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GOVERNANCE PERSPECTIVES

THE 2013 PROXY SEASON: SIGNS OF A TURNING TIDE IN CORPORATE GOVERNANCE?

The 2013 proxy season has ended, and many public companies are in a period of relative calm on the governance front before the season for shareholder proposal submissions begins in a few months. This Jones Day *Governance Perspectives* reflects on some of the highlights of the past proxy season and a few events and trends that may shape the 2014 season.

DECLINING INFLUENCE OF PROXY ADVISORY FIRMS

Events in the 2013 proxy season have signaled that the era of blind adherence to proxy advisory firms' recommendations may be waning, at least to some degree. JPMorganChase's success in defeating a highly contested independent board chair proposal for the second year in a row provides some evidence that the influence of proxy advisory firms is decreasing, at least as to non-core governance issues outside the executive compensation area.

The JPMorganChase shareholder proposal won the support of only 32.2 percent of the votes cast at its 2013 annual meeting, despite Glass Lewis's and ISS's recommendations in favor of the proposal. A *Wall Street Journal* article relating to the vote even included this gem of a quote from a VP of proxy research at Glass Lewis: "Our power is probably shrinking a bit." Would that it were so—investors' reclaiming the power of the shareholder franchise would be good news for corporations and their boards, and for investors as well.

DEBUNKING THE "ONE-SIZE-FITS-ALL" LEADERSHIP STRUCTURE MYTH

JPMorganChase's success in defeating its independent board chair proposal also may signal that investors are abandoning the view that an independent board chair is the appropriate leadership structure for all U.S. public companies. Moreover, the fallacy of this "one-size" myth was supported by a 2013 study conducted at the Indiana University

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Kelley School of Business that examined the performance of 309 companies following the separation of their CEO and board chair roles. The study concluded that the roles should be split only when a company has a performance problem, and then by bringing in an independent board chair but maintaining the current CEO. Further, the researchers questioned why companies would demote their CEOs in the absence of performance issues:

> From our perspective, it appears that boards are acquiescing to outside pressure from activist investors or corporate governance watchdogs to separate the CEO and chairperson positions because it is "best practice." *Based on the evidence from our study, we believe this approach is a mistake.* (Emphasis added.)

The results of this study support a thoughtful and continuing analysis of the appropriate leadership structure on a company-by-company basis. Moreover, it provides ammunition for companies that choose to resist an independent board chair proposal—or choose to recombine their CEO and board chair roles. It also joins the ranks of several other empirical analyses that have provided evidence against so-called "best practices" and instead have supported the very governance practices that have come under attack in the last decade, including shareholder rights plans and classified boards.

FLUIDITY OF GOVERNANCE TRENDS

This in turn brings up an important point about governance trends—they are trends, and so by their nature are fluid and changing. Some of a company's governance practices can be dynamic as well—separated leadership roles can be recombined, and rescinded poison pills can be redeployed at a moment's notice. Other activist-driven changes to governance practices, however, may be permanent, at least from a practical perspective. For example, a company that grants the right to act by written consent to shareholders may never obtain shareholder approval to again restrict shareholder actions to duly called shareholder meetings.

Likewise, a company that declassifies its board of directors will not be able to reinstate staggered directorate terms. This is of particular importance in light of the continuing campaign to declassify public company boards spearheaded by Harvard Law School's Shareholder Rights Project ("SRP"), the unprecedented coalition between academia and several institutional investors, most of which are public pension funds. As of early July, SRP-backed declassification proposals have resulted in the declassification of the boards of 77 companies in the *Fortune* 500 and S&P 500. That is a staggering number, and 89 percent of S&P 500 companies now have annual director elections, compared to 82 percent at the end of 2012 and less than half 20 years ago.

Although some companies have resisted the force of the SRP, most of the companies targeted by these proposals have declassified to avoid the probable, serious, and continuing consequences of failing to respond to a successful shareholder declassification proposal. Given the current incidence of proxy contests and unsolicited takeover proposals, odds are that at least some of those declassified boards may at some point have reason to wish that they had preserved their once-staggered directorate terms.

