BANKING ON CORPORATE

BY NEILL MAY

Advice from proxy advisers shouldn't just be blindly followed

It seems increasingly trendy these days to criticize the clout and role of proxy advisory firms, which are firms that specialize in advising their clients (typically large institutional investors) on how to exercise the voting rights attached to their investments in public companies. Although the highest profile debate about their activity was spawned a few years back by Institutional Shareholder Services Inc. when it recommended that Coke's shareholders vote against the election of Warren Buffett, one of North America's most influential investors, to the company's audit committee, the frequency of criticisms of proxy advisory firms has intensified recently.

There are many reasons for the increasing attention paid to proxy advisory firms, including the pressure on institutional investors to disclose their voting patterns, the growing focus on corporate votes generally in an era of shareholder activism, and the expanding influence and activity of the proxy advisory firms themselves. There is movement afoot as well on the regulatory front, with the U.S. Securities and Exchange Commission having devoted part of its concept release on the proxy system in the U.S. to questions concerning the role of proxy advisers. Proxy advisory firms are not suffering from a shortage of attention, and there's no apparent respite on the horizon.

The criticism generally has two prongs. First, proxy advisory firms may be conflicted, in that they offer, and often provide, consulting services to the public companies about whose shareholder votes they are making recommendations. The consulting services themselves can relate to the very subject matter of the votes, and how to avoid a negative recommendation. Maybe proxy advisory firms and their defenders would find this critique ironic, since such comments often come from parties who don't like the recommendations the proxy advisers have made. But that does not change the fact these potential conflicts are problematic, and that the issue is exacerbated if the proxy advisers make no disclosure of the conflicts when making their recommendations. On the issue of conflicts, sometimes critics of proxy advisers also point to the advisers' lack of share ownership as undermining their advice. However, even if this were an issue it should be understood by proxy advisory firms' clients and serves to actually *avoid* potential conflicts.

The second prong is the claim by critics that proxy advisers' advice lacks the complex and nuanced understanding required of the companies and issues in question. This criticism seems in part due to the formulaic manner in which proxy advisers' decisions sometimes appear to be reached. The recommendation against Buffett's audit committee role at Coke was based on a potential conflict of interest that tripped a flag under ISS's proxy guidelines. As one of Buffett's fellow directors wrote: "Maybe ISS has a strong point that Mr. Buffett's vote on the board can be swayed because a company that he probably forgot that he owned has a small contract with Coke that could add up to as much as three cents of his $50 billion fortune. . . . Maybe they should explain to the rest of the owners that Mr. Buffett's departure from the board against his will would cause a decline in the stock." Advocating for the removal of the Oracle of Omaha in strict application of a proxy voting guideline, where Buffett's association with the company might be expected to enhance value, seems a bit odd. The irony for proxy advisory firms in this context is that if they were to deviate from their guidelines they would likely be criticized for inconsistency.

A lack of nuanced understanding is related to the pointed criticism that proxy advisers simply lack the expertise to make recommendations on at least some of the subject matter they address. This is the root of the issue. Institutional investors have enormous voting influence, and many follow the recommendations of proxy advisers routinely (and, in some cases, automatically).

There is no *deus ex machina* response to this, nor is it clear that there needs to be one. Institutional investors clearly value proxy advisory firms' services, and often follow their recommendations. We can only hope that these institutional investors look carefully at the advice received, and consider whether it's serving their interests. And just as our securities laws recognize that one size doesn't always fit all public companies (for example, with respect to certain governance matters), hopefully the seemingly formulaic process employed by proxy advisory firms to provide advice to their clients will become more flexible and nuanced.

The bottom line is that proxy advisers are here to stay and clearly provide a service valued by many institutional investors, though it would obviously be preferable if the advice provided were regularly considered and evaluated. That said, my humble view is that the only advice you should blindly accept is that which is dispensed through this column, as I've never steered you wrong. But don't call with questions; I'll be too busy explaining to my teenage daughter why I think that corporate law issues are "trendy." CL

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