

AGENDA

RiskMetrics: A Growing Problem for Boards?

Article published on September 21, 2009

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With several proposals circulating in Congress and the **SEC** designed to give shareholders more rights, a number of organizations and individuals are concerned that institutional investors will outsource additional responsibilities to proxy advisory firms.

This would give even more power to the likes of **RiskMetrics Group**, the largest proxy advisory firm and the one that receives the most scrutiny from critics. Many directors complain that the firm already has too much power and that its business model is conflicted: One of the firm's divisions rates companies' governance structures, while another advises companies on fixing those structures.

In light of the additional scrutiny of the proxy advisory industry, some influential groups are calling for changes. The **Shareholder Communications Coalition** has been working with the SEC on issues to consider when the commission takes up a review of the proxy voting system, which is expected to begin this fall. One of the coalition's top issues is to get the SEC to review the proxy advisory firm industry and its influence over the way institutional investors vote. The coalition includes the **Business Roundtable**, the **National Association of Corporate Directors** (NACD), the **National Investor Relations Institute** (NIRI), the **Securities Transfer Association** and the **Society of Corporate Secretaries and Governance Professionals**.

The coalition isn't alone in its concerns. The **New York Stock Exchange** recently appointed a corporate governance commission that will discuss proxy advisory firms. The commission is scheduled to hold its first meeting early next month. Meanwhile, a task force of the American Bar Association recently requested that Congress and the SEC look into this issue.

NIRI raised its concerns to the SEC in a comment letter in March when the agency was considering amending Rule 452 in a way that would prohibit brokers from voting during director elections. (The SEC approved the amendment July 1.) "Any single change, like the implementation of this proposed Rule 452 amendment, without other changes to the proxy system may have unintended and devastating consequences... [including] an increased influence of proxy advisory firms through their voting recommendations," NIRI wrote.

In an environment with 452, say on pay and proxy access, “the proxy governance firms become all that more critical,” NIRI CEO **Jeff Morgan** says.

The increasing scrutiny of the industry attracts even more attention to RiskMetrics’ business model, which critics say is conflicted.

The company’s main business issues recommendations to institutional investors on how to vote their proxies and provides proprietary governance ratings for companies. But it also has a separate division that advises companies on how to improve their governance scores and how to craft compensation plans that RiskMetrics’ investor division will support. Its corporate advisory business accounts for only about 5% of the company’s total revenue.

“Some people ask, ‘Why don’t you just stop doing it?’ But there would be criticism if we didn’t provide a mechanism for companies to vet their plans through the company,” says **Pat McGurn**, special counsel at RiskMetrics. “We’ll be criticized whichever way we go.”

Over the years, RiskMetrics has strengthened the firewalls between its corporate advisory division and investor client services. The two divisions operate with a separate staff, separate systems and separate physical locations. “We have every firewall in place that we can think of, but are open to more suggestions,” McGurn says.

RiskMetrics has also tried to be more transparent in recent years. Last year was the first in which the company solicited feedback from issuers for its annual survey that helps shape any policy changes for proxy voting recommendations. More responses were actually received from issuers (390) than investors (317). The corporate responses represented a broad range of market caps and industry sectors; however, only 2.2% of them were from corporate directors. While the company is listening to more issuers, McGurn says that when there is disagreement between issuers and investors on a proxy voting issue the tie goes to investors. “Those are the ones we work for,” he says.

An Intermediary

Criticism of the proxy advisory industry is not new. The **U.S. Chamber of Commerce** has called for investigations into how proxy advisory firms influence proxy voting for several years. The **Government Accountability Office** issued a report on the topic in 2007 that essentially gave the industry a clean bill of health. But critics of the report say the GAO didn’t dig deep enough. “It’s too bad the GAO report did not really dig into the substance of the process and was too superficial,” **Lynn Turner**, former chief accountant with the SEC, told Agenda at the time. The report did acknowledge, however,

that smaller institutional investors generally rely more heavily on the advice of these firms.

Some directors, however, see value in the role of proxy advisors.

Paul Hobby, a director at **NRG Energy**, which was engaged in a proxy battle with **Exelon** this year, says proxy advisory firms can be most useful during such fights.

"Proxy contests may be the best use of these intermediaries, because there is limited time for road shows and two distinct options that must be reconciled into a definitive vote," he writes in an e-mail.

