REGULATING THE US WILDERNESS: AN INTERVIEW WITH MFS’ MATTHEW FILOSA

RETA KING THE WHEEL: ISS AUTO-VOTERS TAKE ACTION TO BECOME EVEN MORE PASSIVE
As the proxy season begins to slow, some reflection on what has been a rather tumultuous period seems warranted.

One could be forgiven for believing that this proxy season marked a year of shareholder dissent, typified as it was by several investor revolts with considerable levels of opposition.

However, behind the high-profile insurrections against executive pay, the data tells a different story. Although the average level of support for compensation reports has so far declined slightly among the FTSE 250 from 94 percent in 2016 to 93.9 percent in 2017, it has increased for the FTSE 100 from 90.5 to 92.3 percent.

It is a similar story for the S&P 500, with the average level of support for advisory votes on executive compensation increasing from 91.6 percent in 2016 to 92.2 percent in 2017.

These results are certainly much better than expected, especially in the UK where government rumblings about corporate reform precipitated many large investors to express stricter lines in an attempt to nip state regulation in the bud.

Nonetheless, the results show that most companies on both sides of the Atlantic took on board the widely-publicized concerns about executive pay and updated their compensation practices accordingly.

This month has also seen worldwide efforts at corporate reform that go beyond the saber-rattling of the UK government. Fidelity International has recently applauded a rise in five-year periods for long-term incentive plans (LTIPs) in the UK. 65 of the FTSE 100 and 179 of the FTSE 350 now use five-year retention periods for their LTIPs.

In the US, the Dodd-Frank Act’s usurper, the Financial Choice Act, has received flak for supposedly threatening the immemorial right of US investors to put forward shareholder proposals. However, the Act’s possible limiting of say on pay votes to material changes has received far less media attention than it probably should have.

Also in North America, Canada is still musing on whether to make say on pay mandatory for all listed companies after seven years of merely voluntary advisory votes.

However, it is once again Japan where corporate reform is most intense. With the recent updating of the Japanese Stewardship Code, the country’s asset managers have come under ever increasing pressure to disclose how they vote at the companies in which they invest.

Most recently, the world’s largest pension fund, Japan’s colossal Government Pension Investment Fund, waded into the debate, declaring that its managers should comply with the new disclosure requirements or explain why they have failed to do so.

Finally, CalPERS, Legal & General, Standard Life and BMO, not content with Japan’s gradual improvement in board independence, have apparently banded together in an attempt to pressure Japanese issuers into increasing the number of outside directors on Japanese boards to a third of its total members.

Our headline interview this month is with MFS’ Matthew Filosa. We discuss with Matt the current state of corporate governance in the US, and the attempt of MFS, along with other institutional investors, to regulate a landscape that lacks any definitive stewardship and corporate governance framework.

This issue’s main article utilizes ISS synthetic recommendations, a relatively new feature of Proxy Insight. In the article, we analyze ISS auto-voters – investors who usually default their voting rights to ISS.

From our data, we can ascertain on which resolution types auto-voters are most likely to override the recommendations of ISS in order to vote their preferred way.

In the near future, Proxy Insight will be launching its updated website. New features include a sleeker design and an enhanced user interface.

Proxy Insight is the only tool to offer the voting intelligence necessary to navigate today’s investor relations market. If you are not a client and would like to take a look, we would be delighted to offer you a trial. Please get in touch.

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As one of the oldest asset managers in the world, how has MFS Investment Management’s approach to proxy voting evolved over the years?

I joined MFS in 2005 after a few years on Fidelity’s proxy voting team. When I first joined MFS, proxy voting responsibilities only required about half my time, and I had a few other, unrelated legal responsibilities.

Fast-forward to today, where we have three full-time employees who are fully dedicated to our proxy voting activities. This is in large part, due to increased expectations from our clients.

Terms like “Engagement,” “Say on Pay,” and “ESG” were virtually non-existent just 10 years ago. Our clients, of course, have always expected us to be good stewards of their capital, but our proxy voting activities are now a much more critical component of that duty.

The main addition to your 2017 voting policy was a section on the issue of ‘overboarding’ for company directors. Is the number of boards on which company directors sit increasingly becoming a problem?

I think companies are generally mindful of how much more time it takes to serve on a public-company board today.

Many companies already have reasonable limits on how many boards their directors can sit on. Our goal was to help bring awareness to those companies that have not yet addressed this issue. While it admittedly feels a bit un-American to place a limit on someone’s ability, our policy may be just a starting point.

As expectations of boards continue to increase, it seems logical that the number of boards any one person could effectively serve on should also drop.

As a founding member of the Investor Stewardship Group, MFS Investment Management is part of an initiative to create a US stewardship and corporate governance framework. Could you talk a bit about the framework and what you hope it will achieve?

