



Shareholder engagement: the influence of proxy advisory firms and the role of the board

Introduction

On 29–30 June 2010, members of the European and North American Audit Committee Leadership Networks met in Amsterdam for their fifth annual summit meeting to discuss several topics¹, including shareholder engagement, the influence of proxy advisory firms and the role of the board.² For the discussion on shareholder engagement, members were joined by Mr Jean-Nicolas Caprasse, European corporate governance head for MSCI's ISS governance services business.³ *ViewPoints* provides a summary of the key points raised during this discussion, along with background information and selected perspectives that members shared before and after the meeting.⁴ For further information on the networks, see "About this document," on page 11. For a full list of participants, see Appendix 1, on page 12.

Executive summary

The nature of the relationship between companies and their shareholders has long been a matter of public debate, with widely differing views based on the country, the company, the type of investor and the economic climate. Today, as governments, regulators and market participants continue to unravel the causes of the financial crisis, they are asking important questions about the responsibilities of companies and investors to ensure a healthy system with checks and balances. Members gathered to discuss:

- **The changing context for shareholder engagement** (*Page 2*)

Several key trends are reshaping the landscape for shareholder engagement in Europe and the United States: the growing international diversity of companies' shareholders in Europe, a dramatic increase in institutional ownership in the United States and the extensive voluntary, regulatory and legislative changes that are creating new shareholder rights and responsibilities. As a result of these trends, shareholders are paying more attention to corporate governance issues. Interaction between investors and companies is increasing, and these changes are affecting voting at annual meetings.

- **Key challenges to more effective engagement with shareholders** (*Page 4*)

Differing priorities of distinct investor groups complicate the picture for companies seeking to engage with their shareholders. Long-term institutional investors, for example, may not have the desire or resources to engage directly with companies on corporate governance issues. In addition, board directors feel that

¹ Other summit discussions included "The convergence of accounting standards," and "Tax issues and the audit committee." *ViewPoints* for these discussions can be found at http://www.tapestrynetworks.com/networks/net_audit_summit5.html.

² The members are audit committee chairs on the boards of leading global public companies, typically with over \$10 billion in revenue.

³ On 1 June 2010, MSCI, a leading provider of investment decision support tools, completed its acquisition of RiskMetrics. ISS Governance Services, a division of MSCI, advises clients how to vote proxies with respect to securities held in their portfolios.

⁴ *ViewPoints* reflects the networks' use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made before, during and after meetings are not attributed to individuals or corporations. However, the guests have given permission for their remarks to be attributed. Comments by the guests and network members are shown in italics.



investors' reliance on proxy advisory firms interferes with companies' ability to engage effectively with shareholders.

- **Board directors can help their companies engage shareholders more effectively (Page 8)**

Some companies in Europe and the United States are beginning to experiment with board-shareholder forums as a means to discuss corporate governance issues and to solidify relationships with the largest investors “in good times.” Directors may also want to initiate proactive dialogue with proxy advisory firms to defuse the adversarial relationship that has often characterized interaction between them in the past.

The changing context for shareholder engagement

Over the past several decades, several trends have emerged that are reshaping the landscape of shareholder engagement. In Europe, reductions in barriers to international investment have led to an increase in the diversity of public company shareholders. For example, non-domestic investors in individual countries now own 37% of listed European companies – compared with 29% in 2003 – with the UK and Germany seeing some of the most significant shifts away from domestic ownership.⁵ Non-domestic ownership of the UK stock market is now at a record high of approximately 42%.⁶ In the United States, by comparison, the figure is approximately 16%.⁷ John Wilcox, former head of corporate governance at TIAA-CREF,⁸ recently told the *Financial Times*, “It is stimulating change. From the perspective of companies, you cannot separate the increase in the level of foreign shareholders from the higher level of corporate governance.”⁹

In the United States, institutional investors have steadily increased their ownership of the largest US corporations over the last 20 years.¹⁰ In 1987, the average institutional holdings of the top 1,000 US companies was approximately 47%, a figure that has risen to approximately 69% today.¹¹ The percentage is even higher when looking among the largest 25 US companies – institutional owners hold approximately 80% of Qualcomm, 78% of Google and 75% of Hewlett-Packard.¹² Such shifts can produce profound changes in how companies are run and how they behave – for example, a recent European Corporate Governance Institute study found that international institutional investment promotes what they define as good corporate governance practices.¹³

⁵ Richard Milne, “[Europe: A meeting of the minds](#),” *Financial Times*, 28 February 2010.

