

# Lead Director Network ViewPoints

August 19, 2014



## Proxy trends and advisory firm policy

### Introduction and executive summary

Lead Director Network (LDN)<sup>1</sup> and Compensation Committee Leadership Network (CCLN) members met jointly on July 17, 2014 to discuss proxy advisory firm policy and trends from the 2014 proxy season. They were joined for part of the meeting by Martha Carter, global head of research, Institutional Shareholder Services (ISS), and Robert McCormick, chief policy officer, Glass Lewis & Co.<sup>2</sup> For further information about the LDN, see “About this document,” on page 7. For a list of participants, see the appendix on page 8.

This *ViewPoints* summarizes members’ conversations about proxy trends and policy.<sup>3</sup>

- In a members-only session, members shared their observations on board discretion in executive compensation plans and proxy adviser influence. (*page 1*)
- In the session with Ms. Carter and Mr. McCormick, members discussed how ISS and Glass Lewis establish, amend, and apply their policies. The group also discussed members’ concerns about the proxy advisory firms, including policies related to when and how advisers engage with companies. (*page 3*)

### Trends from the 2014 proxy season

The members-only discussion focused on what Meridian Compensation Partners’ Annette Leckie described as “*the tension directors face between what are viewed as best practices and what they believe is right for the company.*” Members agreed that investors, analysts, and the media tend to give boards more leeway when relative stock performance improves.

### Proxy adviser influence

Some members said that proxy adviser influence is meaningful but declining, especially now that board directors, particularly compensation chairs, are increasingly meeting directly with investor groups. One member was concerned that “*ISS and Glass Lewis’s policies get labeled as best practices, whether or not they actually are.*” Another member explained that as boards make better decisions, proxy advisers become less relevant. According to that member, “*In the first couple of years of say on pay there was low-hanging fruit. Companies took legitimate action as issues came up in the advisers’ reports. Now things are cleaned up and the recommendations are either ‘do what everyone else does’ or so minor that they are not worth discussing.*”

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<sup>1</sup> Lead Director Network documents use the term “lead director” to refer interchangeably to the titles lead director, presiding director, and non-executive chair unless otherwise stated.

<sup>2</sup> In another session of the joint meeting, held on July 17, 2014, members met with Keith Higgins, director of the SEC’s Division of Corporation Finance. See Lead Director Network, “*A dialogue with Keith Higgins, Director of the SEC’s Division of Corporation Finance.*” *ViewPoints*, August 19, 2014.

<sup>3</sup> *ViewPoints* reflects the network’s use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

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However, before the meeting, executives from several large asset managers told Tapestry Networks that input from ISS and Glass Lewis is still important to proxy voting decisions. In particular, they review the advisers' annual policy changes and assess whether to change their own policies. One leading investor said, "We like to hear from them when they make changes, because the changes are reflective of their customer base. They reflect where people see governance going." Another said, "If ISS or Glass Lewis change a position, that's often a trigger for us to review our own policy in that area."<sup>4</sup>

### **Board discretion in executive compensation plans**

Members discussed the challenge of creating performance-linked pay packages that both motivate executives and satisfy investors and other outside constituents. One member said, "*The answer to all problems is to be successful.*" Consistent with that theory, Ms. Leckie provided examples of two "*phenomenal performers*" that, despite their idiosyncratic compensation plans, obtained support from both shareholders and proxy advisers.

Members also discussed ways to obtain shareholder support for compensation plans where the alignment between pay and performance is less clear. The most important change in practice they identified was increasing their engagement with institutional investors. One member said, "*At one company, we hired a CEO from the outside and had to pay a higher salary. We needed to explain to our shareholders what it took to hire this person and how the team is doing an extraordinary job digging their way out [of a bad situation].*" Meridian's Jim Wolf explained that outreach to investors presents the board with an additional set of challenges: "*Compensation committees have gone from asking 'what will the proxy advisers think' to 'what will our largest shareholders think.' The problem is that a lot of the investors are not equipped for this engagement. In addition, it is hard enough to keep up with ISS and Glass Lewis. It is more difficult when your 10 largest shareholders have different perspectives.*"

Outside of direct engagement, directors rely on the Compensation Discussion and Analysis (CD&A) to explain their decisions. One member expressed concern about having "*the lawyers and consultants look at the document before the compensation committee.*" Another said, "*I need to put my arms around the summary narrative and not let anyone get to it before me. I try to sit down with the drafters and outline it so there is less editing afterwards.*" Mr. Wolf said that companies that have the courage to clean up their CD&A and consider it an advocacy piece have reaped rewards. He described a case where "*two companies with virtually identical compensation plans and performance,*" received different say-on-pay recommendations from a proxy adviser because of the quality of the communication in the CD&A.