Hobby says the problem with proxy advisory firms is the box checking that occurs. "Any institution that is sophisticated enough to own large blocks of securities should be accountable for understanding who is running the place... It's always about people and good judgment," he says.

However, some experts say one way to minimize the influence of proxy advisory firms is to ignore them altogether and speak directly to shareholders. During its highly publicized proxy battle with **Bill Ackman's Pershing Square Capital Management** this year, Target spent, by some accounts, more than \$25 million for lawyers, bankers, public relations advisors and proxy solicitors (at least two were hired) to get its message out. **Proxy Governance** and RiskMetrics recommended that its clients vote for some of the dissidents to the board, while **Egan-Jones Proxy Services** recommended withholding votes for two incumbent directors. Target ended up winning the proxy battle and all of the incumbent directors were reelected.

The 'Say on Pay' Factor

The most attention proxy advisory firms have received lately has been around the discussion of say on pay. Companies and even some investors fear that it will be impossible for shareholders to adequately vote on compensation packages and philosophy if say on pay is mandated for all, or even most, public companies.

Instead, some fear institutional investors will outsource their voting duties to third parties and vote in lockstep with the advisory firms' recommendations.

RiskMetrics' McGurn says these claims represent a "fundamental misunderstanding."

"This idea of this robotic following of proxy advisors' recommendations is one of those urban myths," he says, adding that some institutions may do that, but not many.

However, in a compliance alert issued in July 2008, the SEC recognized ways in which proxy advisory firms may have too much influence over institutional investors. In some instances, funds had not established controls to confirm that the proxy service providers' recommendations were consistent with the funds' policies and procedures. Other funds voted in a manner that was inconsistent with their proxy voting policies.

Concern about investors' reliance on third-party recommendations has been a pivotal part of the say-on-pay debate and resulted in an alternative triennial say-on-pay proposal, which was submitted at 20 companies this year by the **United Brotherhood of Carpenters**. This calls for a vote on executive compensation every three years. **Microsoft** became the first company to adopt the policy recently.

Despite the triennial alternative, there is considerable momentum in Congress to pass a say-on-pay bill, which has already cleared the House of Representatives. The **Shareholder Forum**, an initiative spearheaded by investment banker **Gary Lutin** that has been looking into the issue of say on pay for several years, is entering what it calls the reality phase of its discussions. Since the bill passed the House, many forum participants feel mandatory say on pay is inevitable and have turned their attention to how it can be best implemented. A meeting hosted by **TIAA-Cref** and the New York Chapter of the National Association of Corporate Directors will be held on Oct. 21 to discuss this topic, including ways investors can effectively vote on pay without relying solely on the advice of third parties.

One possible solution is to create a neutral clearinghouse for compensation information for both issuers and corporations. Other ideas being considered include investor surveys (**Northrop Grumman** became the latest company to do this), and looking at how technology can effectively deliver information and exchange ideas.

"The clearinghouse idea is interesting and promising," says **Jeffrey Gordon**, a law professor at **Columbia University** who has been active in the say-on-pay shareholder forum. One of the important areas to consider with a clearinghouse, he says, is how much effort companies and shareholders will put into compensation questions when and if say on pay is passed. Many people are hoping the policy will create meaningful dialogue between investors and issuers, as has happened in the U.K. But some experts say that's unlikely because the shareholder base in the U.S. is so diverse and scattered and the precedent for dialogue between shareholders and management and boards is not as established as it is in parts of Europe.

Solutions Now

There are actions boards can take now to reduce the influence of proxy advisory firms if they see it as a problem. **Rachel Posner**, the general counsel of proxy solicitor **Georgeson**, says companies should review their

governance profiles (including their charter, bylaws and compensation plans) on an ongoing basis and especially before the proxy season heats up. RiskMetrics looks at those issues very carefully, so a board member should be well versed on what the company's corporate governance policies are, she says.

Another important step is for a company to understand who its shareholders are. "To the extent it's institutional, ask what policies they follow. Do they follow [RiskMetrics] blindly?" Posner says. While it can be difficult sometimes to find out which institutions outsource more of their voting duties to proxy advisory firms, with a little bit of research, it should be evident, she says.

Lastly, Posner recommends that boards get in touch with their shareholders to know what their concerns are.