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Shareholder Engagement

Prepare Now for Next Proxy Season

By Steven Balet

Proxy advisory firms Institutional Shareholder Services (ISS) and Glass, Lewis & Co. retained strong influence over shareholder votes during the 2013 proxy season. But a subtle shift is underway as institutions move away from "voting with their feet" and selling a losing stock. Instead, they are staffing up compliance departments and proactively using corporate governance as a tool to improve corporate performance. To be sure, institutions are still buying the proxy advisor reports and expertise, but more and more consider the intelligence an important input and are not blindly following these firms' voting recommendations.

Companies are spotting this opening and learning to take their cases directly to the institutions. Management teams are beginning to view engagement as a deeper relationship-building process that can improve the odds of a successful voting outcome. This is a departure from companies' traditional practices of engaging institutions only during the proxy season in a mad scramble to get votes. Instead, they use the off-season to inform and educate institutions on their own unique corporate governance principles, and to explain outliers that do not fit the proxy advisors' specific guidelines.

Changing Dynamic of Influence

Historically, institutions voted in lockstep with proxy advisors. FTI research shows dissidents gain board seats more than 80 percent of the time when ISS supports them. A Semler Brossy report shows say-on-pay votes can shift by 30 percent with ISS opposition.

But data points have emerged that show companies are having more success as "yes" vote totals increased, even at companies where ISS did not switch its recommendation (which it did in 158 cases). Companies that received 50 percent to 70 percent in 2012 are receiving 17 percent more support, on average, in 2013. Overall, companies that received less than 70 percent approval ratings for say-on-pay plays gained 13 percent more on average the next year.

On the activist front, companies have been able to overcome ISS dissident slate support in some of the most visible proxy fights of 2013. AOL, Agrium, and Oshkosh all successfully defeated accomplished activist investors—Starboard Value, Jana Partners, and Carl Icahn—even though these activists received full or partial ISS support.

These institutions seem to be promoting a corporate dialogue and independent voting framework on issues they have identified as critical to a company's success. Lead steer institutions such as Fidelity and T. Rowe Price have sophisticated internal modeling on compensation issues that are often different from ISS's formula. Passive investors such as BlackRock, Dimensional Fund Advisors, SSgA Funds Management, Vanguard, and others have dedicated corporate governance teams that are open to discussing a company's compensation, corporate governance, potential shareholder proposals, and activist investor issues. Most large institutions have developed some type of proxy voting committee or corporate governance team. These committees accept input from the portfolio managers, but they retain the ultimate voting decision. Consider the following:

1. Meet in the off-season. With about half of all annual meetings occurring between March 1 and June 1 and thousands of votes to be cast, it is a busy time for proxy advisors and institutions alike. The proxy off-season—particularly October through January—when company governance specialists and proxy advisory firms are far less busy, is a better time. Management teams need to engage on the company's corporate governance strategy and be ready to explain the context of any previous policy outliers. This gives compliance professionals time to consider the proxy and develop a better understanding of the company's track record before the season begins.

2. Talk about corporate governance, not performance. Company engagements with these governance specialists should use the language of corporate governance rather than the typical communications aimed at a portfolio manager. Corporate governance professionals at an institution will have different concerns and mandates than a portfolio manager, and it's important to arm the portfolio manager with the right language to argue a governance position, not just defend the company's track record.

3. Talk through compensation. Discussions can revolve around modifications that could improve the plan from a governance perspective, better explain the company's chosen peer group, or more fully outline the compensation philosophy. Often compensation plans can be voted down based on clauses that are not particularly additive to an executive's compensation but are hot buttons with proxy voters.

The real benefit of direct engagement—in- or off-season—is the strong signal it sends institutions about the level of engagement of the board's compensation committee.

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