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<sup>4</sup> Robyn Bew and Richard Fields, "[Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers.](#)" (Waltham MA: Tapestry Networks and IRRC Institute, 2012), 17-18.

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### A new era of activist investing continues

The LDN and the CCLN each discussed activist investors in separate meetings earlier this year. At those meetings, members noted recent trends that have made companies pay far more attention to activist hedge funds than they had in the past.<sup>5</sup> King & Spalding's Bill Baxley provided members with an update on this topic. He noted that more than halfway through 2014, activist activity *"continues to increase. Activist funds have raised over \$100 billion in capital."* He said the primary lesson companies are learning in the current wave of activist activity is the benefit of building close relationships with institutional investors. *"These relationships can be incredibly helpful. Activists build these relationships, and a company that does not know its long-term investors will start at a disadvantage when an activist approaches."* Members noted that the management teams and boards at their companies continue to assess whether their decisions, particularly with respect to cash on the balance sheet and the level of debt, make them vulnerable to an activist approach.

### Proxy adviser policy

Glass Lewis and ISS provide proxy-voting research and related services to investors that collectively manage tens of trillions of dollars in assets around the world.<sup>6</sup> Both produce company-specific reports for investors before a company's annual general meeting. These reports include information about the proxy ballot questions and recommendations on how to vote, and are based on governance policies that each firm amends annually. While adviser policies shape the firms' recommendations, both guests emphasized that their firms view each proxy proposal on a case-by-case basis and do more than just apply their policies universally. ISS recently invited market participants, including corporate directors, to take its [2015 proxy survey](#).

### The proxy adviser policymaking process

Ms. Carter and Mr. McCormick explained the policy development process that they oversee at their respective firms. Both emphasized that their policies are global in nature and reflect the fact that each firm analyzes proxies in over 100 countries. Final policies are not, and are not meant to be, a recitation of what the majority of the firms' clients think. Mr. McCormick said, *"Our clients have different perspectives on a lot of these issues, particularly controversial ones like disclosure of political contributions."* As a result, the firms balance the views of different constituencies and draft policies that they believe reflect the best ways for companies to achieve long-term success. The guests acknowledged that as a result, some of their policy recommendations are more popular with shareholders than others. Mr. McCormick said, *"Based on voting results, sometimes it may appear that we are tilting at windmills, sure. If it is not an issue for shareholders, it can cause us to reevaluate our approach."*

<sup>5</sup> See Lead Director Network, *Dealing with Shareholder Activism*, ViewPoints (Waltham, MA: Tapestry Networks, 2014) and Compensation Committee Leadership Network, *Shareholder Relations and the Confident Compensation Committee*, ViewPoints (Waltham, MA: Tapestry Networks, 2014).

<sup>6</sup> Joann S. Lublin and Kirsten Grind, "For Proxy Advisers, Influence Wanes," *Wall Street Journal*, May 22, 2013.

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Mr. McCormick explained that his team at Glass Lewis works with their independent research advisory council to develop policies that take a broad range of perspectives into account. The council considers input not just from Glass Lewis' investor clients but also from other market participants, including corporations, directors, and academics. The result of the policy-setting process is the publication of the *Proxy Paper Guidelines* that Glass Lewis publishes each year.<sup>7</sup> These guidelines explain how Glass Lewis is likely to recommend that its clients vote on issues such as the election of directors, say on pay, anti-takeover measures, and environmental, social, and governance proposals in specific countries. In the past, Glass Lewis did not publish these guidelines, but Mr. McCormick explained, *"It may have seemed ironic that we were pushing for transparency and disclosure without publishing our own guidelines. We think it is helpful and constructive to make them public."*

ISS begins its annual process by sending a survey to its clients and to public companies. Ms. Carter explained that the survey seeks *"broad inputs on major issues and regulatory changes."* Recent policy issues that ISS included in its survey include: selecting peer groups, assessing pay for performance, and splitting the role of the chair/CEO. After assessing the annual survey results, ISS' internal team sets its priorities and hosts *"cross-constituency roundtables on specific issues."* Based on that feedback, they draft policy amendments that they make available to the public for comment before finalizing them.

While both Glass Lewis and ISS spend considerable time developing their firmwide policies, the guests conceded that most investors do not follow them wholesale. Glass Lewis notes that *"more than 80 percent of [its] more than 900 clients ... vote according to a custom policy or via a custom process for reaching vote decisions, such as reviewing multiple research providers prior to approving votes."*<sup>8</sup> Both ISS and Glass Lewis work with investment managers to develop customized policies. The advisers then apply those policies to proxy ballots using their own voting platforms. This process is helpful to investors because it eases both the logistical and the records management challenges of voting on large quantities of proxy ballots in a short period of time.<sup>9</sup> Ms. Carter said, *"Our house views are a benchmark, but most of the ballots [cast on the ISS voting platform] are either client-directed or based on a customized policy. Custom policies are a tremendous growth area for ISS."*

### **Proxy adviser decision making**

Once ISS and Glass Lewis complete their annual processes for amending their policies, they use those policies as a guide for making their ultimate recommendations on proxy proposals. The guests explained that this process entails far more than applying their stated policies to particular issues on proxy ballots. Even if a proposal is in an area where the firm has a clearly stated policy, they each consider the dynamics at the particular company before making a recommendation. Nonetheless, members said that they felt the

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<sup>7</sup> Glass Lewis & Co., "Proxy Paper Guidelines: 2014 Proxy Season," accessed June 13, 2014.