A few years ago, a small group of US asset owners and managers got together and asked why we didn’t have our own stewardship or corporate governance code, like many other markets outside the US.

So we worked for over two years to establish a framework that includes a set of corporate governance principles for public company boards, as well as a set of engagement principals for asset managers and owners.

Our primary goal was to establish a baseline for both corporate governance and engagement in the US, but we also felt it was important to address the misconception in the market that proxy advisory firms shape the way we think about corporate governance.

While proxy advisory firms provide very valuable services to many of us, we wanted to be clear that our proxy policies and votes are an expression of our own views.

Currently we have approximately $18 trillion in assets under management committed to the framework, and we are hoping that more US asset managers and owners will join us over the coming years.

Does MFS Investment Management have an official position with regards to the desire of the current US administration to unravel or reform specific aspects of the Dodd-Frank Act?

No, but as the US moves towards a more corporate-centric model of corporate governance, investors will need to reassess their proxy policies and activities.

For example, if the threshold for submitting shareholder proposals...
is increased to a level that virtually eliminates them, then investors will need to find other ways to engage with boards on a specific issue.

If there are no more shareholder proposals to de-stagger the board, will some investors begin to vote against directors for maintaining a staggered board? If I am on the board, I would rather have a shareholder proposal on the ballot in order to gauge shareholder sentiment before possibly losing a seat over the issue.

Do you think the contrast between possible deregulation in the US and the recent attempts of some European countries to increase executive pay regulations underlines a coming divergence between global corporate governance practices?

I am not sure why the US and Europe have diverged on this issue, but it’s clear that they’re moving in a very different direction.

We have regulators here in the US debating whether shareholders have too many votes on executive compensation, and we have regulators in Europe debating whether shareholders have too few votes on executive compensation. Quite a contrast.

There is now a variety of say-on-pay frameworks, from France’s two new binding votes to Australia’s two-strike system. Does MFS Investment Management have a preference?

No, but ultimately engagement on these issues is the critical component here. It can be very confusing for all parties involved to interpret the many different types of votes on executive compensation.

It can also be a bit of a challenge to untangle what exactly we are voting on. So explaining our views on executive compensation directly with the company via our global engagement program will become more critical as the votes become more complex.

Is there one ESG issue that MFS Investment Management considers of paramount importance this proxy season?

MFS believes strongly in workplace diversity. In the context of proxy voting, it is a very challenging issue to address.

We haven’t encountered many companies that are not focused on the issue and sincerely making efforts to increase its diversity either on the board, the executive team or the overall workplace.

The debate often surrounds what companies can do to provide shareholders with more comfort that all of their efforts and stated policies are producing positive outcomes.

Diversity data can be challenging to collect, and government data may not accurately portray the company’s diversity profile. But we do think it is reasonable at this point for companies to provide some level of qualitative data to ensure that the diversity initiatives are having the desired effects.

Board and management diversity data, which typically is available, may be enough for shareholders to analyze a company’s progress on diversity, but it’s unclear whether that represents the overall workplace.

Which country or region do you believe has improved its corporate governance the most over the past few years?

Certainly Japan has taken many positive steps towards better corporate governance, from mandating more independent directors to adopting a stewardship code, which has the effect of improving governance by thorough investor engagement. We would love it if their annual shareholder meetings weren’t all held on the same day.

If you could introduce one reform to improve corporate governance in the US, what would it be?

Majority voting in all director elections. By a mile. It’s funny, when I speak with our clients outside of the U.S., many of them have trouble even understanding the concept of plurality voting. We send letters to the NYSE and NASDAQ every year requesting them to consider adopting a majority voting listing standard, and we are hopeful that at some point it becomes the standard for all US companies.

Thank you Matt.

Mr. Filosa has managed the corporate governance and proxy voting practice at MFS Investment Management since March of 2005.

In his current role, he heads the proxy policy formulation process, shepherds the firm’s proxy engagement efforts and oversees the implementation of the proxy policy for over 2,000 portfolio companies in over 50 markets annually.

Matt earned his BA from Tufts University and his MBA from Boston University.
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Proxy Insight uses a synthetic vote system to calculate how ISS has recommended on specific proposals. These synthetic recommendations are calculated based on those investors who say that they follow ISS’ policy when voting proxies.

However, almost every one of these policies contains the caveat that investors retain the authority to override ISS’ recommendations.

Looking at Proxy Insight’s ISS Vote Comparator table, for most of these investors this is not a right they often feel compelled to exercise. The majority of them vote 99-100 percent in accordance with ISS. Of course, this correlation makes the investors a reliable source for discerning ISS recommendations.

However, we thought it would be interesting to look at what issues would make auto-voters override the voting recommendations of ISS, providing some insight into the proposals that matter most to these investors.

To do this we have taken the ten largest investors by assets under management who vote in accordance with ISS, and analyzed those proposal types where they override most frequently. These include say on pay, the re-/election of directors and auditor ratification.

