their communication efforts on the wrong people in connection with at least some of the institutional vote. Proxy advisory firms influence the way in which institutional shareholders vote through the research they conduct, the recommendations they make and the voting platforms and other services they provide to their institutional investors clients. Directors need to understand the impact that these organizations can have on the outcome of their shareholder votes.

This paper describes the role of the proxy advisory firm in the North American capital markets and the impact of the voting recommendations made by those firms. The paper refers largely to the services offered and the approach used by the two most commonly used proxy advisory firms in North America: Institutional Shareholder Services ("ISS")¹ and Glass Lewis & Co. LLC ("Glass Lewis").²

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¹ ISS is a business unit of U.S.-based MSCI Inc.

² Glass Lewis is a wholly owned subsidiary of Ontario Teachers' Pension Plan.

1 Why Are Institutional Investors Concerned with Their Voting Rights?

The organizations broadly referred to as "institutional investors" include pension funds, mutual funds, money managers and similar organizations that invest money which they hold on behalf of others. The fiduciary nature of the relationship between the institution and the beneficiaries on whose behalf they invest means that the institution must use appropriate care in dealing with the assets in which they have invested. This has generally been seen to include an obligation to exercise the voting rights associated with those investments. In the United States, fund managers are required to vote proxies with the same diligence as making other fund decisions. Institutional investors in Canada take the same approach, even in the absence of a legislative requirement.

Of course, institutional investors exercise their voting rights not simply to satisfy their legal obligations, but also to influence corporate conduct. Few institutions have an interest in governance issues just for the sake of governance – they are generally concerned with matters that come before the shareholders because of the impact they believe those matters can have on the value of the investment they have made in the issuer.

2 Why Do Institutional Investors Engage Proxy Advisory Firms?

Why do institutional investors use proxy advisory firms to assist them in exercising their voting rights?

An institutional investor typically holds positions in a range of issuers through a number of different accounts with a variety of intermediaries. Tracking record dates and proxy cut-off times, analyzing proxy materials and then casting the votes associated with the positions they hold can require significant resources. It is often more cost-effective for institutional investors to outsource to proxy advisors some or all of the functions involved in managing their voting rights. The proxy advisor will have the expertise and technology necessary to consolidate and manage all of the proxy materials to which its institutional investor clients are entitled, making sure that they receive the materials necessary to allow them to cast the votes to which they are entitled.

Some institutional investors vote manually through their own platforms or through the basic ProxyEdge® voting service offered by Broadridge (neither of which feature integrated recommendations from third-party providers). However, many institutional investors use voting platforms offered by proxy advisors to facilitate the voting, recordkeeping, reporting and disclosure requirements of their clients. They typically elect to have a set of recommendations integrated at the proposal level on each ballot as a default instruction (either the advisor's standard recommendations or custom recommendations developed by an advisory firm based on the client's policy). They will also instruct the proxy advisor as to how and when they want to exercise their right to review and approve instructions prior to voting. The proxy advisor takes the instructions provided by their institutional investor clients and delivers those instructions in accordance with the regulatory requirements governing the proxy voting system.

But how do institutional investors make their decisions about how to cast their votes? Most of the proxy season is concentrated in the first several months of the calendar year and more extensive disclosure requirements have multiplied the volume of reading and analysis necessary in order to absorb disclosures and make voting decisions. Rather than incurring the overhead

involved in maintaining research teams in place to keep abreast of market developments and to read and evaluate each proxy circular, many institutional investors use the research and analysis offered by the proxy advisory firms. Even institutions with sophisticated in-house teams that focus on governance and voting issues subscribe to the research reports of one or more of the proxy advisory firms to further inform their own views.

Support with the voting mechanics and research are important aspects of the services provided by the proxy advisory firms, but the influence of the proxy advisor is really felt through the voting recommendations it issues with respect to matters that come before the shareholders. Those recommendations are grounded in the advisor's proxy voting guidelines (discussed in greater detail below) relating to matters that routinely come before a shareholder meeting or which might affect the view that an investor has of management. Some institutional investors may accept the voting policies of the proxy advisory firm as their own and where this is the case, the recommendation of the proxy advisory firm will automatically result in the votes of those clients being cast in accordance with its recommendation. Other clients have their own policies; if they use the voting platform of the proxy advisor, they will instruct the proxy advisor to vote in accordance with those policies. As noted above, the client may, of course, change the standing instruction with respect to any particular vote.