<sup>8</sup> Katherine H. Rabin and Robert McCormick, letter to European Securities and Markets Authority, [Discussion Paper – An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options.](#), June 25, 2012.

<sup>9</sup> Bew and Fields, ["Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers,"](#) 15-16.

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proxy advisers' objective is to get companies to comply with their policy preferences, whether or not there is evidence that the preferences improve company performance.

### Proxy advisers consider company information

Both proxy advisory firms use information provided by the companies to inform their recommendations on proxy proposals. The guests asked members to encourage their companies to see the proxy statement as an opportunity to tell their story, because company disclosures are the advisers' most critical sources of information. In addition, both firms obtain information from companies by communicating with them directly.

- **Glass Lewis engages with companies, but only outside of proxy season.** Mr. McCormick provided two reasons for this policy: *“One, we don’t want to learn material, non-public information. Two, we don’t want to lobby for policy changes. It is the shareholders who are empowered to do that.”* Glass Lewis does, however, allow companies to submit an inquiry on a potential factual error, and Mr. McCormick noted that Glass Lewis republishes reports to correct those errors. He also noted that there’s an exception to this general policy for “Proxy Talk” conference calls that Glass Lewis hosts to discuss specific proxy proposals. *“These are an effective way for us to hear from directors and management and let our clients hear the same thing.”*
- **ISS frequently engages with companies on proxy-specific issues.** Ms. Carter said, *“We have a strong engagement model, and it takes a lot of resources. We believe our engagement policy enhances the work we provide to our clients.”* She noted that, more and more, directors are involved in these conversations, especially those about compensation: *“It is awkward for CEOs to talk about their pay.”* Members generally favor the ISS approach on engagement, whether it includes directors or just management. One member recounted a situation where the member (as lead director) and the company’s chair/CEO met together with ISS to explain why the company did not need an independent chair: *“They saw the interpersonal dynamics and it alleviated their concern.”*

Members remain concerned that despite their information-gathering efforts, the advisers’ reports often include errors of fact. One member asked, *“We have standards we have to live up to, especially when we communicate with shareholders. What standards are you held to?”* Mr. McCormick noted that the market holds the firms accountable: *“We hold annual due diligence visits with our clients where we provide audits of their voting and that helps make sure our reports are correct. If we are inaccurate, our clients won’t keep hiring us.”* Ms. Carter noted that as a registered investment adviser, ISS has a fiduciary obligation to its clients to be accurate. She also said, *“When we hear ‘you made errors,’ a lot of times they are really interpretative differences of opinion.”*

### Recommendations on specific proxy issues

The group also discussed how, after reviewing their policies and information about a company, the proxy advisers reach their ultimate decisions on proxy proposals on particular issues.

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- **Board tenure and refreshment.** Members noted that long-serving directors provide important perspectives, but they also acknowledged the value of new perspectives on the board. Neither proxy adviser recommends hard limits for directors based on age or tenure, or quotas based on gender or other diversity-based criteria. One member said, *“We need to see what is broken that needs to be fixed, rather than just making changes.”* Mr. McCormick said, *“We look for evidence of concern related to lack of board refreshment or diversity. Our clients look for more information on this [than just statistics].”* Ms. Carter noted a lack of investor interest in limits or quotas. She said that investors prefer to scrutinize new nominees on a case-by-case basis, e.g., asking why a board with no women just nominated another man. Members supported the proxy advisers’ positions on these issues and pointed to the topic of tenure as an example of the broader problem with one-size-fits-all policies.
- **Recommendations against specific directors.** Members were concerned that Glass Lewis targets directors with “vote no” campaigns because those directors served on certain boards years ago. In particular, members felt that Glass Lewis disregards subsequent successful board service when making those recommendations. One asked, *“How long, regardless of performance, do you stay on the withhold list?”* Mr. McCormick said, *“We discuss this every year and don’t make that call lightly.”* But he noted that Glass Lewis opposes directors who played a significant role at a company where there was *“significant destruction of shareholder value.”*

