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Time to look at regulating proxy advisory firms

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Executive Summary



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ISS and other proxy advisory firms' influence has been growing in recent years. ISS's recent recommendation to vote in favor of a shareholder proposal at Kuroda Electric's high-profile general shareholder meeting apparently influenced many shareholders' votes. Authorities should consider regulating proxy advisory firms to ensure the adequacy of their controls to prevent conflicts of interest and arbitrary or misinformed recommendations.

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Kuroda Electric's extraordinary general meeting of shareholders

Kuroda Electric, a Tokyo Stock Exchange First Section-listed company, held an extraordinary general meeting of shareholders on August 21, 2015. The meeting was convened at the request of certain shareholders, including two funds headed by Aya Nomura (nee Murakami), the eldest daughter of Yoshiaki Murakami, a once prominent activist investor who had disappeared from public view after being convicted of insider trading. The dissident shareholders proposed enlarging Kuroda Electric's Board by adding four new directors, including Mr. Murakami.

They argued that Kuroda Electric's governance is inadequate from shareholders' standpoint, as evidenced in part by issuance of convertible bonds with a conversion price substantially below the company's book value per share. They sought to elect Mr. Murakami and three other outsiders as directors. All four were in favor of returning 100% of the company's profits to shareholders for the next three years.

In response, Kuroda Electric's Board of Directors called attention to the company's governance reforms, including establishment of majority-independent nominating, compensation and audit committees charged with management oversight. The Board also argued that there was no need to appoint additional nonexecutive directors because the company is performing well in terms of both its earnings and share price. Additionally, the Board opposed the dissident shareholders' proposal on the grounds that election of Mr. Murakami and his three co-nominees as directors would be contrary to Kuroda Electric shareholders' long-term common interests and undermine the company's governance because all four are affiliated with a major shareholder or a party that represents the interests of a major shareholder.

NOTE

1) According to a Kuroda Electric press release. An ISS report (discussed in the main text) said that the dissident shareholders own 16% of Kuroda Electric.

2) Yuichi Ozaki, *Kikantoshika ni yoru giketsukenkoushi to giketsukenkoushijogengaisha*, in Shinsaku Iwahara et al. (Eds.), *Kaisha Kinyu Hou*, Shojihomu (2013), pp.187-. (in Japanese)

3) <https://www.issgovernance.com/file/policy/2015japanvotingguidelines.pdf>

4) ISS claimed that the problem was animosity between Kuroda Electric's management and Mr. Murakami. It argued that election of Mr. Murakami and his co-nominees as directors would stimulate discussion at board meetings to the benefit of shareholders' long-term interests because, even if Mr. Murakami et al. were elected, their four seats on the board would not constitute a majority and they would need to win the support of at least two other directors to pass board resolutions in favor of their proposals. This argument can be construed as a case-by-case recommendation under ISS's 2015 Japan Proxy Voting Guidelines, consistent with its benchmark recommendation to "generally vote for proposals that would improve the company's corporate governance or business profile at a reasonable cost." However, the advisability of disregarding the detriments of a less independent board is questionable.

At the general shareholders meeting, the dissident shareholders' proposal was defeated by a roughly 60-40 margin. Even though the dissident shareholders own only about 14%¹⁾ of Kuroda Electric's shares, their proposal garnered support from nearly 40% of shareholders, presumably because Institutional Shareholder Services (ISS), a major US proxy advisory firm, recommended that shareholders vote in favor of it. Founded in 1985, ISS pioneered the proxy voting advisory business. It is regarded as the most influential proxy voting advisor²⁾.

ISS opted against mechanically adhering to its benchmark recommendations

In a report to its clients, ISS disclosed the rationale behind its recommendation to vote in favor of the shareholder proposal. Interestingly, director nominees who, like Mr. Murakami in the Kuroda Electric case, are affiliated with, or represent the interests of, a major shareholder of the company in question are deemed insufficiently independent to be a non-executive director under ISS's own proxy voting guidelines. On Kuroda Electric's Board, three of six seats were already occupied by independent non-executive directors. If Mr. Murakami and his three co-nominees were elected to Kuroda Electric's Board, independent non-executive directors' share of the Board's seats would have been reduced from 50% to 30%.