⁶ Anousha Sakoui, “[Foreign ownership could be good for Footsie](#),” *Financial Times*, 9 April 2010.

⁷ Michael Tsang and Adria Cimino, “[Rallying S&P 500 Never Cheaper in Europe on Dollar](#),” *Bloomberg.com*, 12 October 2009.

⁸ Teachers Insurance and Annuity Association (TIAA) and College Retirement Equities Fund (CREF), based in New York, is a leading provider of retirement accounts and products on a nonprofit basis to 3.7 million Americans in the academic, research, medical, cultural and nonprofit fields.

⁹ Richard Milne, “[Europe: A meeting of the minds](#).”

¹⁰ The Conference Board, “[The Conference Board Finds That The Recession Did Not Substantially Alter Institutional Investment](#),” press release, 6 October 2009.

¹¹ Matteo Tonello and Stephan Rabimov, *The 2009 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition* (New York: The Conference Board, 2009), page 26.

¹² *Ibid.*, page 27.

¹³ Reena Aggarwal, Isil Erel, Miguel A Ferreira and Pedro P Matos, *Does governance travel around the world? Evidence from institutional investors* (New York: Social Science Research Network Electronic Paper Collection, 2010).

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Change is also being driven by the widespread view that the global financial crisis was a result of failures in corporate governance (among other factors). This has set in motion voluntary, regulatory and legislative changes that favor shareholder rights, particularly on issues such as director elections and advisory votes on executive pay.

In Europe, change is taking place at a country level via reviews and updates to national corporate governance codes and new laws. The most recent country-level efforts tend to focus on enhancing board oversight of key issues, such as risk and executive pay, and on enhancing disclosures. The revised Dutch corporate code, for example, recommends more board oversight of pay.¹⁴ In Germany, a new law requires that pay decisions be made by the board, and it extends the power of the board to “make cuts in the level of [pay] in the event that the company’s situation worsens.”¹⁵

For European countries that are members of the European Union (EU), differing shareholder rights across member states have historically presented real obstacles to cross-border shareholder engagement. The newly implemented Shareholder Rights Directive was designed to remedy the situation by harmonizing shareholder rights pertaining to annual general meetings and voting across the EU. The directive sets standards such as how information is to be communicated prior to the meeting, allows shareholders with a 5% holding (either individually or collectively) to put items on the agenda, requires the company to answer shareholder questions at the meeting and forbids any limitations on shareholders’ participation and voting at the meeting.¹⁶ Mr Caprasse said that as a result, this year’s annual meetings have seen more voting activity, particularly in countries such as France, which incorporated the directive into national law well in advance of the 2010 annual meeting season.

In June, the European Commission launched a public consultation on proposed improvements to corporate governance in financial institutions. Experts say that the proposals go even further than some of the best practices put forth in the UK over the past year on issues such as director remuneration and the civil and criminal liabilities of directors.¹⁷ While this consultative document focuses primarily on banks and life insurance companies, the Commission has started work on a consultation paper relating to the corporate governance of all listed companies that is expected this autumn.¹⁸

In the United States, the Securities and Exchange Commission (SEC) has taken several steps to enhance shareholder rights in the aftermath of the financial crisis. It approved a New York Stock Exchange rule banning broker discretionary voting in uncontested elections of directors, a move that experts predict could tip the balance away from board members who are opposed by institutional investors.¹⁹ And, in order to arm shareholders with more information, the Commission has also enhanced disclosures rules for director

¹⁴ Dutch Corporate Governance Code Monitoring Committee, “[Monitoring Committee presents updated Corporate Governance Code.](#)” press release, 10 December 2008.

¹⁵ German Federal Ministry of Justice, “[Levels of management board remuneration to become more appropriate following adoption of new legislation.](#)” press release, 16 September 2009.

¹⁶ European Union, “[Directive 2007/36/EC of the European Parliament and of the Council on the exercise of certain rights of shareholders in listed companies.](#)” *Official Journal of the European Union*, 11 July 2007.

¹⁷ See Freshfields Bruckhaus Deringer, “[EC green paper on corporate governance in financial institutions.](#)” *Briefing*, June 2010. The green paper compares the proposals favorably with those put forward in Sir David Walker’s *A review of corporate governance in UK banks and other financial industry entities* and the Financial Services Authority’s consultation paper on corporate governance.

