The Ideal Proxy Statement

By David F. Larcker and Brian Tayan
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INTRODUCTION

Institutional investors are highly dissatisfied with the quality of information they receive about corporate governance policies and practices in the annual proxy. Across the board, investors want proxies to be shorter, more concise, more candid, and less legal. According to a recent survey by RR Donnelley, Equilar, and the Rock Center for Corporate Governance at Stanford University, 55 percent of investors believe that the typical proxy statement is too long. Forty-eight percent believe that it is difficult to read and understand. Investors claim to read only 32 percent of a typical proxy, on average. They report that the ideal length of a proxy is 25 pages, compared with an actual average of 80 pages among companies in the Russell 3000.[1]

The fundamental complaint about proxies is rooted in a perception that companies are not communicating candidly with owners. Shareholders want corporations to *explain* information rather than *disclose* it. Investors view corporations as using the proxy as a vehicle to meet disclosure obligations without a willingness to provide information in a format that is clear and understandable to a typical—or even sophisticated—owner.

The largest complaint involves executive compensation and the inability of investors to read the information that companies disclose and determine whether senior management is paid appropriately. According to the survey above, less than half (38 percent) of institutional investors believe that executive compensation is clearly and effectively disclosed in the proxy. Responses are consistently negative across all elements of compensation disclosure. Sixty-five percent say that the relation between compensation and risk is "not at all" clear. Forty-eight percent say that it is "not at all" clear that the size of compensation is appropriate. Forty-three percent believe that it is "not at all" clear whether performance-based compensation plans are based on rigorous goals. Significant minorities cannot determine whether the structure of executive compensation is appropriate (39 percent), cannot understand the relation between compensation and performance (25 percent), and cannot determine whether compensation is well-aligned with shareholder interests (22 percent). Investors also express considerable dissatisfaction with the disclosure of potential payouts to executives under long-term performance plans.

Inadequate disclosure negatively impacts the voting process. Only half (54 percent) believe that the proxy allows them to make an informed decision regarding "say on pay" (see Exhibit 1).

THE IDEAL PROXY

The challenge that corporations face is to find a solution that satisfies investor demands for clarity while at the same time satisfying numerous regulatory requirements for the disclosure of specific elements. Based on the feedback of major institutional asset owners and asset managers, the ideal proxy would include the following:

Context. Investors believe that proxies, as written today, lack context. In the words of one investor: "We've lost sight of what the proxy is for. It's become a catch-all for non-financial information." Investors want to know how the company's governance choices are informed by its strategic goals, in particular its choices relating to board composition, shareholder rights, financial targets, performance measurement, and executive compensation:

> *Contextualize it. I cannot recall reading a proxy and walking away with a full appreciation of the link between the pay structure, where the company wants to go, and how it will get there. Instead, it's a bunch of discrete information that's disconnected and too long. It forces the reader to fill in the blanks.*

Investors want companies to avoid the use of boilerplate, legal, and compliance-oriented language and instead to describe the context for corporate decision making in simple and direct language. Preferably, this information would come from the independent chairman or lead director (~1 page in length).

Investors cite Pfizer as a company that does a notable job of summarizing governance information in the proxy.

Board Composition. Investors want a better understanding of why each director is on the board and how they contribute to the corporate strategy and governance of the firm. This information could take the form of a skills matrix that maps director qualifications to the needs of the organization. Shareholders would be able to make decisions about director reelection based on their assessment of the company's performance in each of these areas. Investors also want to understand the process for committee assignments, director evaluation, and refreshing the board over time, including some information about board succession planning.[2] In addition, the proxy should continue to summarize the company's ownership guidelines and provide a table on director compensation and ownership levels (~2 pages).

Investors cite The Coca-Cola Company as an example of a company that does an exemplary job describing director qualifications and the value they add to the board.

