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"Pre-Populated" Proxy Protocols and the Narrowing of Proxy Participation

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Editor's note: Thomas J. Dougherty is a partner at Skadden, Arps, Slate, Meagher & Flom LLP. This post is based on an excerpt from the Foreword of the 2017 Edition of The Directors' Handbook. The views expressed herein are not necessarily those of Skadden Arps or any one or more of its clients.

How many directors of U.S. publicly traded corporations are aware that the institutional investors that dominate share ownership, may utilize "pre-populated" voting instructions on shareholder vote issues rather than make individualized proxy vote decisions based on a reading of the issuer's proxy statement? I submit that very few are aware. And perhaps fewer still are aware that the provider of this splendid short-cut service is none other than Institutional Shareholder Services (ISS), the self-appointed proxy voting advisory firm that (along with Glass Lewis) has become a dominant factor in shareholder vote decision-making. In practice, under this "pre-populated" voting instruction protocol, an institutional investor can specify its presumptive votes on proxy issues (even a merger vote) *without* reference to the particular proxy disclosures and nuances of particular issuer specifics. All this, based on pre-selected predilections translated into pre-populated voting instructions automatically sent through ISS to the issuer, subject only to a manual override provided that (a) the institution chooses to look at the specifics of the vote; (b) the institution makes a timely change to the pre-populated vote; and (c) the mechanics of implementing the exception, (d), are successfully executed to reverse prior pre-population.

With three-quarters of *all* shares in publicly traded companies held by Depository Trust Company ("DTC"), ISS has placed itself between the institutional investors and institutional portfolio managers (and/or governance policy manager) and the share custodian Member of DTC in a way that not only "services" the institution's proxy voting implementation but streamlines it to a point that raises questions about over-simplification of issuer-specific desiderata, and the potential for ISS influence on voting decisions far beyond published ISS recommendations on issuer proxy matters. This process is dark. There is no regulation or transparency. It is worth corporate directors' and SEC attention.

Implications: Discretion Delegated is Discretion Darkened

As the institutional owners' practice of delegating proxy voting arose, institutional investors assimilated various voting practices through working group efforts to define and summarize practical guidance for institutional investors and those charged with oversight of proxy voting. Over the past several years preferred flavors or models of institutional proxy voting have arisen. These are, for the most part, self-explanatory—up to a point (the sharp end of that point being the increasing prevalence of pre-populated proxy voting protocols, as described below). At some institutions, the institution's board of directors retains *all* proxy voting authority over all of the many proxy votes cast by it on its many stockholding issuers' proxy ballots.

That is quite a challenge for large institutions. For that reason, many large institutions and others delegate proxy voting to a proxy committee—shifting the challenge one step aside, but not reducing it. Still other institutions delegate proxy voting to a full-time "governance staff." This further delegation (in each of its manifestations) has had its own effects: whereas a "governance staff" may be au courant with the latest "institutional consensus" on "reasonable" issuer governance methods (whether or not the institution itself practices same) that governance staff may be relatively clueless about the financial and strategic performance of any particular issuer in the institution's myriad stockholdings. Conversely, portfolio personnel (specialized in various industries) have less "governance" immersion or clout. Each such further delegation has its own drawbacks, and most institutions try to mix governance discretion with a bit of portfolio input (not necessarily via in-person discussion).

Enter now the "proxy service vendor," a useful means of reducing workload on any of those proxy voting model participants. Here, I refer particularly to ISS and Glass Lewis. No doubt there are a number of *administrative* functions that a third-party service provider can perform to help implement an institution's proxy voting, including gathering proxy statements, and ballots, and addressing the follow-on mechanics of effectuating the institution's voting decisions. But, in addition to those administrative functions, institutions increasingly have added the practice of "pre-population" of proxy votes by which the vendor suggests or predicts, in their view, how an institution would *likely* vote based on an institution's general policies. The institution is then free to leave in-place the vendor's suggested pre-populated vote, or negate it. But the latter requires timely institutional initiative in order that it matter. At this point, as a director of a Fortune 500 or Russell 2000 company, it likely has struck you—yikes! … that with "pre-population" it is entirely possible that the institution itself has *no one* who actually read the issuer's proxy statement.