In addition to creating their own analysis and recommendations, proxy advisory firms increasingly provide investors with custom analysis and recommendations based on an investor's policy. In some cases, the policy and recommendations may be in line with that of the advisory firm. In other cases, it will differ.

In summary, proxy advisory firms such as ISS and Glass Lewis offer two types of services to their institutional investor clients. First, they assist their clients with the complex mechanics of managing their voting rights. Second, they provide research and analysis relevant to the issues on which their clients are entitled to vote and make recommendations about how those votes should be cast. Although these two types of services are separate (and some institutions use one service, but not the other) they are highly synergistic. Many institutional investors see economies in outsourcing all of the functions associated with exercising their voting rights to one proxy advisory firm.

3 Proxy Voting Policies and Recommendations

As noted above, proxy advisory firms develop governance guidelines, which they make publicly available. Issuers, and the capital markets community more broadly, are therefore aware of the general advice which the proxy advisors are providing to their institutional clients.

ISS and Glass Lewis have different approaches to the development of their policies, including the selection of the factors that they consider and the weight they give to each of those factors. ISS seeks to reflect back to the issuer community the views of its institutional clients. It consults with its client institutions and provides them an opportunity to comment before its policies are finalized. It also communicates regularly with organizations representing institutional investors, including the Council for Institutional Investors (United States) and the Canadian Coalition for Good Governance (Canada). Glass Lewis, on the other hand, places greater reliance on its own

expertise and research, offering an independent perspective on the issues of concern to their clients.

Before an institutional investor adopts the guidelines of a proxy advisor as its own, it will consider whether those guidelines and the proxy advisor's approach to conducting its analysis are in line with their own philosophy and can enable them to exercise their fiduciary responsibilities with respect to voting proxies. An institutional investor may delegate the evaluation and approval of a proxy advisor's policy to a proxy committee, fund board, compliance officer, chief operating officer or its portfolio managers (or may require review and approval at more than one level). If an investor chooses to vote in accordance with the proxy advisor's policy and recommendations, the investor always has the ability to review and override the advisor's recommendations prior to votes being cast or to re-vote up until the vote cut-off time. This will be particularly important, for example, in connection with high-profile meetings, meetings at companies where they have significant holdings or meetings with key issues on the agenda, such as a merger, contested director election or compensation issues. Of course, before a decision is made by an institution to deviate from the recommendations of the proxy advisory firm, some type of internal approval is usually also required. Understandably, the person responsible for making the voting decisions may only be inclined to seek such approval in the most compelling circumstances.

4 Issuer Concerns with Proxy Advisory Firms

Increasingly, issuers are expressing concerns with the nature and extent of the influence of the proxy advisory firms. Several of the issues most frequently raised are canvassed below.

(a) Degree of Influence

The overarching concern that issuers have about proxy advisory firms is the degree of influence that they have on the way in which institutional investors vote. We are not aware of any statistics with respect to the number of institutional investors who adopt the voting policies of the proxy advisors as their own or the percentage of the shares voted in accordance with those policies. However, many issuers are convinced that the number of institutions that routinely follow the recommendations of the proxy advisors is significant. In a recent submission to the SEC on issues relating to the proxy voting system, U.S. pharmaceutical giant Pfizer noted that while large institutional investors may evaluate issuer disclosure themselves and make their own voting decisions, many smaller institutional investors lack the staff and other resources needed to carefully evaluate matters being voted on, and such investors base their votes largely or entirely on proxy firms' recommendations.³

In its SEC submission, IBM noted the coincidence of ISS releasing its recommendations and a significant number of institutional investors casting their votes in accordance with ISS's recommendations. It cited voting patterns for a number of issuers as well as the voting patterns for its own meetings in 2009 and 2010. In those years, within a day of the release of the ISS recommendation, an estimated 13.5 percent and 11.9 percent of the total votes cast in each year

³ Comment letter from Pfizer Inc. to SEC, "Comments on Release No 34-62495; IA-3052; IC-29340; File No. S7-14-10" (23 November 2010).

