LATHAM&WATKINS LLP

Corporate Governance Commentary

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Corporate Governance Activism: Here To Stay?

Highlights

- Corporate Governance Activism seems to be going from strength to strength, with Say on Pay providing new leverage and, as important, a new cause with great visceral appeal.
- Corporate governance activism's fundamental structure as an alternate universe, essentially separate from the value creation function of its institutional investor clientele, has not changed and is not likely to do so in the future.
- The proxy advisory services, principally ISS and Glass Lewis, are a permanent part of the alternate universe of corporate governance and the crucial enablers of the universe's key function — exercise of the share voting franchise.
- Missing from most discussions of the alternate corporate governance universe are:
  - Recognition that the inhabitants of the parallel universe of corporate governance are not principals in their own right, but rather merely agents of the institutional investor industry, which in turn is an agent of the ultimate beneficial owners of the bulk of the equity securities of US companies.
  - Consideration of the large and growing agency costs imposed on the ultimate beneficial owners of public companies by the corporate governance universe, not only as a result of its own operation and growth, but also as a result of the significant expansion of the governance function at public companies needed to cope with the demands and distractions of corporate governance activism.
  - Most fundamentally, understanding that the foundation of the parallel universe of corporate governance activism — the precept that the shares of all portfolio companies be voted on all matters — is not imposed by the fiduciary duties of institutional investors. Rather, it is the product of a misreading of the legal requirements of fiduciary principles which, properly understood, require voting of shares by fiduciaries only if doing so creates more value than cost — a test that is clearly not met in most voting situations.
- The obvious path of correction would be:
  - Recognition that there is no convincing empirical evidence that voting to advance so-called corporate governance best practices causes value creation.
  - Adherence by institutional investors to the cost benefit analysis that should be the basis for each voting decision, rather than simply voting all shares on all matters utilizing the cumbersome and costly machinery of corporate governance's alternate universe.
  - Dismantling of the unnecessary and costly corporate governance universe that has developed at institutional investors and at portfolio companies, along with the enablers of that universe (including, in particular, the proxy advisory firms), thereby eliminating unnecessary agency costs from our public company governance structure.

Introduction

We have been observing the corporate governance movement in the United States for the past several years.

- Share voting decision makers at most institutional investors inhabit an alternate universe from investment decision makers.[1]
- Two incompatible economic and philosophical belief systems drive these alternate universes:
  - Investing professionals, overwhelmingly, are rationally apathetic about exercising the voting franchise embedded in stock ownership.[2] Absent a readily observable and positive correlation between exercise of the corporate franchise and creation of shareholder value (as is the case in most M&A votes and proxy contests), investing professionals view the task of making voting decisions on each ballot item for each of their portfolio companies as not merely time consuming and distracting but, worse, economically wasteful.[3]
  - On the other hand, notwithstanding the lack of a demonstrable connection between what is labeled good corporate governance and a positive increase in share valuation, corporate governance advocates continue to maintain that good corporate governance does, in the aggregate, enhance share values.[4] Accordingly, in their view, voting on all ballot issues at each and every portfolio company in order to achieve better corporate governance is a value creator. Starting from this core ideology, corporate governance advocates have successfully persuaded many national politicians, most regulators of the securities and investment industries and virtually all of the financial press, that its so-called corporate governance best practices are an essential requirement for shareholder value creation and that professional investment managers, as a matter of their fiduciary duty to their customers, should be required to vote all portfolio shares on all ballot matters.
- The tension between investing professionals' rational apathy with regard to share voting and corporate governance activists' insistence that all shares be voted on all issues has resulted in a search to find a way all portfolio shares can, in fact, be voted on every issue for the lowest possible out-of pocket costs to institutional investors. For better or worse, the answer to date has been:
  - The invention of the proxy advisory function — a third party that provides voting recommendations on all ballot votes for all public companies for a quite small annual fee.
  - The creation and proliferation of universally applicable voting policies, which can be applied to all public companies with the least amount of "hand" labor. The one-size-fits-all approach of universally applied voting policies is the only efficient methodology for "automating" the overwhelming number of voting recommendations required to be generated each proxy season. It is the sine qua non for an "affordable" (aka, cheap) system that can deal with the thousands of ballot issues that comprise an annual proxy season in the United States.[5]
  - The growth of a separate community of corporate governance advocates at institutional investors to manage the voting process and implementation of voting recommendations in furtherance of institutional investors' perceived fiduciary duty to vote all shares on all matters. Over time, as that community has solidified its position, it has grown its function at many larger institutional investors by taking on responsibility for developing and implementing voting policies for the institutions in addition to or in lieu of utilizing the voting policies and/or recommendations of a proxy advisor.[6]