Say on pay is not only one of the most frequently voted issues for auto-voters, but is also usually near the top (see Table 3) when it comes to the disparity between investor voting and ISS recommendations.

This is unsurprising, given that say on pay is one of the most contentious proxy voting topics, which is seemingly never out of the news.

However, as Table 1 illustrates, even on contentious issues auto-voters receive a correlation with ISS that ranges in the high 90s.

Moreover, the lower correlation on exclusively ISS against recommendations (Against recs (%)) indicates that the auto-voters are more passive than ISS, overriding the proxy adviser in order to vote with management.

Other proposals near the top of the list include the approval of stock option plans and restricted stock plans.

Naturally, if an investor is displeased with the compensation of a company they may not merely be content to oppose the advisory say on pay vote, but also any other associated compensation proposals up for approval.

The undue influence of proxy advisers is a common accusation. Taking this argument to its extreme, this month we look at those investors who delegate their voting entirely to ISS and see where they override its recommendations.
The second most commonly occurring resolution type where auto-voters differ from ISS’ recommendations is the re-/election of directors.

This may be explained by the fact that ISS has adopted the policy that directors are culpable for specific failings either in addition to, or in absence of, a standard resolution on the issue in question when concerns are serious enough.

For instance, ISS may oppose the re-election of directors sitting on a company’s compensation committee in addition to, or in the absence of, a say on pay vote on the company’s compensation. Auto-voters may find this approach to proxy voting too aggressive.

As Table 2 shows, the correlation between auto-voters and ISS on director re-/elections is not dissimilar to that of say on pay.

However, the correlation on only ISS against votes is considerably lower for some auto-voters. This suggests that such investors are substantially more passive than ISS on director re-/elections.

This leads on to one of the most interesting statistics to come out of this analysis, which is that some investors do not deviate from ISS in order to be able to oppose certain resolutions.

Rather, it seems that auto-voters, such as First Eagle and Grantham, Mayo, Van Otterloo, are choosing to vote more passively than ISS.

This is surprising, as it seems illogical for investors to acquire the services of a major proxy adviser, only to ignore its recommendations in favor of voting in line with management.

John Ferguson, Senior Partner from Saratoga Proxy, says that this is because “several funds portend to have adopted ISS or Glass Lewis voting guidelines but the on-the-ground reality is often quite different. Despite a fund’s disclosure of their voting process, there are often individuals at that fund willing to consider overriding advisory firm recommendations.”

Table 3 below shows correlation between auto-voters and ISS on key issues. From this data, you can see that the pattern of overriding ISS in order to vote with management applies virtually across the board.

Interestingly, it is only on shareholder proposals where auto-voters tend to vote more aggressively. Correlation is almost 100 percent when only ISS against recommendations are taken into account, suggesting that these investors not only tend to side with ISS in opposing shareholder resolutions, but also vote against proposals which ISS has not opposed.

In this case, of course, ‘aggressive’ still means siding with management, rather than the shareholders putting forward the proposals. The fact that this is the only context in which the trend flips supports the view that auto-voters have stronger faith in management than ISS, and are willing to override in order to express that faith.

The conclusion to be drawn from this analysis therefore seems to be that the auto-voters will, somewhat paradoxically, become more active in the realm of proxy voting in order to vote more passively than ISS recommends.
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State Street opposes non-voting shares

State Street has asked the SEC to prevent companies that adopt non-voting shares, such as Facebook, Alphabet and most recently Snap, from listing.

According to State Street Global Advisors’ Head of Corporate Governance, Rakhi Kumar, the US financial regulator needs to intervene on this matter, as shareholder efforts to stop companies limiting the voting rights of its investors have failed.

“We have engaged on this for years. Our ability to have an impact is limited. We think it has to come from the regulator to stop the dual share-class issue,” said Ms Kumar.

The most recent controversy surrounding US companies adopting non-voting shares is that of Snap Inc. In February, Snap disclosed that it would become the first US company to issue shares at its IPO that provided its shareholders with no voting rights. Unsurprisingly, many institutional investors were appalled at the lack of shareholder representation that Snap’s dual-class structure would provide.

Similarly, both Facebook and Alphabet have dual-class structures that allow their founders to own voting rights out of proportion to their capital investment in their respective companies. Currently, over a tenth of the S&P 500 index deviates from the one share, one vote norm by offering shares with limited voting power.

Morrison defends pay after shareholders rebel

Morrison has defended its pay practices after a rebellion by its shareholders. The supermarket giant has lashed out at ISS after nearly half of voters rejected an increase to chief executive David Potts’ LTIP.

