# How Proxy Advisors View Your Board

## by Gary Larkin

**Corporate boards realize that shareholders are watching them more closely today, and giving their performance tougher grades. However, much of what shareholders learn about your board comes to them through the major proxy advisors, such as ISS and Glass-Lewis. What do these top influencers look for when making their board and governance advisories?**

What is the job of a corporate director? That question probably is not asked enough by key company stakeholders. At first glance, the answer may seem obvious. Over time, though, the range of expectations for doing the job well has widened, and has become a prism. How it is defined, though, shifts depending on the perspective of the observer.

Why ask this question now? It is a natural follow-up to the questions people ask when they see headlines such as: "CFPB Fines Wells Fargo $100 Million for Widespread Illegal Practice Secretly Opening Unauthorized Accounts" or "Mylan Agrees to Settlement on Medicaid Rebate." People ask: "Where was the board?" or "What did they know and when did they know it?"

In order to answer those questions and get to the bottom of what causes such catastrophic corporate failures, The Conference Board Governance Center undertook a two-year research project. The project's goal is to provide direction to corporate directors and foster a common understanding among market participants of how to view the job of the corporate director.

Each stakeholder has its own relationship with the corporate board that plays a part in the board's decision making and management oversight. Proxy advisors are the most unique. They do not own stock in a company, nor vote proxies. They are not hired by a company. Yet they carry significant influence in the boardroom because of services they provide to shareholders. Those services include analysis and voting recommendations for investors on such proxy items as director elections, shareholder proposals, advisory executive compensation proposals, and corporate actions, like mergers and acquisitions.

As for investors, they are the primary "owners" of the company who look to the board to carry out their fiduciary duties. Among all the stakeholders, their relationship with the board seems to have evolved the most. The communication between shareholders and the board traditionally consisted of the required annual proxy and quarterly SEC filings. At many companies, it now includes regular meetings with independent directors and some officers of the company.

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When it comes to directors, their view of their own job calls for some introspection (something not all board members are inclined to do). They see a need for more regular communication with each other and management about such topics as board composition, CEO succession, and company strategy. They also realize the importance of a shareholder engagement plan, but admit that is difficult to execute. Finally, they struggle with evaluating the effectiveness and competence of fellow board members.

At a roundtable of proxy advisors and leaders from the corporate governance community, The Conference Board found:

□ *Proxy advisors are concerned by the trends of a lower refreshment rate, higher director age, and predominance of white males on public company boards.* The average director tenure of S&P 500

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boards in 2016 was seven years for white male directors, versus six years for minorities and five years for women. The average age for those same boards in 2016 was 62.8 for white males, 60.8 for minorities, and 60.2 for females.

Some are worried that boards lack the younger and more global directors that their companies will need to be competitive in a more technological and international marketplace. While the board refreshment rate at S&P 500 companies has increased over the past eight years, it has declined over the past year.

**Until recently, shareholder engagement typically only happened around proxy voting, proxy fights, and shareholder lawsuits. Now, companies and investors are communicating about a whole litany of issues.**

□ *Several forces are heightening director expectations.* Increased regulatory pressures following accounting scandals and the financial crisis, geopolitical risks, IT governance and cybersecurity risks, and shareholder activism all influence what is expected.

□ *Proxy advisors agreed that a company's engagement with shareholders is now trending toward more in-person meetings that include board members.* Until recently, shareholder engagement typically only happened around proxy voting, proxy fights, and shareholder lawsuits. Now, companies and investors are communicating about a whole litany of strategy, environmental, social and governance (ESG), compliance and governance-related topics. More board members are becoming directly involved.

At a panel discussion of three corporate directors and interviews with two other experienced directors, we came away with the following observations:

□ *Directors need to communicate regularly with each other and management about complex issues in order to be effective.* They also need the skills necessary to compromise and gain consensus on important issues like executive pay, capital allocation, and shareholder engagement.

□ *CEO succession planning is one of the corporate board's most important jobs.* Our director panelists agreed that there has to be a regular process the board and management stick to over several years, and that it needs to go beyond just the CEO.

□ *While disclosure of shareholder engagement plans is not a regular practice, directors understand the importance of having such a plan.* One director panelist offered three things a board can do before engaging a shareholder: determine how much company stock the shareholder owns, communicate with the company's investor relations department, and understand if the shareholder has an issue with a particular governance area.

□ *Boards need to develop a gap analysis of what skills directors have and what skills they need.* One director explained the reason for a third-party evaluation: "The skills of board members from 15 years ago may not be what the board needs now."