In the case of companies, like Kuroda Electric, with a US-style three-committee board structure, ISS's 2015 Japan Proxy Voting Guidelines recommend voting against non-executive director nominees who do not meet ISS's independence criteria if the board would not be majority independent after the general shareholders meeting³⁾. Accordingly, in Kuroda Electric's case, where independent non-executive directors would have occupied only 30% of board seats if Mr. Murakami et al. had been elected, ISS should have recommended voting against Mr. Murakami et al. per its guidelines. In fact, ISS said in its report on Kuroda Electric that if it had mechanically applied its policy, shareholders would have been advised to vote against all nominees.

However, ISS deemed the Kuroda Electric case to be an exception. It argued that the four nominees were capable of providing new insights and needed to be elected because the current board members alone could not initiate changes in the way presented by the dissidents⁴⁾.

Such a recommendation that overlooks director nominees' lack of independence is at odds with the high degree of importance that ISS has usually placed on non-executive

5) Stephen M. Bainbridge, *Corporate Governance after the Financial Crisis*, Oxford University Press, 2012, p.258. At the time, Prof. Bainbridge wrote in a blog, "If Warren Buffett doesn't qualify as independent under the ISS and CalPERS [which likewise publicly opposed Buffett's nomination] standards, the problem is with the standards not Mr. Buffett."

directors' independence. In 2004, ISS even recommended voting against the legendary investor Warren Buffett's proposed appointment as a non-executive director of Coca-Cola on the grounds that Berkshire Hathaway, whose Board was and still is chaired by Mr. Buffett, owned a 10% equity stake in Coca-Cola⁵. More than a few observers are surely perplexed by ISS's value judgment implying that Mr. Murakami, who is notorious for pressuring investee companies' management to comply with his demands as a major shareholder, is more independent vis-à-vis Kuroda Electric than the Sage of Omaha was vis-à-vis Coca-Cola.

Additionally, ISS states in its own Proxy Voting Guidelines that it may recommend voting against individual directors given the existence of "egregious actions related to a director's service on other boards that raise substantial doubt about his or her ability to effectively oversee management and serve the best interests of shareholders at any company." However, Mr. Murakami's conviction for insider trading in violation of the Financial Instruments and Exchange Act apparently did not raise such doubts in ISS's mind.

6) Under the Companies Act (Article 331(1)(iii)), persons convicted of insider trading violations or other violations of the Financial Instruments and Exchange Act are barred from serving as a company director until completion of their probation or parole or until two years after completion or expiration of their prison sentence. Mr. Murakami completed his probation over 18 months ago and is therefore no longer barred from serving as a director by the Companies Act.

Regarding the insider trading conviction, the ISS report said that Mr. Murakami had already been penalized for the incident in question and is not legally barred from serving as a director of a listed company⁶. It went on to say that Mr. Murakami personally denies any wrongdoing and some observers believe that the charges against him were politically motivated. ISS argued that the important point for Kuroda Electric's shareholders is not Mr. Murakami's past actions but what he wants to accomplish at the company going forward. It recommended voting to elect Mr. Murakami as a director on these grounds.

Proxy advisory firms' growing influence

For institutional investors, appropriately exercising the voting rights associated with their shareholdings is an important part of their fiduciary duties to their shareholders' beneficial owners (e.g., pension plan participants). At the same time, scrutinizing and deciding how to vote on all proxy resolutions of all investee companies, which in some cases number in the thousands, requires enormous manpower. Additionally, from a macro perspective, it is very wasteful for every institutional investor to individually conduct due diligence on the same proxy resolutions, given today's widespread consensus on corporate governance best practices. In Japan in particular, it is practically impossible for many institutional investors to peruse all of their investee companies' proxy resolutions within the severe time constraints imposed by the

fact that the vast majority of Japanese companies have a March fiscal year-end and distribute their proxy materials shortly before their annual general shareholder meetings, most of which are held at around the same time in June.