48.1 percent of shareholders voted against plans to increase Mr Potts’ LTIP from 240 percent to 300 percent of base salary while also reducing performance targets. Interestingly, the concept of a pay rise for Mr Potts was actually spurred on by investor demand, following his dramatic reversal of the once-beleaguered company’s fortunes. However, ISS recommended that investors reject the changes to Mr Potts’ LTIP - a recommendation which over 48 percent of shareholders apparently agreed with.

Morrison was critical of ISS’ recommendation, with chairman Andy Higginson saying that the supermarket “fundamentally disagree[s] with the ISS analysis of the performance targets.” Mr Higginson also said that the company had “consulted widely with shareholders on the new remuneration policy which received […] more than 92 percent in favor,” making the level of opposition encountered at the meeting something of a surprise.

While the changes to Mr Potts’ LTIP were unpopular, pay as a whole went down relatively smoothly with Morrison shares. The implementation of the LTIP was supported by 92.4 percent, and a binding vote on the company’s remuneration policy was passed by 92.3 percent.

Will Mrs May renege on corporate reform?

Given the importance of the upcoming Brexit talks, many proponents of corporate reform are worried that Prime Minister May’s promise to overhaul UK corporate practices will fall by the wayside.

According to Stefan Stern, director of the High Pay Centre, corporate-governance legislation is now “in the balance.” It is expected that issues central to Mrs May’s corporate governance reform, such as pay ratios, annual votes on pay and worker representation on boards, are to be abandoned.

Naturally, it seems unlikely that Mrs May would utilize her valuable parliamentary time and limited political capital for changes in corporate governance, given more pressing matters.
Abercrombie & Fitch’s long battle for proxy access

A long battle to enact proxy access at Abercrombie & Fitch seemingly reached its conclusion at this month’s annual meeting. This is the fourth year running that proxy access has appeared on the ballot in one form or another but, despite consistent majority support, circumstances have so far kept it from being enacted.

A shareholder proposal for proxy access was originally put before the company’s 2014 annual meeting. The board recommended that shareholders reject the proposal, but instead it was passed with a 55.2 percent majority. However, the proposal asked the board to present the necessary bylaw amendments to shareholders for approval, and that proved to be a bigger obstacle than was likely anticipated.

Management’s bylaw amendments, which were in line with the criteria requested by the original shareholder proposal, appeared on the ballots at the company’s 2015 and 2016 annual meetings. In both cases, the resolution received support from a significant majority of votes cast - 87.6 percent the first time and 85.8 percent the following year.

However, under the company’s bylaws, the resolutions required the support of at least two thirds of all shares outstanding in the company. In both years, the number votes actually cast was not sufficient to hit this target.

At June’s AGM, the matter of proxy access returned to the ballot for the fourth time. This year, however, it once again took the form of a shareholder proposal asking for proxy access to be provided. It was, as the supporting statement acknowledged, almost identical to the request made in 2014.

But there was one important difference; management was asked to directly implement the necessary bylaw amendments rather than present them to shareholders. With 82.3 percent of voters supporting the resolution it seems that, three years and four meetings after they first voted for it, the company’s shareholders have finally gained the right to nominate directors.

CalPERS considers slight executive pay increase

CalPERS is considering increasing the base salaries of the pension fund’s senior executives and top investment managers by as much as 5 percent.

The increase is a direct result of an attempt by CalPERS to overhaul its pay structure in light of findings that the current structure was inadequate and created “potential difficulty in the hiring and retention of qualified candidates for key positions.”

CalPERS, as a staunch critic of both poor corporate governance practices and excessive remuneration, recognizes that this slight increase in salary could have negative ramifications for the pension fund’s public image.

According to CalPERS, the challenge for the pension fund’s remuneration committee is to set pay “high enough to encourage individuals to accept and remain in positions, but not so high as to attract candidates solely for the compensation.”

Study says say-on-pay is working

A study from the University of Georgia has indicated that say-on-pay seems to be doing exactly what it is supposed to. When executive pay is put to a shareholder vote, the study found, company values rise and executive remuneration falls.

The study looked at over 17,000 listed companies spread across a number of jurisdictions. Some of these areas mandate regular say-on-pay votes, and others have no such requirements. Comparing the two, researchers reached several conclusions which seem to support the value of giving shareholders a role in determining pay.

In companies which have say-on-pay votes, the study found, executive remuneration is likely to be more closely linked with company performance. On average, the passing of say-on-pay laws leads to a 7 percent drop in CEO pay, with much steeper declines seen in companies which have been criticized for overly generous compensation packages. This is generally followed by growth, but at a slower rate than in jurisdictions with no say-on-pay requirements. Company valuations, on the other hand, tend to increase when say-on-pay votes are introduced.

Interestingly, there was only a modest difference between the impact of binding and non-binding votes, and even low levels of shareholder opposition in a vote can help drive change. The study also found that where say-on-pay votes are in effect, the disparity between pay for the chief executive and other senior management was less marked than in other regions.
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