¹⁸ *Ibid.*

¹⁹ Joann Lublin, “[Directors Lose Elections, but Not Seats.](#)” *Wall Street Journal*, 28 September 2009.

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qualifications and elections, board structure and leadership, compensation (particularly the impact of pay on risk) and board risk management and oversight.²⁰ In July, the SEC issued a concept release seeking public comment on the US proxy system that governs how investors vote their shares at shareholder meetings. The concept release requests input on whether the current system allows accurate, transparent and efficient voting, enables sufficient communication with shareholders and shareholder participation, and the relationship between voting power and economic interest.²¹

The US legislative agenda has also been active: President Obama recently signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which includes governance provisions that will apply to all US public companies. While the final bill does not require companies to adopt a majority voting standard for director elections, it provides shareholders with an advisory vote on pay and gives the SEC authority to promulgate a proxy access rule that will allow shareholders to place their nominees on companies' proxy ballots.²² Proxy access is probably the provision generating the most concern for corporate boards, given the increased access this may provide to short-term investors looking to unseat directors.²³

Key challenges to more effective engagement with shareholders

While market participants often suggest that more active engagement between companies and their shareholders on corporate governance would be of benefit to all, challenges exist that limit such engagement:

- Investors have differing views on the importance of corporate governance
- Proxy advisory firms are seen to have unfair influence on shareholders

Investors have differing views on the importance of corporate governance

Mutual fund groups, pension funds, insurance groups and other institutional investors are among the largest shareholders of multinational public companies. These groups often identify themselves as long-term investors.

Traditionally, these investors have expressed their dissatisfaction with what a company is doing by selling their shares. However, as institutional investment holdings have grown and diversified, it has become harder to take this approach. For example, Roger Ferguson, president and CEO of TIAA-CREF, pointed out that “portfolios that aim to replicate the performance of a benchmark index can’t sell the shares of all underperforming companies.”²⁴ Instead, Mr Caprasse said, they may seek to “change corporate governance behavior.”

Of course, long-term investors do not share a common corporate governance agenda:

- **Some view corporate governance as more important than others.** Some investors view the quality of corporate governance as a key determinant of future performance; others do not. For example, CalPERS, the

²⁰ These disclosures will be enhanced further once the financial regulatory reform bill is passed: the bill directs the SEC to require that companies provide charts comparing executive pay with stock performance over a five-year period. See Melissa Klein Aguilar, “[Congress Nails Down Governance, Compliance Reforms](#),” *Compliance Week*, 29 June 2010.

²¹ The Securities and Exchange Commission, “[SEC Votes to Seek Public Comment on U.S. Proxy System](#),” press release, 14 July 2010.

²² Mary L. Schapiro, “[Embracing the Change](#),” speech to the 37th Annual Securities Regulation Institute, Coronado, CA, 20 January 2010.

²³ Ernst & Young and Tapestry Networks, “[The 2010 proxy season: a forewarning of what’s to come in 2011](#),” *InSights*, January 2010, page 9.

²⁴ Roger W. Ferguson, Jr., “[Riding Herd on Company Management](#),” *Wall Street Journal*, 27 April 2010.



largest public employee pension fund in the United States, is active on corporate governance: “We believe good corporate governance leads to better performance. We seek corporate reform to protect our investments. The corporate governance team challenges companies and the status quo.”²⁵ However, as Mr Caprasse stated, “Some investors have evangelist views. You have to live with the variety of views in your investor base.” A member shared an experience with such an investor group: “Our company has a combined chairman and CEO role. One of our investors came to meet with us and upon receipt of the chairman and CEO’s business card, threw the card on the table and left.”

- **Some devote internal resources to analyzing corporate governance, while others do not.** Active pension or labor-dominated funds²⁶ often take special care in developing their own views and policies on corporate governance and vote accordingly. They may have teams of up to a dozen employees focused on governance, voting and company engagement.

Others, such as some institutional fund managers,²⁷ may have determined there is no benefit in developing internal resources to do so. A member said, “Being active sounds like a good thing, but of course it requires knowledge and resources they might not have. It may detract from returns.” These investors may appear to follow the recommendations of the proxy advisory firms.²⁸ A member commented, “Index funds vote with ISS because they can’t justify to shareholders why they invest in their own analysis.”