At a roundtable of three investment management companies, The Conference Board noted:

□ *Attorneys, general counsels, and investors agreed that board oversight is guided by specific long-term strategic planning and risk management processes and plans.* Those plans relate to CEO succession, capital allocation, mergers and acquisitions, and crisis management. They aid boards in making important decisions on executive changes, merger agreements, shareholder activism, major internal wrongdoing, and widespread product and/or operational disasters.

□ *Investors expect the directors of their portfolio companies to be their representatives in the boardroom when important decisions are made.* They want those directors to have at least three traits that will get the job done: independence, courage, and openness.

□ *During a crisis, management will actively lobby large investors to stave off any replacement of directors in upcoming elections.* Investors get a lot more of those calls now than in the past. The initial reaction to a crisis is that a board sees it as a public relations problem. They ask management to walk them through the details of the crisis before a shareholder vote on directors is taken.

□ *Investment management firms will vet their portfolio companies to judge whether the board understands company risks, the thought process behind*

*board and management decision making, and whether the board and management own the decisions they make.* Investors want to make sure the board does not let management take improper risks.

Of all the stakeholders engaged in this corporate director job description project, the proxy advisor stood out because of its nature as the arbiter of director fitness. When looking at the board's job through the eyes of the proxy advisor, we realized there are four major elements of a director's job: the expectations of stakeholders, their expertise, the refreshment of the board, and their level of engagement with shareholders.

☐ ***Director expectations.*** Boards have many roles—oversight of financial reporting, CEO hiring and firing, executive pay, IT, cybersecurity and overall risk management, and company strategy, to name a few. Certainly, those roles call for a certain level of knowledge in different areas.

Today, there are quite a few forces driving expectations of all directors. One of the most predominant is the increased regulatory pressure following the accounting scandals in the early 2000s, and the financial crisis in the late 2000s. Another force is the fact that corporations increasingly compete in a global marketplace and have to be more aware of geopolitical risks. Also, boards must monitor IT and cyber risks. Then there are the shareholder activists who are targeting board seats, CEOs, and even the business models of companies.

Directors of companies today perform a hybrid role of strategic advisor and monitor. They are asked to conduct in-depth tasks pertaining to a variety of technical areas, such as audit, compensation, risk management, succession planning, and drivers of sustainability, to name a few.

Yet how many of these directors actually have the expertise and capacity to cover all these areas? Management provides these services as part of its day-to-day responsibilities. Still, what happens when a company, such as an Enron or WorldCom, is run by corrupt officers who are only looking to meet aggressive profit margins and maximize stock prices at any cost, and not looking out for the company's other stakeholders' interests?

That is one of the reasons proxy advisors and some investors have focused on what is expected of directors and their skills.

☐ ***Director expertise.*** It is human nature to take an interest in the competence of someone after there has been a crisis or failure. Following the Penn Central collapse in 1970, there was a call for creating new independent director responsibilities for all public companies. Those included authorizing major corporate actions, delegating board authority by creating independent committees, monitoring corporate conduct, and advising and counseling top management. The type of expertise for independent directors included institutional knowledge of the company and industry, executive compensation, and productivity and competitiveness.

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While it was reactive, the institution of those responsibilities seemed to get the job done for the better part of 30 years. Then, the next great wave of company failures hit U.S. companies. This time, it was in the form of accounting scandals, i.e. Enron, WorldCom, and the 2008-2009 financial crisis.

This time around, the independent director responsibilities grew to include CEO succession, overseeing long-term strategic planning, monitoring risk and crisis management plans, executive pay, board composition and refreshment, and shareholder engagement. Board expertise now requires financial expertise, operational knowledge, IT governance/cyber risk management, and global business knowledge.

As a corporate governance standard-setter for boards and investors, proxy advisors have focused on director skills to determine how shareholders should vote in director elections and related proxy proposals. That goes as far as rating a company based on the independence of its board, how many outside directorships its CEO has, and the refreshment of its board.