Corporate Governance Triumphant

The corporate governance universe has become increasingly important in public company decision making because of its ability to use the threat of withhold vote and vote no campaigns against nominees for the board as a powerful lever to force companies to take actions that they otherwise would not take. This effective power has been greatly enhanced by the legislative victory scored by corporate governance adherents in the Dodd-Frank legislation, which as a practical matter mandated annual Say on Pay votes at all significant US public companies.

- The growing significance and sheer number of Say on Pay votes is today consuming the time and energy of the parallel universe of corporate governance advocates and has turned the two major proxy advisory firms into the effective arbiters of executive pay for almost all significant US public companies. This is obvious to all of the participants in the 2012 proxy season and is further evidenced by the decreasing number of, and lack of excitement attendant to, shareholder proposals on other governance issues. For example, proxy access, which once was a focal point of corporate governance professionals and companies alike, has become an afterthought, perhaps not even worthy of a footnote. Attempts to curb, or at least force disclosure of, political contributions and lobbying efforts have gained significant traction, but seem to have evoked little passion outside the pages of the Wall Street Journal. As a practical matter, aside from Professor Bebchuk's heavily self-publicized, student-powered cottage industry devoted to eliminating staggered boards, not much of significance is happening in the world of corporate governance today, other than Say on Pay.

  - Because Say on Pay is the name of today's corporate governance game, it is important to understand the rules of the game.
  - A majority of votes in favor of executive pay is not a victory. In the new math of corporate governance activism, anything less than a 70-75 percent favorable vote is insufficient.
  - ISS, and to a far lesser extent Glass Lewis, control the outcome in a great many cases. The statistics are incontrovertible that, on average, a negative vote recommendation from ISS will swing 30 percent of the total votes into the vote no column, thereby making a 70-75 percent favorable vote difficult or impossible.[7] Many observers believe that Glass Lewis accounts, on average, for a similar swing of 5-6 percent or more.

- ISS' one-size-fits all metrics are deeply flawed.[8] For example:
  - The mechanical formula ISS uses to select a peer group for comparison purposes frequently produces odd, sometimes positively weird, peer groups that defy rational explanation.
  - ISS consistently overstates executive compensation by making no allowance for actual performance of stock based compensation awards. Rather it consciously uses what it euphemistically calls pay opportunity data, which is based on a notional Black Scholes valuation model for stock options as of grant date and on stock price as of grant date for restricted stock awards. ISS conveniently ignores (as, sad to say, does the SEC in its disclosure rules for summary compensation tables) the obvious fact that stock price on the date of grant bears no relationship to the actual value of a stock based award at the date of vesting, let alone the date of sale of the stock. A far more realistic approach would be to measure an executive's compensation for a calendar year by looking to the value of stock and stock option awards that vested during the year and thus became tangible, rather than a merely theoretical value that might or might not ever pan out.[9]
  - ISS rigidly equates performance with Total Shareholder Return and studiously ignores all other possible measures of company performance.
  - ISS frequently bases its recommendations on inconsistent or misapplied methodologies, factual errors or mistaken interpretations of companies' compensation policies. It is also frighteningly inconsistent in applying subjective judgments on executive pay, which it euphemistically calls qualitative analysis.
  - ISS rarely takes into account special circumstances, such as newly hired senior executives, implementation of turn-around-plans, special incentive programs keyed to strategic initiatives and the like.