Compensation. The compensation section of the proxy could be improved through a more concise presentation of data and clearer description of how compensation is tied to long-term strategy, financial metrics, and risk. According to one investor, the compensation section of the proxy would benefit from context: "A big sticking point for us is that we want to see better disclosure, not more disclosure." According to another, investors need better information to help them determine whether pay levels are appropriate: "Pay can be perfectly aligned with performance, yet still be too high." To improve their understanding of these issues, investors would like to see the following:

- The value of compensation granted, realized, and realizable by named executives during the year.
- Comparable data among peers or industry averages.
- Metrics, targets, and weightings used to award performance-based awards.
- The company's actual performance relative to targets.
- Outstanding awards and the conditions under which they can be realized.
- A justification for discretionary payments.
- Ownership guidelines and ownership levels. (~4 pages).

Investors cite Apple and ExxonMobil as two companies that do a particularly good job framing and discussing compensation practices.

Shareholder Rights. Investors want a concise summary of charter and bylaw provisions that spells out their rights to influence the corporation, including changes made in recent years and an explanation of why those changes were made. They want plain-language statements of company opposition to shareholder-sponsored proposals, and an explanation of the process the board will take in response to shareholder engagement (~1 page, plus summary discussion for each proposal).[3]

Ironically, the ideal proxy statement today in many ways resembles proxy statements as written over fifty years ago. Then, a typical proxy was less than 10 pages in length, was simple in design and language, and contained a specificity of disclosure consistent with what investors are requesting today.[4]

Regulatory requirements and investor demands for information make a return to historical proxy formats unlikely. Still, one approach that suggests itself from the research above is to make expanded use of a summary section at the beginning of proxies for increased clarity, while retaining detail in the body. Investors express considerable preference for summarized data, and respondents to the survey above claim they are most likely to read the summary section first (see Exhibit 2). This is consistent with the practice of including a summary prospectus in the event of a merger or acquisition.

WHY THIS MATTERS

1. Corporate proxies contain more disclosure than ever, and yet investors are highly dissatisfied with the quality of information they receive. What changes can companies make so that proxies contain the detailed information that investors want, in a format that is easy to read and navigate?
2. Would shareholder understanding of corporate governance practices improve if companies provided clearer and more succinct information in a summary proxy statement—with detailed, supplementary information available on the Internet for those shareholders that value it?
3. How might the debate about executive compensation change if shareholders were given more useful information to determine whether pay packages are appropriate? Would this improve the effectiveness of "say on pay" voting to rein in bad practices? ■

[1] All figures and quotes in this Closer Look are derived from: RR Donnelly, Equilar, and The Rock Center for Corporate Governance at Stanford University, "2015 Investor Survey: Deconstructing Proxies—What Matters to Investors" (2015).

[2] For a discussion of committee assignments, see: David F. Larcker, Brian Tayan, and Christina Zhu, "A Meeting of the Minds: How Do Companies Distribute Knowledge and Workload Across Board Committees?" Stanford Closer Look Series CGRP-46 (December 8, 2014).

[3] The recent controversy on proxy access proposals is one example of an issue where shareholders want more information from the company. For example, in January 2015, the SEC reversed a previous decision to allow Whole Foods to exclude a resolution allowing certain qualifying shareholders the right to nominate candidates to the board of directors. Shareholders will want the company to explain what actions, if any, it will take in response to the proposal and its outcome.

[4] See: David F. Larcker and Brian Tayan, "A Historical Look at Compensation and Disclosure: Cool and Refreshing!" Stanford Closer Look Series CGRP-04 (June 15, 2010).

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The Stanford Closer Look Series is a collection of short case studies that explore topics, issues, and controversies in corporate governance and leadership. The Closer Look Series is published by the Corporate Governance Research Initiative at the Stanford Graduate School of Business and the Rock Center for Corporate Governance at Stanford University. For more information, visit: http://www.gsb.stanford.edu/faculty-research/programs/cgri.

