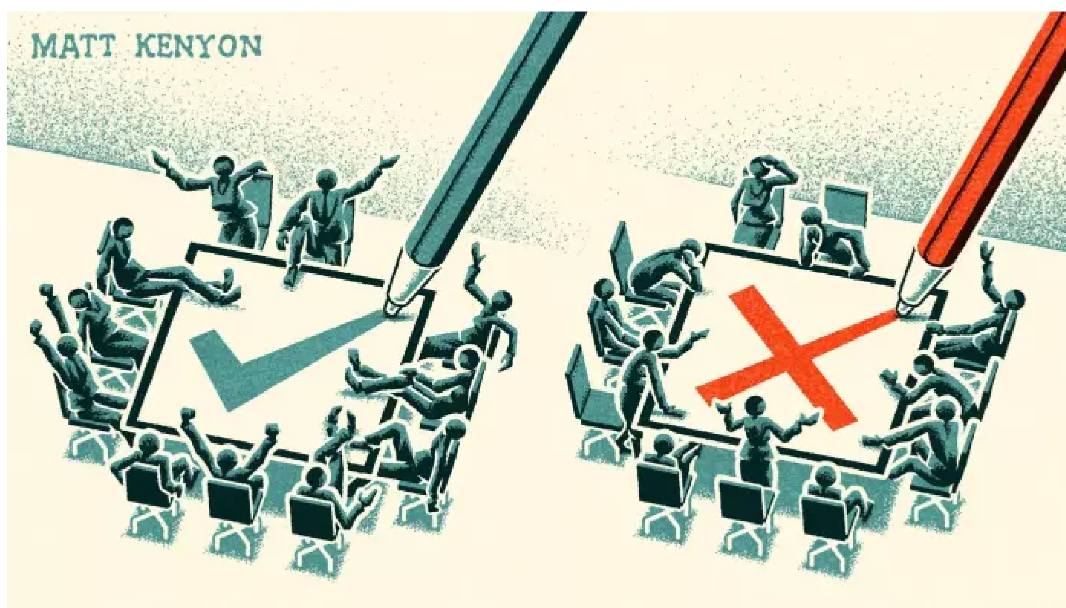
Corporate governance

# Investors pass the buck on governance

Proxy advisers incentivise the wrong company behaviour by creating rigid checklists

Rana Foroohar




YESTERDAY by Rana Foroohar

Does corporate governance matter? Or, to be more precise, do investors really care about it? This is a question that I have been pondering for two reasons. First, huge amounts of passive investment has made questions about corporate decision making irrelevant for many investors. When you are just tracking the index, you are not looking at what a company is really doing on the ground and whether its leaders are making the right calls. You are simply passing the buck to the market.

But there is another, less explored, way in which investors may be passing the buck. Institutional investors have come to own roughly two-thirds of all the outstanding shares in US corporations. That gives them tremendous power over executives and their decisions. Yet a large chunk of that power is outsourced to proxy advisers like Institutional Shareholder Services and Glass Lewis, which give investors advice on how to vote on everything from management to corporate pay packages. While it is understandable that large asset managers like BlackRock or Fidelity and myriad smaller institutions would want to offload this task, the result is that individual corporate decisions sometimes get short shrift.

Companies, trade and lobbying groups (the Conference Board and the Business Roundtable, for example), as well as some academics and corporate governance experts, have begun complaining that proxy advisers are incentivising the wrong behaviour — focusing not on the nuances of corporate governance, but rather creating rigid checklists that must be followed lest the proxy adviser vote no on issues like pay or board membership.

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The issue is not new: more than a decade ago, ISS opposed the re-election of Warren Buffett to the board of Coke, as some of his holdings — such as Dairy Queen, which serves Coke products — triggered a conflict of interest provision. It is tough to argue that Mr Buffett was not a worthy director; he said the decision was "absolutely silly . . . checklists are no substitute for thinking". But shifts towards "say on pay" (shareholder votes on executive compensation) have attracted investor scrutiny, as has a long-run bull market in which it is tougher to achieve the returns investors crave.

These factors have conspired to create new proxy pressure for companies. Since total shareholder return is the key metric of corporate performance for proxy advisers, companies that are doing anything that fails to raise the share price year on year — regardless of whether it is smart or not — may find themselves opposed by investors.

Consider the recent saga of Credit Suisse. Over the past couple of years, the company has been trying to orchestrate a turnround, settling a big fine over dicey (pre-financial crisis) mortgage-backed-security deals with the Department of Justice, offloading bad assets and restructuring the business. None of this is good for share price in the short term, but it was necessary. No surprise, then, that the Credit Suisse management team was disappointed when proxy advisers opposed its corporate pay plan, citing 2016 losses, despite the fact that the top brass took a 40 per cent cut in its own compensation as part of the turnround effort. "It was just totally demotivating for staff and management," says one insider. "We could have left these decisions for someone else to worry about later and there would have been no issue over pay."

ISS stands by its recommendation, and adds that it does take into account other performance metrics, like return on invested assets, revenue growth, and so on. But TSR is "what investors want

to see," says Patrick McGurn, special counsel at ISS, and therefore determines a yes-or-no vote on pay. "We've talked to our clients about using non-financial performance to judge pay, but they want something quantifiable. You can't just have some vague judgment about it."

Maybe so. But as an increasing body of research shows, share price does not always correlate with good long-term decision making; a Stanford study showed that firms lauded by proxy advisers did not actually have better returns, fewer lawsuits, or higher valuations over time. Jacking up the stock price of a company is as easy as a stock buyback, proven by the record number made over the past two years as companies struggle to get a bit more juice out of what may well be the end of a bull market. Unfortunately, that money does not go into things like research and development or training, or other types of real business investment to create value.

In the US, there is now a push to realign incentives. A House proposal last year suggested forcing proxy advisers to register with the SEC and disclose any conflicts of interests — which could be substantial, given that they are paid by asset managers. Other proposals include giving companies more time to respond to proxy reports and make their case about individual management decisions. Yet the criticism of proxy advisers is "really part of a larger philosophical debate about who companies are being run for", says Douglas Chia, head of corporate governance at the Conference Board. Boards and management? Shareholders? Or some larger group of stakeholders? Whatever the answer, it is worth thinking about the kind of corporate governance our system is incentivising.

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