- Glass Lewis is harder to appraise than ISS because it provides far less transparency about its methodology. To its credit, Glass Lewis is working on new analytics in conjunction with Equilar that purportedly will be based on more sensible peer group selection and realizable pay, rather than pay opportunity. The new metrics, however, will not be visible until this summer and are unlikely to have any significant impact until the 2013 proxy season. Moreover, even if the new

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Glass Lewis model takes a more realistic view of what constitutes pay and uses an appropriate peer group, it nevertheless will of necessity be a one-size-fits-all analysis with all of the inherent inadequacies of that methodology.

- An increasing number of companies are improving their pay and performance disclosure in an effort to prompt favorable analysis by proxy advisors and by corporate governance advocates imbedded at their key institutional investors. Moreover, an increasing number of companies appear to be actively soliciting against negative proxy advisory recommendations by issuing post-recommendation supplemental proxy materials in an effort to correct the record and to persuade institutional investors to disregard vote no recommendations. While anecdotally these efforts have borne fruit, they have come at great cost to the companies in terms of out-of-pocket expense and distraction for both senior management and the board.[10]
- The notion of company "engagement" (frequently including personal appearances by directors) with the corporate governance universe on a year-round basis has gained considerable traction. At least, these engagement campaigns give companies an opportunity to discuss compensation policy (and other governance issues) with corporate governance specialists at key institutional investors in a more orderly and less fraught climate than the week or two preceding the company's annual meeting.[11]
- The growth of the corporate governance universe in size and importance has created a similar build-up of the corporate governance function inside public companies. While hard to measure, it seems likely that the company-based corporate governance function is far larger in terms of headcount and cost than the investor side. Whether or not true, there can be no doubt that the company response to the growth of the alternate corporate governance universe represents a large hidden cost to shareholders that is almost universally ignored in discussions about the economic merits or demerits of the alternate corporate governance universe.
- Finally, it is increasingly clear that the alternate universe of corporate governance harbors at least two separate solar systems, one which encompasses large cap, "big" name companies — the Fortune 100, if you will — and the other which is home to the rest of the herd of some 6,000 public companies that lack the heft to matter much to the corporate governance community.
    - The fortunate large cap, big name companies can get an audience with corporate governance specialists at their key institutional investors throughout the year and quite often during the throes of the proxy season. For these companies, engagement is feasible on a year-round basis, and a real hearing is often possible during the interval between the publication of an adverse recommendation by ISS and/or Glass Lewis and the annual meeting.
    - Members of the corporate herd have no chance for such a hearing in the run-up to their shareholder meetings and very often find it difficult or impossible to get the attention of the corporate governance specialists at their key institutional investors at any time during the year. The simple fact is they are too small to count in the context of their limited importance to portfolio values and the deliberately constrained size of the corporate governance function of institutional investors.

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The Expanding Universe of Corporate Governance

The future seems clear, barring a significant change in policy by the institutional investor community.