- **Corporate governance analysts may not have significant influence on their portfolio managers’ buy and sell decisions.** One member noted that a lack of connectivity within institutional investor groups may also mean that discussions with the governance professionals are at odds with the thinking behind investment decisions. However, Mr Caprasse noted this is changing: “We are seeing that governance specialists [at our clients] are collaborating more directly with their investment colleagues, so they are having more influence within their organizations. And they have more influence when there are special issues, such as mergers and acquisitions and proxy fights, and high-concern governance issues.”
- **Some investors view voting their shares and company engagement as more important than others.** This issue has garnered significant attention from regulators, politicians, standards setters and other investor groups who question whether hands-off investors were implicated in the financial crisis.

In early July, the Financial Reporting Council published the UK Stewardship Code, with the goal of promoting more and better engagement. The code encourages (on a comply or explain basis) institutional investors to monitor the companies in which they invest, to publicly disclose how they will undertake their stewardship responsibilities and to have a clear policy on voting and the disclosure of their voting activity, among other recommendations.²⁹ It also lays out good practices for UK institutional investors seeking to engage with UK listed companies. The European Commission’s public consultation on corporate governance

²⁵ CalPERS, “[Corporate Governance](#).”

²⁶ Examples include ABI (Association of British Insurers), CalPERS, Change to Win, Governance for Owners, Hermes and PGGM (a Dutch pension fund administrator).

²⁷ Examples of institutional investors include Allianz Group, BlackRock, Crédit Agricole Asset Management, Invesco, Standard Life and State Street Global Advisors.

²⁸ Ernst & Young and Tapestry Networks, “[The 2010 proxy season: a forewarning of what’s to come in 2011](#),” page 8.

²⁹ Freshfields Bruckhaus Deringer, “[New UK Stewardship Code for institutional investors](#),” Briefing, July 2010.



in financial institutions also invites commentary on whether institutional investors should be required to adhere to a national or international code of best practice.³⁰

Short-term activist investors may use corporate governance to attract support for their agendas

Short-term activist investors are known to push for strategic and governance changes that they believe will boost the value of their shares for the period that they wish to own them, typically 18–24 months. For instance, The Children’s Investment Fund, one of the UK’s most aggressive activist hedge funds, removed the chairman and CEO of Germany’s Deutsche Börse (who famously called such activists “locusts”).

While short-term activist investors typically have an equity position of 2% or less in the large-cap companies they target, they often seek to ally themselves with other investors to bolster their position. To attract the support of other investors and the proxy advisory firms, short-term activists may use discontent with a company’s corporate governance as a platform. They may also threaten a public proxy contest, seeking to place directors on the boards of the companies they are targeting. A network member described this scenario: *“I call it the hedge fund manifesto: they use say on pay, etc., to attract the governance folks in. It’s a drawing card ... Once [the new directors] are on the board, they don’t mention the governance issues at all.”*

Proxy advisory firms are seen to have unfair influence on shareholders

Proxy advisory firms provide their investor clients with research services and voting recommendations with the goal of allowing their clients to make informed voting decisions more quickly and easily. Mr Caprasse said, *“Our clients are often the heads of corporate governance at large institutional investors. Here [in Europe], they’re often called the head of sustainable development, or environment, sustainability and governance. Some have set up proxy advisory committees to involve the portfolio managers and to ensure robust processes are in place.”*

Members voiced significant concern about the increasing influence of proxy advisory firms in the United States and Europe. Several members agreed with their European colleague who said, *“I see more and more disconnect between the real owners, who should care [about the governance of the companies they own], and intermediaries, to where this has been shifted.”* Members said that it was an especially worrying trend given how important corporate governance has become in how shareholders vote. Members articulated the following concerns about how proxy advisory firms operate:

- **Control of proxy votes.** A common concern among market participants is that many investors, and especially long-term institutional investors, follow proxy advisory firms’ recommendations without sufficient analysis. A member said, *“What I find most worrying is that shareholder activism is being channeled through [ISS]. Many [investors] leave their decision making to [this group] to decide how to vote.”* Some believe that proxy advisory firms actually make decisions on behalf of clients.