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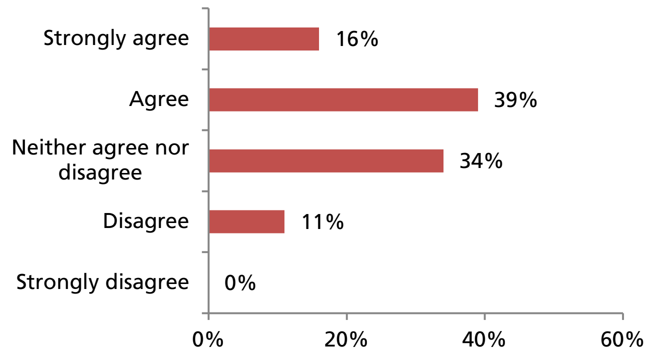
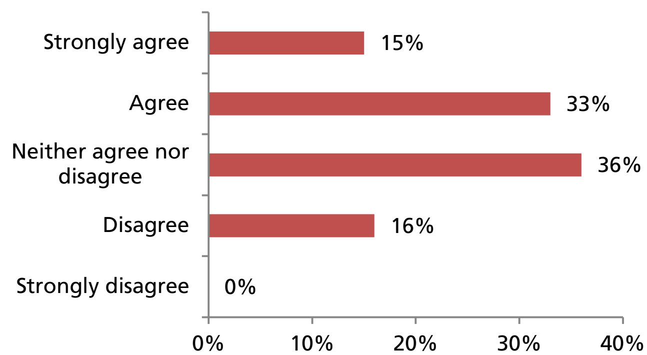
EXHIBIT 1 — INVESTOR PERSPECTIVE ON PROXY DISCLOSURE

TO WHAT EXTENT DO YOU AGREE WITH THE FOLLOWING STATEMENT: "THE TYPICAL PROXY STATEMENT IS TOO LONG"?



TO WHAT EXTENT DO YOU AGREE WITH THE FOLLOWING STATEMENT: "THE TYPICAL PROXY STATEMENT IS DIFFICULT TO READ AND UNDERSTAND"?



IN GENERAL, DO YOU BELIEVE THAT INFORMATION ABOUT EXECUTIVE COMPENSATION IS CLEARLY AND EFFECTIVELY DISCLOSED IN PROXY STATEMENTS?

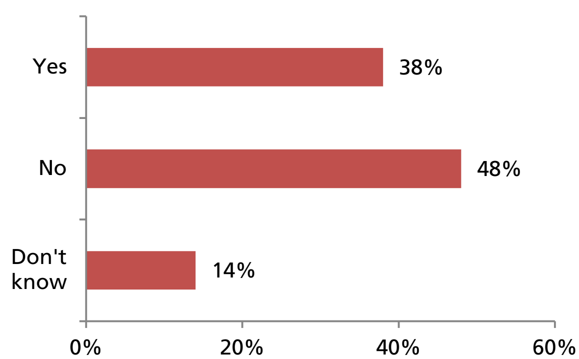
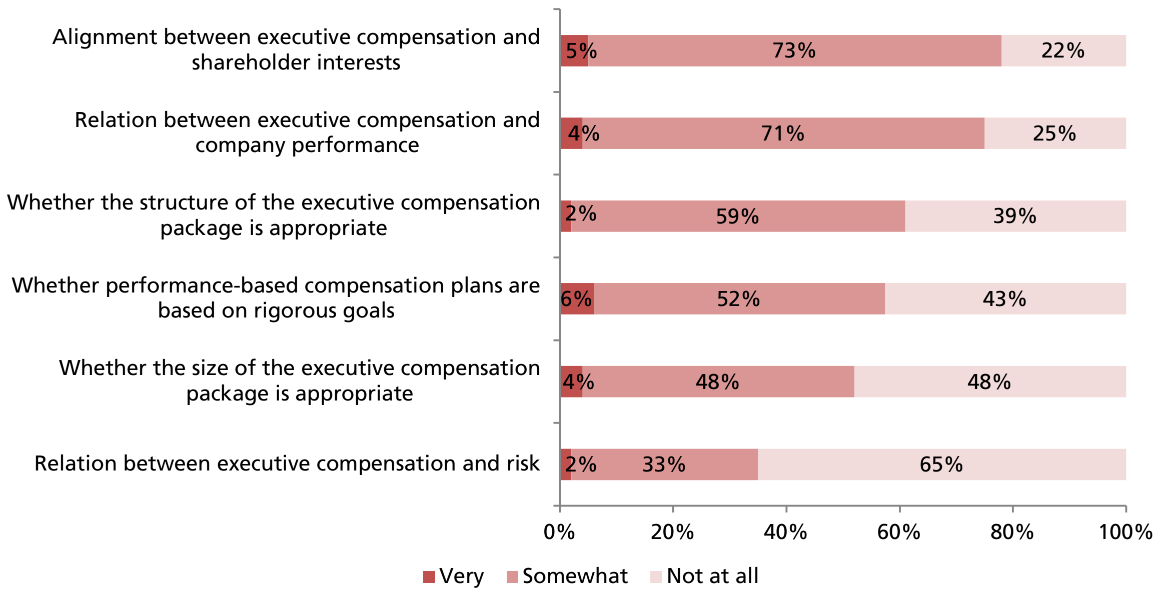