INTERNALIZATION OF VOTING DECISIONS

Part of JPMorganChase's success may be attributable to the continuing internalization of the analyses of proxy proposals and related voting decisions. This trend gained additional attention in the 2013 proxy season when *The New York Times* published an article that discussed the letter that BlackRock, the world's largest private-sector asset manager, sent to the CEOs and/or board chairs of 600 U.S. public companies in 2012.

BlackRock's letter was intended to encourage the board chairs and/or independent directors of those companies to engage directly with BlackRock if corporate governance issues were to arise in the coming proxy season. The letter stated that BlackRock reaches its voting decisions using its own internally generated voting guidelines, which are developed independently from proxy advisory firms. Moreover,

BlackRock stated that *it applies its voting guidelines "pragmatically because we believe that effective corporate governance is nuanced.*" Of course, many companies and governance practitioners have long espoused that view, but it is refreshing to hear the position asserted so publicly by such an important fund family. And the influence of firms like BlackRock cannot be underestimated—with almost $4 trillion in funds under management, BlackRock owns a significant stake in approximately 40 percent of U.S. public companies.

Of course, scores of institutional investors—including Fidelity, Vanguard, and many others—have long relied on their own voting guidelines to make voting decisions. Many others create their own voting policies and supplement them with research and recommendations from proxy advisory firms. We believe that there is no substitute for thoughtful analysis of proxy proposals by an investor's own personnel using the investor's own voting guidelines, which reflect its investment priorities and strategies. It is clearly a better approach to decision-making than blind reliance on and deference to voting recommendations issued by advisory firms that have no investment in the companies that are the subjects of their recommendations nor any fiduciary responsibilities to their shareholders.

We hope that BlackRock's public articulation of the importance of thoughtful exercise of the suffrage by institutional investors will encourage other investors to further internalize analyses relating to matters on the corporate ballots of their portfolio companies and to make independent and informed voting decisions in a pragmatic manner. In addition, we hope that the recent appointment of a new SEC chair will prompt a renewal of the SEC's examination of whether and how these firms should be regulated, an effort that has lain dormant since the issuance of its "proxy plumbing" release in 2010.

CHALLENGES TO SHAREHOLDERS' RULE 14a-8 ELIGIBILITY

One interesting note in the 2013 season was National Fuel Gas Company's success in securing a withdrawal of a declassification proposal "sponsored" by a public pension fund after National Fuel filed litigation in federal court. The lawsuit challenged the fund's eligibility to submit the proposal because it had delegated voting authority over its National Fuel shares to a third-party investment manager. National Fuel's success may embolden other companies to adopt aggressive and creative tactics to preserve their classified board structures, and to challenge a proponent's eligibility to submit any kind of Rule 14a-8 proposal in federal court rather than through the SEC's no-action letter process.

EVER-EVOLVING ISS POLICIES

Of course, the late fall is the time that ISS and other proxy advisory firms reevaluate and revise their voting policies and, with past as prologue, we expect that those policies will be tightened, not loosened, for the 2014 proxy season. We already know that the ISS voting recommendations will put even more pressure on corporate boards to acquiesce to shareholder sentiment, as ISS's new policy regarding responses to majority-supported shareholder proposals will go into effect for the 2014 proxy season.

Overall, the 2013 proxy season may show that the notion of one-size governance "solutions" is waning and that there is a corresponding movement toward more independent, informed, and responsible investor participation in governance matters and voting decisions. Both trends would be welcomed in the 2014 proxy season and beyond.

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This issue is part of a new series of *Governance Perspectives*. As the year goes on, we will be writing to you periodically to report on new insights and developments and, most importantly, to suggest topics for consideration and deliberation in your boardrooms. Stay tuned for our thoughts on exclusive forum provisions, challenges to shareholder proposals, preserving board classification, shareholder activism, and other topics.

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