Such being the case, institutional investors both in Japan and overseas are increasingly following ISS or another proxy advisory firm's voting recommendations or using a screening process whereby they automatically vote in favor of management's proposals if the company is performing satisfactorily and scrutinize proxy materials more closely only if the company seems problematic in some respect.

As a result, proxy advisory firms' recommendations have become increasingly influential in recent years as a driver of institutional investors' voting behavior. Moreover, in addition to ISS, reportedly the largest proxy advisory firm, there is only one other prominent proxy advisory firm: Glass, Lewis & Co.⁷⁾ These proxy advisory firms' recommendations are consequently becoming more likely to determine the outcome of shareholder votes. In response to such trends, the issue of whether proxy advisory firms should be regulated in some form is under discussion in Europe and the US⁸⁾.

7) Glass, Lewis & Co. recommended voting against Kuroda Electric shareholder proposal on the grounds that the dissident shareholders' plan to return 100% of profits to shareholders for the next three years would not enhance Kuroda Electric's medium/long-term value. It did not address the issue of Mr. Murakami and his co-nominees' independence.

8) For more details, see the Ozaki paper cited in Footnote 2 above.

Issues surrounding proxy voting recommendations

Proxy advisory firms disclose their own recommendation standards and prepare reports explaining the rationale behind their recommendations, as ISS did in the recent Kuroda Electric case. Institutional investors presumably usually follow the recommendations of a proxy advisory firm whose recommendation standards they agree with while occasionally delving deeper into the advisory firm's reports to make voting decisions.

However, problems still occur. For example, given the multitude of proxy resolutions on which recommendations must be made, concerns sometimes arise about whether a proxy advisory firm properly applied its recommendation standards to individual resolutions. In one such case reported in a blog⁹⁾, an individual appointed as a non-executive director of a listed Japanese company in 2009 was surprised to find that many votes were cast against his appointment. Upon investigating, he discovered that the nay votes were cast in response to a proxy advisory firm's recommendation to vote against him on the grounds that he lacked independence. The individual's job history included a temporary contract position with a company that is a major shareholder of the company at which he served as a nonexecutive

9) <http://www.tez.com/blog/archives/001419.html>

director. This temporary position (shokutaku) had been mistranslated into English as "former executive" and was the reason cited for the nominee's supposed lack of independence.

The risk of such mistranslations going undetected by institutional investors and leading to miscast votes cannot be eliminated, particularly in the case of foreign institutional investors voting on Japanese companies' proxy resolutions. Another risk is that proxy advisory firms could make not simply erroneous recommendations but arbitrary ones.

Of course, when proxy resolutions are expected to be contentious, including outright proxy fights like the recent Kuroda Electric episode, proxy advisory firms and the company in question typically engage actively with each other. Such dialogue would hopefully rectify any factual misunderstandings between the parties.

Another issue prone to differences of opinion is whether a proxy advisory firm should rigidly and mechanically apply its voting recommendation guidelines or, as ISS did in the Kuroda Electric case, make recommendations based on in-depth analysis of company-specific facts and circumstances. One way to preclude arbitrary decisions by proxy advisory firms is for them to set standards as formally as possible and rigidly apply those standards. However, this approach poses a risk of resulting in voting recommendations that do not appropriately reflect company-specific facts and circumstances¹⁰⁾.

¹⁰⁾ Ozaki, p.205.

Conclusion

While not currently subject to industry-specific regulations in Japan, proxy advisory firms undeniably wield growing influence. The advisory firms themselves have demonstrated a willingness to operate within a semi-public framework through such means as endorsing Japan's Stewardship Code unveiled in February 2014.

Credit rating agencies were previously also exempted from regulation in deference to freedom of speech on the grounds that their ratings are merely opinions, but the view that rating agencies need to be regulated given the extent of their market influence has become conventional wisdom in many countries. In Japan, credit rating agencies are now subject to moderate regulation (e.g., voluntary registration) pursuant to a 2009 amendment of the Financial Instruments and Exchange Act. The time has come for Japan to rethink regulation of proxy advisory firms also, focusing mainly on issues under discussion in Europe and the US, including establishing controls to ensure

appropriate recommendations, preventing conflict of interests and ensuring decision-making processes' transparency.

about NRI

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