³⁰ Freshfields Bruckhaus Deringer, *“EC green paper on corporate governance in financial institutions.”*

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Mr Caprasse clarified, “[ISS] advises clients to make informed decisions. We don’t make the decisions for them; we don’t own shares.” However, Mr Caprasse acknowledged that “many of our clients can have voting guidelines that closely follow our recommendations.” He went on to explain that institutional investors create the demand for proxy advisors: “Back in the 1970’s, IRRC was the dominant governance advisor in the US. It offered facts to help clients make their own voting decisions. But investors, especially those with thousands of companies in their portfolios, said, ‘Please don’t just provide the facts; tell us how you think we should vote.’ Finally, a group of analysts spun off to form ISS. It is a real demand from our clients to help them prepare their decisions.”

In addition, Mr Caprasse pointed out that increasingly, clients are requesting custom policies from ISS that are developed based on the clients’ own voting policies. He said, “They have their own guidelines at a regional or country level. Four hundred institutional investors currently subscribe to a custom policy by ISS, 60% of our European clients and 40% of our US clients.”

All meeting participants agreed that the broader problem is getting investors to understand that it is their fiduciary responsibility to take voting more seriously. Mr Caprasse said, “ISS conducted research for the European Commission that identified that many European institutional investors are ‘absentee landlords.’ They don’t exercise their voting rights. Many need to step up to the plate.”

- **Policies that indicate a lack of understanding and nuance.** One member said, “In the United States, I see a mechanical, machine-like approach to some of the issues. [ISS] picks up an issue and does a computer scan and then contacts 200–300 companies demanding change. I wonder if some of this activism is mechanical or genuine.” Another said, “I see that ISS is formulaic in how it arrives at its recommendations.”

The role of proxy advisory firms in investor voting has come under the scrutiny of the SEC. As part of its 14 July concept release soliciting opinions on the US proxy system, the SEC is seeking views on whether proxy advisory firms conduct sufficient research in the development of their recommendations, and whether they should be subject to greater regulatory oversight.³¹

Mr Caprasse shared with members the approach ISS takes in developing its policies: “On the basis of 44,000 annual general meetings that we analyze in 108 markets, we develop our standard voting policy and update it on an annual basis. It’s an enormous workload. [For more specific regional policies], there are four main ingredients: the legal framework for shareholder rights in each country, best practices in the country (for example, the Combined Code in the UK), the expectations of our clients and company practices.”

- **Publication of their views in advance of annual meetings.** A US member said, “[ISS] makes its recommendations public in the press before the votes at the annual general meeting. That seems more like agitation, not just advice to a client.” Another asked, “Why does ISS issue its advice and recommendations through the press? This is why ISS is seen as an activist.”

Mr Caprasse stated that ISS’s approach is based on consultation with clients: “Our US clients, the majority of whom do not have a custom policy, see this as sensible, and the US press expects intermediaries will publish their general policies before the AGM [annual general meeting] season. However, our European clients [who more often subscribe to

³¹ The Securities and Exchange Commission, “SEC Votes to Seek Public Comment on U.S. Proxy System,” press release, 14 July 2010.



custom policies] say we shouldn't unduly influence [other investors] this way, and that we shouldn't comment until after the AGMs. That is our practice in Europe."

- **Conflicts of interest.** Many board directors believe that companies can influence the voting recommendations of proxy advisory firms by using the firms' corporate services: *"It feels like if you want to buy a good grade, you have to buy [the firm's] corporate governance services ... There is ... therefore a level of mistrust."* The SEC's concept release on the US proxy system is also seeking public comment on potential conflicts of interest in proxy advisory firms, and whether greater regulatory oversight is required.³²

Mr Caprasse said, *"ISS is a registered investment advisor with the SEC. This is not a requirement for proxy advisors. We did it on a voluntary basis to increase transparency and regulatory oversight of our activities. There has been no causality found regarding the conflict of interest and how we make our recommendations. We believe transparency is cleaner. We set up rules to manage our conflicts, and they are available on our website."*³³

- **Lack of engagement between companies and proxy advisory firms.** Several members said it was difficult to have a dialogue with the proxy advisory firms, especially regarding specific issues relating to their company. A member said, *"There is a low level of engagement with [proxy advisory] analysts."* Another added, *"If [proxy advisory firms] want to promote good corporate governance, they should engage [with companies]."*

Mr Caprasse stated, *"Our policy is to be open. We have recommendations on how we prefer to engage, such as that we never want to risk being an insider in a company, and there are certain times that are preferable for engagement, as investors and companies alike are bound by tight deadlines during the general meeting season."*³⁴

