



## Proxy Advisory Firms' Beefed-Up Role In Exec Pay

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Managing a public company, whether as an executive officer or as a board of directors, is challenging, especially in this economic environment. All major business decisions receive heavy scrutiny in the capital markets and media, and the evaluation of a company's financial performance and compensation practices by proxy advisory firms is, in many respects, even more intense.

Over the years, the power these firms hold in controlling the outcome of director election contests, executive compensation practices and other matters requiring stockholder consent has increased significantly.

While management and boards should not run their companies based on the standards of proxy advisory firms, it is nevertheless pragmatic to consider how a proxy advisory firm will react to a company's executive compensation practices. To ignore the power these firms have to influence voting behavior of institutional investors is foolhardy, especially for larger public companies with concentrated ownership among pension plans, private equity funds and the like.

With the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act, proxy advisory firms, and principally ISS, will become an even more powerful influence over executive pay practices.

### **What Are Proxy Advisory Firms?**

Many institutional investors (including pension plans and mutual funds) use third-party proxy advisory firms to help them vote their proxies, both in annual meetings and extraordinary transactions. These proxy advisory firms offer voting recommendations on proposed corporate directors, as well as management and shareholder proposals. At least one of these firms also has the capability to cast votes directly on behalf of its clients' shares. In addition, their firms rate public companies' corporate governance practices.

According to a Towers Watson survey, most public companies believe that these proxy advisers have a substantial influence on executive pay decisions. It is clear that proxy advisory firms wield significant influence in elections, as their institutional clients have large stock holdings relative to other investors.

### **Who Are They?**

There are six major private and public corporations offering proxy advisory services:

- MSCI Inc./RiskMetrics Group (ISS)
- Egan-Jones Proxy Services
- Glass Lewis & Co.
- Marco Consulting Group
- Proxy Governance Inc.
- C&W Investment Group

Also, The Corporate Library is a possible seventh contender. Publicly traded ISS is by far the largest, with more than 1,700 clients. ISS, Marco Consulting Group, and Proxy Governance Inc. are registered with the U.S. Securities and Exchange Commission as investment advisers.

### **Very Powerful and Gaining**

With the enactment of the Dodd-Frank Act, proxy advisory firms, and principally ISS, will become even more powerful. The legislation could shift power over compensation from boards of directors to proxy advisory firms.

It is common knowledge that the Dodd-Frank Act imposes a mandatory but nonbinding shareholder vote on executive pay programs. In addition, the Dodd-Frank Act followed and expanded on recent action by the New York Stock Exchange by amending the Securities Exchange Act of 1934 to prohibit brokers from voting shares beneficially owned by another investor without that investor's express direction.

Large retail investors generally hold their investments through brokers. The broker is typically the "legal" owner of the stock, and the client is the "beneficial" owner. Brokers are generally required to ask their clients for voting instructions. However, very few retail investors actually go to the trouble of instructing their broker on how to vote. This leaves the shares "uninstructed."

Brokers can generally vote uninstructed shares as they choose but only if the matter voted upon is "routine." Historically, brokers tended to vote in favor of the positions recommended by management and the percentage of the retail vote of a typical public company varies from a few percentage points to more than twenty percent. So the retail shares are, in practice, a significant and reliable pro-management voting bloc.

Under the new NYSE rules, normal, uncontested elections of directors are now "nonroutine." Furthermore, the Dodd-Frank Act imposes mandatory voting by beneficial owners only on the appointment of directors, executive compensation and "any other significant matter." If the retail shares are not voted by brokers, it is much harder to reach the required majority on those proposals requiring a majority vote.

Several dozen companies have already adopted say-on-pay on a voluntary basis. Those companies generally treat the vote as a routine matter, and so brokers are permitted to vote the uninstructed shares.

This is usually very helpful in reaching majority support for the company's compensation programs, and in fact, very few companies have experienced a majority no vote on their say-on-pay resolutions. With the change in broker voting rules, however, it will be harder to obtain that majority support because the retail vote will essentially not exist. Undoubtedly, the SEC hopes that retail investors will spend the time to instruct their brokers, but many observers think this is unlikely.

This will put more voting power in the hands of institutional investors and therefore in the hands of ISS. ISS has been revising its voting guidelines based on the assumption that, one way or another,

say-on-pay will become the law. They have said that violations of their compensation policies will initially be channeled through the say-on-pay process (as opposed to immediately recommending withhold votes against directors). If a company gets a majority “no vote” on say-on-pay and “fails to remedy the situation,” then ISS will consider recommending withhold votes on directors. Therefore, as a result of the Dodd-Frank Act, companies will face much greater pressure to adhere to ISS’ compensation policies.

### **Lack of Transparency and Accountability**

Proxy advisory services have a significant impact on the proxy process, permitting institutional investors to out source voting analysis and execution. Despite the large role that proxy advisory firms play in the corporate governance arena, they generally remain unregulated and unsupervised, and the firms often are not transparent with regard to standards, procedures, compensation arrangements, and conflicts of interest.

Who holds ISS accountable? The answer is: no one other than the market itself. Proxy advisory firms are not subject to any required disclosures or oversight regarding their ability to control or influence the outcome of a vote. Some proxy advisory firms also have an inherent conflict of interest in the voting process because they also provide related consulting services, such as corporate governance ratings, corporate governance advice, and other research services, in addition to providing voting recommendations on proposals submitted in elections.

In any event, it is widely acknowledged that proxy advisory firms’ voting recommendations are sometimes ill advised and that for good reason corporations often dispute such recommendations as well as the corporate governance ratings imposed by these firms.

In addition, there is substantial empirical evidence that these corporate governance ratings have little predictive value regarding future stock market performance. It is not uncommon for one proxy advisory firm to give a favorable corporate governance rating to a company while another proxy advisory firm finds the same corporation engages in poor corporate governance practices. Obviously, the criteria applied by these firms to evaluating corporate governance is not the same among them.

### **Let Your Voice Be Heard — Contact the SEC**

The SEC is seeking comments on the reform of the U.S. proxy system, including the role of proxy advisory firms. (SEC Content Release No. 34-62495) Let your voice be heard. The SEC and industry should strive to develop solutions that benefit both companies and their shareholders.

Comments must be submitted to the SEC on or before October 20, 2010 (90 days after publication of the Release in the Federal Register). Comments may be submitted by any of the following methods:

Electronic comments:

— Use the SEC’s Internet comment form ([www.sec.gov/rules/concept.shtml](http://www.sec.gov/rules/concept.shtml));

— Send an e-mail to: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-1410 on the subject line; or

— Use the Federal eRulemaking Portal ([www.regulations.gov](http://www.regulations.gov)). Follow the instructions for submitting comments.

Paper comments:

— Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-14-10. This file number should be included on the subject line if e-mail is used.

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