- ISS and Glass Lewis will continue to dominate the corporate governance dialog because of their often decisive role in voting outcomes. This reality is not limited to Say on Pay, but is most prominent in this area because of the dramatic impact of the vote.[12]
- While it is possible that ISS will correct some of its Say on Pay metrics and that Glass Lewis will successfully adopt metrics for sensibly creating peer groups, as well as a realizable pay model instead of the ISS pay opportunity approach, it is highly unlikely that either or both proxy advisors will ever get Say on Pay "right."
    - Institutional investors simply will not pay proxy advisors enough to permit anything resembling a case-by-case analysis by competent executive compensation specialists. The patent lack of shareholder value creation that would be entailed in development of a more robust case-by-case analytical function dooms corporate America to being judged by one-size-fits-all Say on Pay metrics.
    - Worse, there cannot be any realistic hope that the proxy advisory firms will be able to develop truly sensible one-size-fits-all Say on Pay metrics. The endless variety of facts and circumstances reflected in the executive pay policies of over 6,000 public companies will defeat any attempt to generalize executive pay into a simple to apply one-size-fits-all model.
    - Executive compensation, for better or worse, is extremely complex and detail ridden. While the SEC may well have gone overboard in its detailed disclosure requirements in the Compensation Discussion and Analysis section of proxy statements, it is clear the topic does not lend itself to sufficient simplification, and lacks sufficient uniformity to make easy the task of developing a computer-driven model dependent on a careful and accurate reading of proxy statements. Maybe Google could master the algorithms and data entry challenges over time. ISS and Glass Lewis do not have the resources or competencies to do so, nor do they have access to the kind of funding that would be required to pay for the effort.
    - A related, and important, factor is that neither ISS and Glass Lewis, nor the corporate governance universe as a whole, possess any meaningful expertise in any aspect of executive compensation policies and processes. As a result, their views on executive compensation are often ideological and overly simplistic. Given all the programing skill in the world, the proxy advisors (and other members of the corporate governance world) simply lack the understanding of the complexities and nuances of executive compensation needed to build a sensible set of metrics that would accurately identify, across the spectrum of thousands of public companies, true pay for performance disconnects or absolute overpayment of such significance as to warrant a principled negative vote on Say on Pay.
    - In short, we are doomed to remain in the same Say on Pay circle of the inferno that we have suffered through in 2011 and 2012.
        - ISS and Glass Lewis will continue to make up many of their executive compensation policies as they go, they will fiddle with their one-size-fits-all metrics at the margin and they will continue to get it "wrong" in at least several hundred cases each year (assuming for the moment that they don't arbitrarily increase the percentage of companies they "ding" in a given proxy season from the 15-18 percent range of the past two years).
        - Companies, in turn, will react by either consciously trying to game the proxy advisors' metrics to avoid controversy, or standing on principal in the hope they can prevail on the Say on Pay vote based on year-round engagement with key investors, good summary disclosure in their proxy materials and a little bit of luck.
- The situation is no different in kind, only in effect, for all of the other one-size-fits all voting policies that comprise the corporate governance manual of so-called best practices. None of these policies has been shown to have a meaningful causal connection to the creation of shareholder value. Most of the practices have been adopted by a self-referential cycle, in which leading corporate governance activists first develop and publicly promote a new corporate governance standard.13 The proxy advisors mull over these standards internally, often in

consultation with the promoters of the policy, and eventually poll the larger corporate governance universe as to the desirability of translating the standard into a proxy advisory voting policy. Low and behold, members of the corporate governance universe, having watched and, in many cases, participated in the creation and propagation of the new standard, routinely respond favorably, and a new corporate best practice is proclaimed.[14]

- Moreover, there is an insidious but crucial reality that impels both ISS and Glass Lewis to toughen existing policies or adopt new policies frequently — they, like the corporate governance universe they represent, need to keep raising the bar. Policy stasis on the part of the proxy advisory firms and the corporate governance universe in general is high risk. If the bulk of corporate America learns to get it "right", the need for a vibrant and growing corporate governance universe would be reduced. There would inevitably be shrinkage in the universe's size and influence; inhabitants would lose both practical power and psychic income. A principal driver of the corporate governance community, like any agency institution, is the all too common institutional desire for growth in size and importance. The corporate governance community is no different. It can never rest on its laurels and declare victory without risking its very existence. Hence, each year will see some further ratcheting, whether it be new twists on Say on Pay or a focus on some other corporate governance initiative.
- As noted above, what has gone largely unnoticed to date is the huge amount of time, effort and resources companies are now devoting to the executive compensation and corporate governance engagement processes, solely for the sake of coping with annual Say on Pay voting and other "of the moment" corporate governance initiatives that hit their proxy statements in any given year. The true cost of the corporate governance universe is not just that of maintaining the members of the universe in the style to which they have become accustomed (which of course is a cost borne directly or indirectly by the ultimate beneficiaries of the investment funds — that is to say, the real shareholders who are the principals and who must bear the costs of their agents). It also includes the out-of-pocket and opportunity costs implicit in the legions of company personnel (including increasing time commitments from senior executives and board members) and outside company advisors that are needed to cope with incessant, growing demands of the corporate governance universe. In the end, the real economic shareholders, the people who have invested through institutional investors voluntarily or otherwise, are required to pay the bill for the alternative corporate governance universe not once, but twice.