were cast "lock-step" with ISS's recommendations. The submission noted further that "[T]o put that into proper perspective, the IBM voting block essentially controlled by ISS has more influence on the voting results than IBM's largest shareholder."⁴

Organizations such as the Council for Institutional Investors that represent the interests of institutional shareholders dispute the assertion that proxy advisors control the institutional vote. "The notion that proxy advisory firms 'control the institutional vote' wrongly assumes that institutions are a unified bloc of voters. In fact, many institutional investors are passive voters that defer routinely to the recommendations of management. We note that state and local pension funds, whose ranks include many of the most activist investors, hold just 6 percent of total outstanding equity."

Others argue that while the voting patterns of institutional investors may reflect the fact that some institutions are quite passive in their approach to voting, their default position is in fact in favour of management, as opposed to being aligned with the recommendations of third-party advisors. This would reflect a sentiment on the part of the investor that so long as they are prepared to hold the stock, that can be read as support for management and their votes will typically be cast accordingly.

(b) Proxy Advisory Firms as Standard Setters

Recognizing that the proxy advisory firms will have significant influence on the way in which votes are cast, issuers pay close attention to the proxy voting guidelines issued by these firms. Where possible, many issuers will align their approaches to governance, compensation and other matters to conform with the views of the proxy advisors. For this reason, many people regard the proxy advisors as being the true standard setters of governance and compensation practices and question whether the capital markets should accept the fact that this role is being played by private companies with no public policy mandate or oversight. The proxy advisors respond to this concern by noting that their views are either formed or accepted by the institutional investors who adopted their analysis and that it is entirely appropriate for institutional investors to have a significant degree of influence over these issues.

A related concern is whether the proxy advisors have the flexibility to adapt their standard recommendations in situations where their guidelines are not appropriate for a particular issuer. Issuers are concerned that proxy advisors adopt a one-size-fits-all model to corporate governance and are reluctant to accept considerations such as financial stability, size and sector that might argue in favour of a more nuanced approach to governance for a particular issuer.

ISS and Glass Lewis both believe that their analysis and recommendations are much more calibrated than this criticism suggests. ISS advises that it has country- and market-specific voting policies that reflect best practices in each market. In Canada, for example, it has two distinct proxy voting policies tailored for the different market components – TSX and TSX Venture. Within the TSX policy, ISS has a policy section that applies solely to the largest and most widely held companies in the S&P/TSX Composite Index. Beyond these differences, the Canadian

⁴ Comment letter from IBM to SEC, "Comments on Release No 34-62495; IA-3052; IC-29340; File No. S7-14-10" (15 October 2010).

policy is purposely drafted to provide flexibility where needed in order to be relevant for the Canadian "comply-or-explain" governance regime. ISS's Canadian analysts have some flexibility in applying policy taking into consideration the particular unique circumstances of a reporting issuer if warranted. In making voting recommendations, Glass Lewis advises that its analysts conduct a detailed analysis of each issue at each company. The Glass Lewis analysts have discretion to make case-by-case decisions for issues at all companies regardless of size, maturity, country or specific exchange listing.

(c) Opportunities for Issuer Input

Many issuers are critical of the quality of the analysis – and therefore of the credibility of the recommendations made on the basis of this analysis. There is particular concern with the ability of the proxy advisors to analyze M&A transactions, including that they may lack the specialized expertise in specific sectors. Canadian issuer Kinross Gold Corporation notes that ISS's recommendation against its friendly combination transaction with Red Back Mining Inc. in September 2010 was not supported by geological or mining expertise.⁵

For routine matters as well as special matters, such as the approval of a transaction, issuers complain that there is not sufficient, if any, opportunity to comment on the analysis and recommendations of the proxy advisory firms in order to correct misinformation and faulty analysis or to engage in an open discussion about the views held by the proxy advisor.

ISS and Glass Lewis take different perspectives on engaging with issuers before they issue their recommendations. For the most widely held companies in the relevant index, ISS circulates its report and recommendations to the issuer in advance of releasing it and gives the issuer an opportunity to vet the report for factual content only. Glass Lewis does not meet with issuers once the proxy materials have been sent out because they believe it is more appropriate to restrict their analysis and recommendations to the issuer's public disclosure. In special circumstances (for example, contested meetings and certain major), Glass Lewis will meet with the issuer and dissidents on a call with some of its clients. It does not, however, provide issuers with an opportunity to comment on its report and recommendations before it is released.