## Proxy Advisors On Governance

### Major Voting Recommendations

| Proxy advisor | Director independence | Overboarding | Board refreshment (term limits, diversity, retirement age) |
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| ISS | Vote against election of directors if the nominee name is not disclosed in a timely manner before AGM and does not comply with minimum board independence requirements. | Generally vote against or withhold from directors who sit on more than five public company boards or are CEOs of public companies who sit on more than two public companies besides their own and withhold votes only at their outside boards. | Vote against proposals for mandatory retirement ages or term limits. However, ISS will scrutinize boards where the average tenure of all directors exceeds 15 years for independence from management and for sufficient turnover to ensure that new perspectives are being added to the board. |
| Glass Lewis | Vote for boards that are at least two-thirds independent. In cases where there is more than one-third affiliated or inside directors, vote against those directors to satisfy two-thirds threshold. | Generally vote against a director who serves as an executive officer of any public company while serving on more than two public company boards and against any other director who serves on more than five public company boards. | Vote against the nominating/governance committee if the board waives its term and age limits unless the waiver was granted with sufficient explanation. |
| Egan-Jones | Vote for shareholder proposals asking that two-thirds of directors be independent and that the board's audit, compensation, and nominating/governance committee be composed of independent directors. | Withhold vote for director nominees who sit on more than five other public company boards, serve as CEOs and hold more than one outside directorship, and serve as Chair of the board and hold more than one outside directorship. | Vote against shareholder proposals to limit tenure of outside directors or imposing a mandatory retirement age for outside directors. |
| Segal Marco | Vote for outside directors and against/withhold insiders when board is less than two-thirds independent. | NA | Vote against proposals to limit tenure of directors. Vote for proposals requesting company make efforts to seek more qualified women and minority directors. |

☐ ***Board refreshment.*** The trends of a lower refreshment rate over the past year, higher average director age, and predominance of white males concern most proxy advisors. They are dumbfounded that a board could have 70- and 80-year-old directors who think they can oversee the way a business is run today based on standards from 30 years ago.

The Conference Board research found that proxy advisors believe a lack of stable board turnover might be the fundamental cause of many problems. At the same time, those proxy advisors acknowledge the danger of removing all older directors in one fell swoop. They worry about the loss of institutional knowledge. For the most part, they believe that mandatory board refreshment should only be done on a case-by-case basis.

Some companies, like General Electric, are confident enough in their board refreshment that they

have memorialized it in their governance principles. GE now has a 15-year tenure limit for independent directors, with a two-year transition period for existing directors. There is an age limit of 75, with limited exceptions, and an annual board evaluation led by its lead director.

As for the rest of the largest public companies, proxy advisors observe that many S&P 500 directors are old, white, male, and not leaving anytime soon—and the statistics back that up. However, when it came to what to do about making boards younger, more diverse, and less entrenched, there is no agreement.

The solutions run the gamut from term limits and mandatory retirement age to improved board evaluations and succession planning. At the roundtable, there was little inclination to discuss how these structural items relate to the job description/expectations of a public company director.

A proxy advisor who studied 10 companies in crisis prior to the roundtable found common director attributes at those companies: low level of board independence with high levels of insider control, extremely short average director tenures (which bucks conventional thought about long tenure), weak independent business leadership structures, and lagging public disclosure of problems.

The proxy advisor concluded that board behavior is attributable to basic personal character, integrity and leadership qualities. It was also raised that those companies in crisis might have benefited by interviewing director candidates with a broader background and experience dealing with domineering CEOs.

In some cases, some boards and management have discussed the issue of board refreshment with large institutional shareholders that have made that the focus of director and proxy access campaigns.

☐ ***Shareholder engagement.*** Today, there are hundreds of meetings between companies and institutional investors, and the engagements have moved beyond just executive pay and include succession planning, sustainability, risk/compliance, and environmental, social, and governance (ESG) issues.

Many governance experts say it is imperative that public company boards do a lot more than just set up meetings with shareholders. In these meetings, they need to be equipped to address the activists looking to make wholesale changes to policies affecting governance, compensation, and even operations as well as the long-term institutional and retail investors. A growing trend is activists gaining seats in the boardroom itself through successful proxy fights, or even the threat of a proxy fight.

Proxy advisors see independent directors as the ones who drive the engagement with shareholders. They work with a company's corporate secretary and investor relations department to make sure to schedule meetings during the proxy off-season, draft an agenda, review the investor's guidelines and voting records, and make sure the right people are in the room.

While the job of a director has changed over the years, the job of one of its most influential stakeholders—the proxy advisor—most certainly has not. Between ISS, Glass Lewis, Egan-Jones, and Segal-Marco, proxy advisors still see affirming a public company board's primary responsibility to the shareholder (sometimes referred to as "shareholder primacy") as Job One.

When describing the job of a corporate director, the challenge for proxy advisors is that they are not naturally inclined to draw up a list of qualifications and responsibilities. Proxy advisors tend to see corporate governance through the prism of their proxy voting recommendations.

It seems like proxy advisory firms do not really look at the job of the director as a whole, ask what it should entail, and then shape their policies around that idea. Instead, they look at each component of the director's job (informed by what their clients tell them are the highest priority items) essentially in a vacuum, and opine on what they think is the best way to design or perform each part.

Proxy advisory firm critics may see this as a "check-the-box" approach, but the firms themselves see it as part of a "check and balance" against the powers of other important company stakeholders. ■



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4440 Hagadorn Road, Okemos, MI 48864-2414,
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