EXHIBIT 1 — CONTINUED

ON AVERAGE, HOW CLEAR AND EFFECTIVE ARE PROXY STATEMENTS IN HELPING YOU TO UNDERSTAND THE FOLLOWING?



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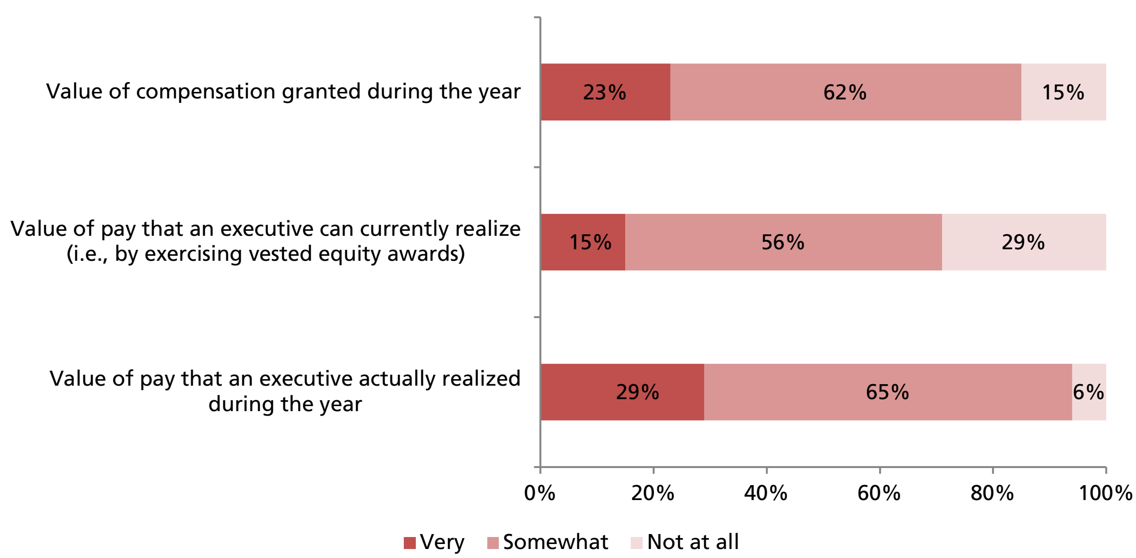
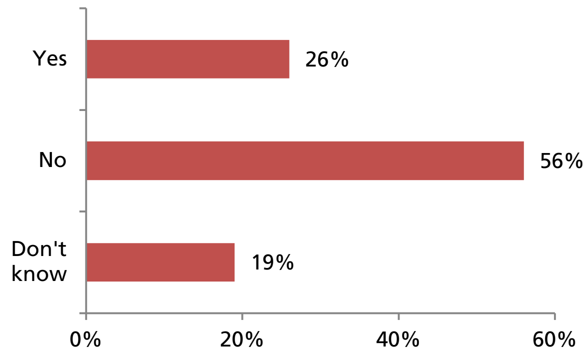
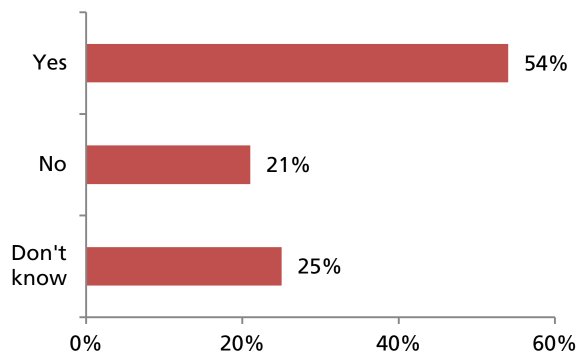