Members were also critical of the proxy advisory firms’ policies for recommending votes against directors based on committee membership. For example, both firms frequently recommend voting against governance committee members at companies that do not follow certain governance practices. One member challenged this approach by observing, *“There is a lack of recognition that corporations are dynamic enterprises that don’t always follow a fixed pattern.”* Some members encouraged proxy advisers not to recommend a vote against an individual director without specific knowledge that the person was actually involved in what subsequently proved to be an unwise decision. Another noted that the proxy advisers do not recognize when a decision was made by the whole board rather than by a specific committee. Mr. McCormick noted that in such a case, the alternative is for the adviser to recommend that investors vote against the whole board. Not surprisingly, members did not favor that solution. Ms. Carter added, *“We rely solely on public information; if you want us to understand what you did: disclose, disclose, disclose.”*

- **Executive compensation issues.** Glass Lewis and ISS both make say-on-pay recommendations based on the correlation between pay and performance, but they use different methods to judge that relationship. The group discussed ISS’ model of assessing pay plans based on the date compensation is granted rather than looking at realized or realizable pay. Ms. Carter said that *“grant-date pay allows us to assess the efficacy of the compensation committee’s decision,”* and noted that other methods lack consistent definitions. Mr. McCormick said that Glass Lewis does consider realizable pay as part of its assessment but agreed with Ms. Carter that it is challenging to find a method that is both consistent and accurate: *“We understand Black-Scholes was not designed for 10-year compensation plans.”* Both guests noted that as compensation plans become more complex, it is incumbent upon compensation

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committees to make their case in the CD&A and not to rely on quantitative assessments. Mr. McCormick noted that in 2013, 18% of the companies that received an “F” grade in Glass Lewis’ quantitative analysis still received a positive say-on-pay recommendation, because they justified the plan qualitatively.

### Conclusion

As they exercise oversight for their companies, directors listen carefully to their shareholders and to the proxy advisers. A recent increase in communication about broader policy issues among these groups has allowed boards to explain their decisions and to point out why one-size-fits-all policies do not work for all companies. Proxy advisory firms’ influence may be waning, but investors do not ignore them; boards cannot afford to ignore them, either.

### About this document

*The Lead Director Network (LDN) is sponsored by King & Spalding and convened by Tapestry Networks. Drawn from America’s leading corporations, the LDN is a group of lead independent directors, presiding directors, and non-executive chairs who are committed to improving the performance of their companies and to earning the trust of their shareholders through more effective board leadership. The views expressed in this document do not constitute advice for any purpose (legal, financial, business, or otherwise) of network members, their companies, King & Spalding, or Tapestry Networks.*

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### Appendix: Meeting participants

The following directors participated in all or some of the meeting:

- Frank Blount, Former Lead Director, KBR
- Peter Browning, Lead Director, Acuity Brands
- Loren Carroll, Lead Director, KBR
- Erroll Davis, Compensation Chair, Union Pacific
- Tom Donohue, Former Compensation Chair, Union Pacific
- Bonnie Hill, Former Lead Director, The Home Depot
- Karen Horn, Compensation Chair, Eli Lilly
- Bill Kerr, Compensation Chair, Interpublic Group
- Mary McDowell, Compensation Chair, Autodesk
- Steve Miller, Non-Executive Chair, AIG; Compensation Chair, Symantec
- George Muñoz, Audit Committee Chair, Altria
- Ed Rust, Presiding Director, Caterpillar; Lead Director, McGraw-Hill Companies
- Laurie Siegel, Compensation Chair, CenturyLink
- Samme Thompson, Compensation Chair, American Tower
- Linda Wolf, Compensation Chair, Wal-Mart Stores

The following directors took part in pre-meeting discussions:

- Ed Kangas, Non-Executive Chair, Tenet Healthcare; Lead Director, United Technologies
- Marshall Larsen, Compensation Chair, Lowe's Companies
- Jack O'Brien, Lead Director, TJX; Non-Executive Chair, Cabot Corporation
- Steve Reinemund, Compensation Chair, Marriott International
- Michael Rose, Presiding Director, General Mills
- Wes von Schack, Lead Director, Bank of New York Mellon and Edwards Lifesciences
- Sam Scott, Compensation Chair, Bank of New York Mellon
- Stephanie Shern, Presiding Director, GameStop



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The following King & Spalding attorneys participated in one or more of the meeting sessions:

- Bill Baxley, Partner; Co-Chair, Mergers and Acquisitions Practice
- Dixie Johnson, Partner; Special Matters and Government Investigations Practice Group
- Glen Reed, Partner and Chair; Healthcare Industry Group
- Laura Westfall, Senior Associate; Employee Benefits and Executive Compensation Practice
- Chris Wray, Partner and Chair; Special Matters and Government Investigations Practice Group

The following Meridian partners participated in the meeting:

- Annette Leckie, Partner and Lead Consultant
- Jim Wolf, Managing Partner