Conclusion

Corporate America is saddled with the burden of co-existing in some fashion with the parallel corporate governance universe, notwithstanding the lack of convincing evidence that corporate governance "best practices" do indeed create shareholder value.

- An irony is that the corporate governance universe exists as an agent for institutional investors solely to atone for their rational apathy about exercise of the voting franchise.
- And those institutional investors, of course, exist solely as agents for ultimate beneficial owners who, if they held their investments directly, would likewise be rationally apathetic about exercise of their voting franchise.
- Conceptually, the separate universe of corporate governance resembles the proverbial house of cards that would collapse if the perceived requirement that institutional investors vote all shares on all matters were withdrawn from the bottom of the edifice.[15] Absent this lynch pin, there is simply no reason to have a universe devoted solely to the exercise of the corporate franchise on matters that lack any demonstrable connection to economic value creation.

Viewed in this light, the only way to eliminate the agency function and agency abuses of the corporate governance universe would be for institutional investors to reject the perceived requirement that they vote all shares on all issues. Perhaps if there were a complete and fair accounting of the full economic costs of the parallel universe of corporate governance, including the costs borne by corporations, institutional investors would realize the loss of shareholder value attributable to the ideology that generated that universe in the first place and would refuse to continue bearing the costs directly, and indirectly through corporate spending on public companies' counterpart corporate governance edifices.

In the meantime, US public companies appear to be doomed to a "grin and bear it" response to the corporate governance universe—a universe that will continue to thrive, notwithstanding its significant economic costs and lack of empirically substantiated benefits.

Endnotes

1. *See* Latham & Watkins Corporate Governance Commentaries: "The Parallel Universes of Institutional Investing and Institutional Voting", available at http://blogs.law.harvard.edu/corpgov/2010/04/06/the-parallel-universes-of-institutional-investing-and-institutional-voting; "Future of Institutional Share Voting: Three Paradigms", available at http://www.lw.com/thoughtLeadership/future-of-institutional-share-voting-three-paradigms; "Proxy Advisory Business: Apotheosis or Apogee?", available at http://www.lw.com/thoughtLeadership/corporate-governance-commentary-march-2011 (hereinafter called "Apotheosis or Apogee"); "Future of Institutional Share Voting Revisited: A Fourth Paradigm", available at http://www.lw.com/thoughtLeadership/4334-CorporateGovernanceCommentary-FutureofInstitutionalShareVotingRevisited-AFourthParadigm (hereinafter called "Fourth Paradigm").
2. Individual investors, likewise, are rationally apathetic about the exercise of the share voting franchise, notwithstanding "public service" educational campaigns advocating the merits of exercising the corporate franchise.
3. It is likewise obvious that the ultimate beneficial investors, who pool their investment funds in vehicles managed by institutional investors, share this view. They are patently not willing to pay their investment advisers for the research personnel and systems that would be required for the investment advisers to make individual voting decisions on the merits on all ballot issues presented each year for each portfolio company.
4. A less charitable view would be that many (perhaps most) corporate governance advocates are driven principally by a populist political ideology. This construct would help explain why the earliest and still staunchest supporters of corporate governance activism are union and union dominated pension funds and why the movement sees its principal mission as constraining the functions of managements and boards of directors and enhancing shareholder power.
5. *See*, e.g. Bew & Fields, "Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisors", Tapestry Networks and IRRC Institute (June 2012) available at [insert link if possible — Michele Bravo hs it] (hereinafter called the "Tapestry Networks Whitepaper").
6. *See* Tapestry Networks White Paper. Some insightful academics have recently modified the traditional Berle & Means view of agency capitalism. They have observed that the character of the vast bulk of shareholders of public companies has changed from mostly so-called "retail" investors to mostly institutional investors. The dramatic change in the demographics of share ownership in the US has not eliminated the agency issues inherent in the separation of management and ownership in the modern public company. Rather, it has created a second set of agency issues because of the intermediation of investment professionals between ultimate beneficial owners of collective pools of equity capital and the public companies in which their equity funds are invested. The growth of a separate universe of corporate governance specialists devoted to voting decisions rather than investment decisions has created yet a third, and largely unrecognized, agency problem. While ultimate beneficial owners of collective pools of capital and their delegated investment advisers are rationally apathetic about utilizing the share voting franchise outside of economically significant votes, corporate governance professionals care principally or only about the use of the franchise for non-economically significant votes and are narrowly focused on their view of good corporate governance policies and practices.
7. *See*, e.g., Semler Brossy "Say on Pay Reports" (May 30, 2012) available at http://www.semlerbrossy.com/sayonpay (hereinafter called "Semler Brossy"). See also the Tapestry Networks White Paper at 23-26.
8. *See*, e.g., Semler Brossy at "Appendix: Responses to ISS and Other Proxy Advisors on Say On Pay Recommendations" which summarizes the 105 proxy supplements filed as of June 14, 2012 criticizing various aspects of ISS and Glass Lewis Say on Pay recommendations.
9. *See*, e.g., Barrall, "Proxy Sesaon 2012: Seven Lessons for the Other 70 Percent", Los Angeles and San Francisco Daily Journal (May 22, 2012); Barrall, "Proxy Season 2012: The Year of Pay for Performance, Harvard Law School Forum Corporate Goverance and Financial Regulation, available at: http//blogs.law.harvard.edu/corpgov/2012/05/17/proxy-season-2012-the-year-of-pay-for-performance.
10. Semler Brossyin its Summary of Conclusions has voiced skepticism about the effectiveness of companies' post-recommendation proxy supplements and attendants in-person proxy solicitation at key investors ("Company responses to an 'against' recommendation from ISS do not appear to have a material impact on vote results"). It is not clear whether this observation accurately captures the results of such campaigns. It is also not clear whether the conclusion reflects anything more than the lack of time available to read and/or discuss the company response by the corporate governance specialists at most institutional investors during proxy season, when they may be responsible for literally hundreds or even thousands of votes a week. See the Tapestry Networks Whitepaper at 5-6.
11. Year around engagement by companies (preferably including company directors) with corporate governance specialists at core investors has become a world-wide corporate governance aspiration. The concept mimics the traditional year-round engagement of portfolio managers and buy side analysts by senior company management, with the glaring exception that it is not about business, profits or share value creation, but rather about corporate governance practices. While corporate governance engagement certainly provides great psychic income to the corporate governance universe, it of course results in yet additional opportunity cost, expense and distraction for directors and managers of public companies.