Some members complained that it was difficult to enter a dialogue on particular issues because of the short turnaround time the proxy advisory firms may request. A member said, *"[They] issue a letter on a Friday indicating their position, saying, 'If you don't clear it up by Monday, we will vote against you.'" Mr Caprasse noted that in a particular phase in the development of its independent analysis and voting recommendations, ISS solicits feedback on draft analyses within a 48-hour period: *"This is when we do fact checking and correct errors by analysts."**

- **Undue influence accorded to short-term activist investors.** In pre-meeting conversations, a few members also noted the influence proxy advisory firms may have on proxy battles. Some companies that have been subject to such proxy fights have found that the involvement of the proxy advisory firms increases the likelihood of success of the short-term activists and can increase the expense of resolving conflicts.

Board directors can help their companies engage shareholders more effectively

Given the complexity of investor issues companies face, a more direct form of board-shareholder engagement may be warranted, especially as annual meetings are not seen as conducive to meaningful dialogue. Directors may also want to ensure that their companies are more proactive in their engagement with the proxy advisory firms.

³² The Securities and Exchange Commission, ["SEC Votes to Seek Public Comment on U.S. Proxy System,"](#) press release, 14 July 2010

³³ ISS rules for managing conflicts of interest are available at <http://www.riskmetrics.com/practices>.

³⁴ For more information on ISS engagement policy, including frequently asked questions, see <http://www.riskmetrics.com/policy/EngagingWithISS>.

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Direct board-shareholder meetings

John Brennan, chairman emeritus of Vanguard, recently advised board directors to engage with investors, suggesting companies establish an “owner’s relations committee” at the board level that would “be charged with engaging the company’s serious, long-term stockholders on a regular, meaningful and candid basis.”³⁵ The director of corporate governance of a prominent London-based fund management group has proposed company board directors offer a “fifth analyst call” that would be focused entirely on corporate governance.

Some boards have adopted new approaches to enable direct interaction with shareholders. Slightly less than one quarter of the audit chairs attending the summit are involved with companies that have undertaken such an approach – with all but one based in the UK. One such member commented, *“Our company invited [a number] of our largest shareholders to an informal meeting for question and answers. It was before our AGM. Corporate governance was the topic, and there were clear ground rules about what could be discussed. Many participants were corporate governance folks from our largest investors. It was well received.”* In the United States, companies such as The Home Depot, HP and Northrop Grumman have held board dialogues with shareholders to discuss compensation issues or even board nominees.³⁶ Mr Caprasse said, *“I expect this trend to develop on the [European mainland] as well. Access there is complicated, and it varies by country. There will be some resistance at first because board members aren’t ready.”*

Several members were skeptical about the benefits of such an approach. One said, *“The fact is, the real owners know very well how to get in touch with management and boards if they want to know something ... I am puzzled by this.”* Several members voiced concern about the risk of unfairly disclosing material information to a limited number of shareholders. One noted, *“Shareholders won’t just come to talk about the sky and moon, without wanting to talk about the company. It’s difficult to defend that you are not providing advance notice to some privileged shareholders. There is a world of things to avoid.”* Another added, *“[Engagement] is primarily the role of management. However, the door should be open for access to a senior independent director.”*

Some of the benefits of direct board-shareholder engagement include avoiding costly shareholder proposals and gaining investors’ trust, especially before a difficult situation arises. While most members indicated that their boards did not intend to establish a program of regular board-shareholder communication, several members agreed with their colleague who said, *“It’s needed when it’s needed. Setting up a system to allow you to do this is important. Then, when you need it, you do it.”*

More direct board engagement with proxy advisory firms?

Given proxy advisory firms’ influence on shareholders, boards might be wise to engage with those firms as well. One member noted, *“My experience is that companies have to be proactive in terms of engagement with the proxy advisory firms. Then you may be able to change a recommendation. ISS has been more open, in my experience.”*

Directors have a range of options for engagement:

³⁵ John J. Brennan, “Improving Corporate Governance: A Memo to the Board,” *Wall Street Journal*, 10 May 2010.

³⁶ Gretchen Michals Salois, “A Failure to Communicate,” *Directorship*, 1 August 2009.