Even when an issuer has the opportunity to comment, issuers such as Dupont note that they may only be given a day or two to do so. Moreover, Dupont notes, "...[i]t has been our experience that substantive disagreements over content, such as peer group analyses, are rarely resolved in favor of the issuer."⁶ It argues that issuers should be given a sufficient amount of time to review and comment on a proxy advisor's report and that, to the extent there is a disagreement that cannot be resolved through a formal appeals process, the proxy advisor's report should disclose that disagreement.

⁵ Comment letter from Kinross Gold Corporation to SEC, "Comments on Release No 34-62495; IA-3052; IC-29340; File No. S7-14-10" (20 October 2010).

⁶ Comment letter from Dupont to SEC, "Comments on Release No 34-62495; IA-3052; IC-29340; File No. S7-14-10" (20 October 2010).

(d) Conflicts of Interest

Concern is often also expressed about conflicts of interest that may influence (or be seen to influence) the recommendations made by the proxy advisory firms. Conflicts may exist, for example, where the proxy advisory firm (or its shareholders or senior executives) have business relationships with issuers and investors.

The potential conflict that attracts the most attention, however, arises when the proxy advisory firm offers advice to directors and managers of companies on how to improve the ratings that they assign. For example, this service is offered by ISS (but not by Glass Lewis).

ISS has advised us that it mitigates conflicts of interest between these divisions in several ways. They are run from different locations and are led by and staffed by different employees. Their internal databases are not accessible outside of that division and are secured and password protected. It also makes available to its institutional clients the results of an independent third-party SAS 70 audit of its processes and internal controls for mitigating potential conflict.

Still, many issuers believe that it is advisable for them to retain ISS to review their proxy circular in order to be sure that they will receive a favourable recommendation from the other side of the ISS house. Some believe that it is inappropriate for ISS to earn additional fees from issuers in connection with matters for which they earn fees from the institutional shareholders – regardless of whether or not the services provided to issuers increase the likelihood of a favourable recommendation.

5 Regulatory Issues

The role played by proxy advisory firms in the shareholder voting process is under review in a number of jurisdictions around the world.

In July 2010, the SEC released a concept paper, soliciting comment on various aspects of the U.S. proxy system. It outlined some of the concerns that have been raised regarding the reliability, transparency, accountability, and integrity of the proxy system. This included issues relating to proxy advisory firm as well as some possible regulatory responses.. The SEC Concept Release states in part as follows: "...we are considering the extent to which the voting recommendations of proxy advisory firms serve the interests of investors in informed proxy voting and whether, and if so how, we should take steps to improve the utility of such recommendations to investors." The SEC received a large number of responses, including many commenting on various issues relating to proxy advisory firms. It is not yet clear what steps the SEC is proposing to take with respect to the matters raised in its concept paper or the comments it received in response.

In the United Kingdom, the Financial Reporting Council released its U.K. Stewardship Code, in July 2010 as well, recommending a disclosure regime under which institutional investors disclose how they use proxy advisory firms.

In January 2011, the Ontario Securities Commission (the securities regulatory in Canada's largest capital market) released a staff notice on shareholder democracy issues, asking the Canadian capital markets community whether the effectiveness of the proxy voting system (among other

things) requires additional review (and possibly regulation) at this time. The responses from the Canadian community will undoubtedly include issues relating to proxy advisory firms.

6 What's the Bottom Line?

From the perspective of the issuer community, the concern with proxy advisory firms is that they can influence the outcome of a shareholder vote without appropriate accountability. While they are contractually accountable to their clients, there is no penalty for analysis that is, in the view of the issuers, flawed to the detriment of the issuers and their shareholders.

From a director's perspective, it is important to be informed about the views of the proxy advisory firms regarding the organizations on whose boards they serve, as well as about the recommendations issued with respect to the matters put before their shareholders. This is also the time for issuers and their boards to make their views about proxy advisory firms and their processes known to securities regulators as well as to the institutional investor community that relies on those organizations.