But it gets curiouser. Consider index funds. They must own the shares of each issuer in the respectively index-tracked index fund. Yet, considering that the purpose of the index fund is to include related (often competing) issuers in the same industry regardless of individual differentiating factors, it is no surprise that index funds (and others) may delegate the *entire voting decision* to vendors such as ISS and Glass Lewis. Some legal academics have argued that such funds should instead direct the vendor to abstain on proxy votes. However, the magnitude of index funds among institutional (and all) owners would result in a black hole in the middle of ballot counts if that practice were adopted. For example, approximately two-thirds (63.76 percent as of June 2017) of The Walt Disney Company shares are owned by institutions and 25 percent of those are owned by index funds. Alternatively, index funds might appropriately vote all their shares in proportion to the other votes cast. This would at least avoid the risk that, by abstaining from voting on a proposed merger for example, where abstentions are effectively votes against, an otherwise favored merger would not receive a majority of votes cast due to a 10 to 15 percent level of abstentions by index fund shares.

Similarly, when a proxy statement is challenged as materially misinformative, it is U.S. Supreme Court law that a jury is instructed to determine whether information misstated or omitted would have had actual significance in the mind of a reasonable reader of the proxy statement. If two-thirds of the votes are cast by institutions which may, or presumptively do, delegate voting to vendors who "pre-populate" votes and/or base votes on policies (as filters for, or without regard to the proxy wording), then the reasonable investor assumption needs added thought and evidence to reflect these dynamics. As a starting point, it would help if Form N-PX were amended to require that each institutional vote listed on Form N-PX contain the suffix "V" if that voting decision was delegated to a third-party vendor such as ISS. I would suggest that now "you get the picture" except that the processes are so dark that no full picture develops for the following reasons.

The registered fund industry may be the most transparent of institutional investors. But even there significant limitations exist. The SEC requires registered management investment companies to file a Form N-PX by August 31 of each year containing the registrant's complete voting record for the most recent 12-month period ended June 30. But nothing in that form reveals who made the proxy vote decision on the basis of what information. Funds do disclose which proxy voting model they generally follow, but often no more.

Further, and equally importantly, Form N-PX contains no information about all the other consulting services for which ISS or Glass Lewis are concurrently paid by the institutional investors and/or the issuers of the subject proxies. Some equivalent of SEC auditor fee disclosure and of the duration that the vendor has been engaged as well as the voting and other services performed related to that Form N-PX-listed vote should be required to be included in the Form N-PX disclosure.

Other institutional investors are not even subject to Form N-PX requirements or their equivalent. Is it any wonder that ISS and Glass Lewis have developed a series of presumptive one-size-fits-all "good-governance" positions (recommended proxy votes) applicable to issuer board composition, takeover protections, CEO/chair role-splitting, diversity, proxy-access, say-on-pay, etc.? And in light of the delegation/concentration of voting discretion summarized above, it is unsurprising that many institutions subscribe generally to this consensus view of issuer governance.

Although those norms may be laudable in the main, they are neither a substitute for particularized examination of an issuer's own good reasoning, nor transparent in their implementation for the reasons noted above.

Years ago, Reliance Group approached Disney with potential $80 per share offer at a time when its stock was trading at a depressed price of $60 and its prospects for self-turn-around were good. Reliance may have split up the film library, movie studio and theme parks, then sold off one or more of them. But the Disney board declined that offer and kept to its strategy. In 18 months, the share price more than doubled. Today, the ISS and Glass Lewis recommended institutional governance-policy—adopted (or should I say "pre-populated") by most major institutional investors—is to *uniformly* oppose adoption of any shareholder rights plans by any issuer's directors seeking to gain time for the very type of turnaround Disney effected, *and* furthermore to recommend voting against any such directors of any issuer who dare take such action.

This constellation of factors is not healthy.