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Proxy Advisory Firms and Corporate Governance

In recent years the exercise of proxy voting rights by institutional investors has been taking off. Together with this there has been an increase in calls expressing concern over the influence of proxy advisory firms.

Proxy advisory firms refer to companies that offer advice related to the exercise of proxy voting rights by shareholders, with institutional investors serving as their primary clients. The exercise of proxy voting rights by pension funds and other institutional investors has been thriving in the United States since the latter half of the 1980s, and since the start of the 2000s in Japan. Prior to that, institutional investors had no interest in exercising their proxy voting rights (they would just sell their shares if they were displeased with the company's management), and so it was rare for them to exercise said rights by carefully scrutinizing the companies they were investing in. In 1988 the US Department of Labor expressed the view that "proxy voting rights are assets," resulting in a state of affairs whereby institutional investors were compelled to proactively make use of their proxy voting rights. But since the institutional investors lacked the investigative abilities and structures related to exercising their proxy voting rights, many such investors began to make use of the services provided by proxy advisory firms. Nowadays it is small and medium-sized institutional investors, which

lack the ability to investigate the management of the companies they are investing in, that comprise the major clients for proxy advisory firms.

Proxy advisory firms advise their clients on whether they should approve or reject the proposals submitted at general shareholders' meetings. Global proxy advisory firms include Institutional Shareholder Services, Inc. (ISS), Glass, Lewis & Co., LLC (both from the United States), and others.

ISS was established in 1985, and counts among its clients 1,700 institutional and other investors from around the world that have a total of roughly US\$25 trillion in invested assets. Every year it analyzes proposals from general shareholders' meetings from roughly 40,000 companies (of which about 3,000 are Japanese companies). Glass, Lewis & Co., LLC was established in 2003, and has approximately 800 customers with invested assets of approximately US\$15 trillion.

For institutional investors, the advantage of using a proxy advisory firm is that said investors do not have to closely scrutinize the proposals on their own. In Japan general shareholders' meetings are concentrated in the end of June. The degree to which they are concentrated has comparatively diminished relative to what it was before, yet institutional investors must still closely scrutinize the proposals of a large number of companies over an extremely short period of time and decide if they are for or against them. The only institutional investors who have the capabilities to do this are the major ones, and so following the recommendations of proxy advisory firms allows small and medium-sized institutional investors to reduce their costs.

Thanks to proxy advisory firms the rate at which institutional investors exercise their proxy voting rights has increased, but various problems have arisen along with their rising influence. There are also cases where proxy advisory firms provide consulting services to companies in order to evaluate their management, which has the potential to produce problems with conflicts of interest. What is more, in cases where there are proxy fights and the like there are oftentimes recommendations made by the institutional investors, but in cases where funds get entangled in this conflicts of interest with other stakeholders become problematic, as has recently been a topic of

conversation in Japan.

Institutional investors cannot ignore the trends surrounding proxy advisory firms, and now neither can companies. According to a survey conducted in the United States in 2012, 70% of 110 large or medium-sized enterprises replied that their executive compensation has been influenced by recommendations made by proxy advisory firms.

In 2012 ISS issued a recommendation to reject a proposal for director compensation at Hewlett-Packard Company (HP). This was done for the reason that when the company's board of directors decided on this incentive reward for its directors, it had not taken into consideration the booking of impairment losses from the money tied up in the acquisition of a software company. HP revised their compensation plan a mere several days before the general shareholders' meeting, following which ISS withdrew its recommendation to reject the proposal.

What is more, in its 2013 advisory policy for Japan, ISS recommended opposing proposals to nominate representative directors to companies that did not have a single outside director on their boards. Canon Inc. is a company without any outside directors, and at its general shareholders' meeting from 2013 approval for its proposal to nominate a representative director plunged downwards to 72% (from 91% the previous year). This is believed to have been affected by ISS's recommendation to oppose such proposals. On the other hand Toyota Motor Corporation, which introduced outside directors in 2013, obtained high approval ratings in the 95% and up range for all of its director nomination proposals.

As this indicates, the influence of proxy advisory firms is increasing in Japan, and as such the following two points could be brought up as issues that merit future consideration. The first point is that, as mentioned previously, the problem of conflicts of interest will occur since ISS provides consulting services to companies. The second point is that this industry is non-competitive. As things currently stand, ISS maintains a 65% share worldwide, with it claimed that the top two companies account for 97% of the total share.

Despite the fact that proxy advisory firms do not retain shareholders' rights they are still able to have an enormous influence on companies. At a public hearing in June 2013 before the US Congress, the fact that proxy advisory firms are capable of influencing companies in a manner that is not grounded in either their retaining shares as a shareholder or undertaking fiduciary duty as a manager was viewed as problematic and debated. There were also calls seeking legal revisions that would impose upon proxy advisory firms the duty of registering with the SEC. The Autorité des marchés financiers (AMF), which is the French finance agency, harbors similar concerns, and has demonstrated a proactive approach when it comes to fostering proxy advisory firms that are local (meaning within France). In addition, the AMF also recommends that institutional investors conclude contracts with multiple proxy advisory firms.

Conversely, major institutional investors are beginning to make decisions on exercising their proxy voting rights of their own accord. BlackRock, Inc., the world's largest index money manager, has a team of experts for its own corporate governance. They claim that the conclusions of the proxy advisory firms are nothing more than one resource, and that they do not necessarily make their decisions on exercising proxy voting rights based on their recommendations. While the influence of proxy advisory firms like ISS and Glass, Lewis & Co., LLC is incredibly large, forces that stand in opposition to them are being fostered in the West. In Japan, as well, setting in place a competitive environment for proxy advisory firms will surely be a challenge for the future.