12. Semler Brossy is replete with data on the efforts of companies that received adverse Say on Pay votes in 2011 to rectify the situation in 2012 often by wholesale changes in their executive compensation policies. See also the Tapestry Networks Whitepaper for insights into the significance of the role played by the proxy advisors on Say on Pay and other votes and voting policies. The Tapestry Networks Whitepaper also substantiates the reality that many public companies adopt and/or change their corporate governance policies solely to conform to the policies of proxy advisory firms. These actions often are not a product of considered judgment by a board of directors concerning its view of proper corporate governance, but rather an obvious and usually effective effort to "go along to get along," regardless of the underlying merits.

13. Often borrowed from another country without regard to the similarity or dissimilarity to the US of that country's capital markets, corporate law, historic corporate governance structures and business culture. The idea that there should or can be global corporate governance best practices may make a good sound bite but does not bear thoughtful analysis; it is the equivalent of postulating that every country in the world should be governed in accordance with a single governance model.

14. *See* the Tapestry Networks Whitepaper. The process is strikingly similar to the fabled Wicked Witch's dialog with her mirror in the fairy tale Snow White.

15. We have observed in Apotheosis or Apogee and in the Fourth Paradigm that institutional investors' perceived obligation to vote all portfolio shares on all matters is bottomed not on an accurate interpretation of the fiduciary duty requirements under ERISA, the 1940 Investment Advisers Act or common law, but rather on a misreading of several ambiguous administrative interpretations issued by the Department of Labor and the SEC staff, none of which are imbedded in actual regulation. The perceived requirement that regulated investors must vote all portfolio shares on all matters, too, is a house of cards, albeit a house of cards based on ambiguous regulatory pronouncements and a failure to apply common sense and good legal judgment to a relatively simple problem.

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