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- **Ask management to keep them informed of proxy advisory firm policies.** This is particularly critical if activism is likely to lead to a proxy fight, when it is essential that the proxy advisory firms recommend a vote with the company. Companies may also seek to understand the new Governance Risk Indicators (GRiD) methodology used by ISS, which provides important insight into how the firm views and ranks key corporate governance risks in differing regions. The methodology consists of a set of 60–80 questions across four different governance categories (audit, board, compensation and shareholder rights). Answers are weighted by market (due to differences in what is considered best practice and in the regulatory landscape) and arrive at an absolute score for each category.³⁷ One member said that GRiD “*is an improvement*” over ISS’s previous measurement tool, the Corporate Governance Quotient.
- **Ensure companies provide input to the proxy advisory firms when they are developing their policies.** Mr Caprasse noted, “*We make contact with companies on behalf of our clients when we update our policies. Then we have open, transparent discussions.*”
- **When a withhold vote is likely, contact the liaison the firm recommends, such as the regional head of corporate governance.** Mr Caprasse emphasized that ISS is open to dialogue and encouraged members seeking to discuss particular issues to contact the liaison the firms recommend, such as the regional heads of corporate governance. He stated, “*We appoint senior analysts whose sole job is to talk with companies to assist our other analysts.*” Mr Caprasse also noted that “*while we are open to listening, we may not accept the explanation. In some situations, we will; in others, we won’t.*”

Conclusion

Following on the fraud cases of the early 2000s and the financial crisis at the end of the decade, corporate governance has come to have more and more influence on how shareholders vote. One way for boards to handle the opportunistic activism of short-term investors and the occasional apathy of long-term investors is through engagement, perhaps even direct board-shareholder engagement. At a minimum, boards may want to establish a process for doing so, which could be called into action if issues arise that necessitate it. Given many institutional investors’ rely on proxy advisory firms, the latter will continue to have significant influence on shareholder voting for the foreseeable future, and here too, direct engagement may offer a way to replace mistrust with mutual understanding and useful interaction.

³⁷ Subodh Mishra, *Governance Risk Indicators: A New Measure of Governance-Related Risk* (New York: RiskMetrics, 2010).

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About this document

The European Audit Committee Leadership Network (EACLN) and Audit Committee Leadership Network (ACLN) are groups of audit committee chairs drawn from leading European and North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The networks are convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit committee environment.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management and their advisors as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, members of management and advisors who become systematically engaged in this dialogue, the more value will be created for all.

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Appendix 1: Participants at the Audit Committee Leadership Summit

European and North American Audit Committee Leadership Network members participating in the summit, who sit on the boards of approximately 50 large-, mid- and small-cap public companies between them, included:

- Mr Aldo Cardoso, Audit Committee Chair, GDF SUEZ
- Mr Leslie Brun, Audit Committee Chair, Merck
- Mr John Dillon, Audit Committee Chair, Caterpillar and DuPont
- Mr Douglas Flint, Audit Committee Chair, BP
- Mr Phil Hodgkinson, Audit Committee Chair, BT Group
- Ms Judy Richards Hope, Audit Committee Chair, General Mills and Union Pacific
- Mr Labe Jackson, Audit Committee Chair, JPMorgan Chase
- Ms Marie Knowles, Audit Committee Chair, McKesson
- Mr Daniel Lebègue, Audit Committee Chair, SCOR
- Mr Mike Losh, Audit Committee Chair, Aon and TRW Automotive
- Mr Oscar Munoz, Audit Committee Chair, Continental Airlines
- Sir Ian Prosser, Alumnus, former Audit Committee Chair, BP
- Mr Hans-Joerg Rudloff, Audit Committee Chair, Rosneft
- Ms Guylaine Saucier, Audit Committee Chair, Areva and Danone
- Mr Kees Storm, Audit Committee Chair, Anheuser-Busch InBev and Unilever
- Mr Tom de Swaan, Audit Committee Chair, GlaxoSmithKline and Royal Ahold
- Mr Jack Tai, Audit Committee Chair, ING
- Dr Bernd Voss, Audit Committee Chair, ABB
- Mr Mario Zibetti, Audit Committee Chair, Fiat Group

Ernst & Young leaders participating in the meeting included:

- Mr Tom Hough, Americas Vice Chair of Assurance Services
- Mr Steve Howe, Americas Managing Partner
- Mr Tom McGrath, Managing Partner, EMEIA Financial Services
- Mr Christian Mouillon, Global Vice Chair Assurance
- Mr Mark Otty, Managing Partner, EMEIA