EXHIBIT 1 — CONTINUED

ON AVERAGE, DO YOU BELIEVE THAT CURRENT DISCLOSURE PRACTICES ABOUT THE POTENTIAL PAY-OUTS TO EXECUTIVES UNDER LONG-TERM PERFORMANCE PLANS ARE CLEAR AND EFFECTIVE?



IN GENERAL, DO YOU BELIEVE THAT THE DISCLOSURE IN THE PROXY STATEMENT ALLOWS YOUR ORGANIZATION TO MAKE INFORMED DECISIONS REGARDING "SAY ON PAY"?



Source: RR Donnelley, Equilar, and the Rock Center for Corporate Governance at Stanford University, "2015 Investor Survey: Deconstructing Proxies—What Matters to Investors" (2015).

EXHIBIT 2 — INVESTOR USE OF PROXIES FOR VOTING AND INVESTMENT DECISIONS

WHAT THREE SECTIONS OF A COMPANY'S PROXY ARE YOU MOST LIKELY TO LOOK AT FIRST? (PICK ANY THREE)

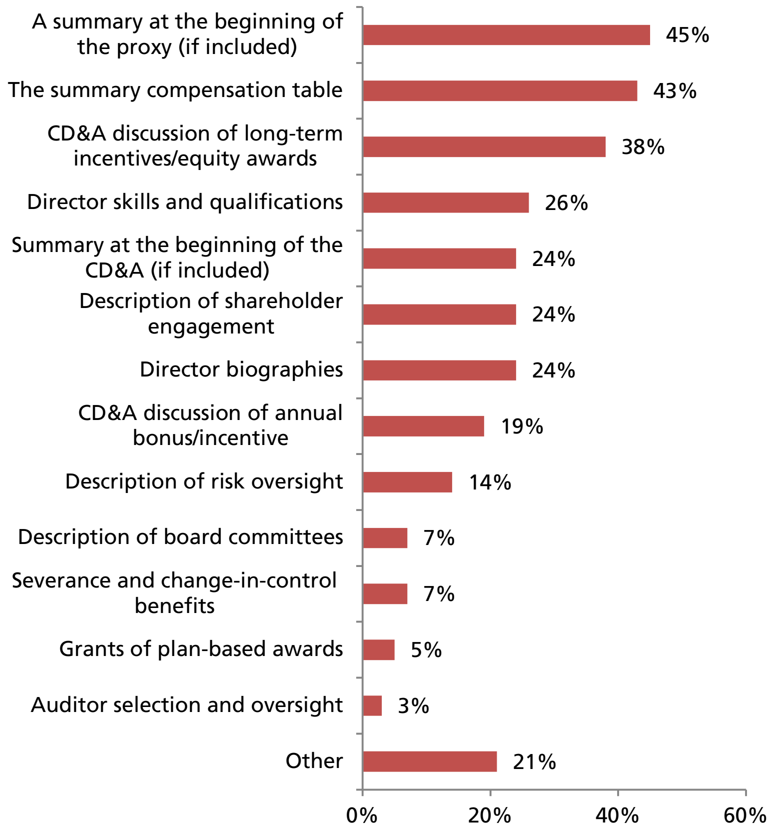
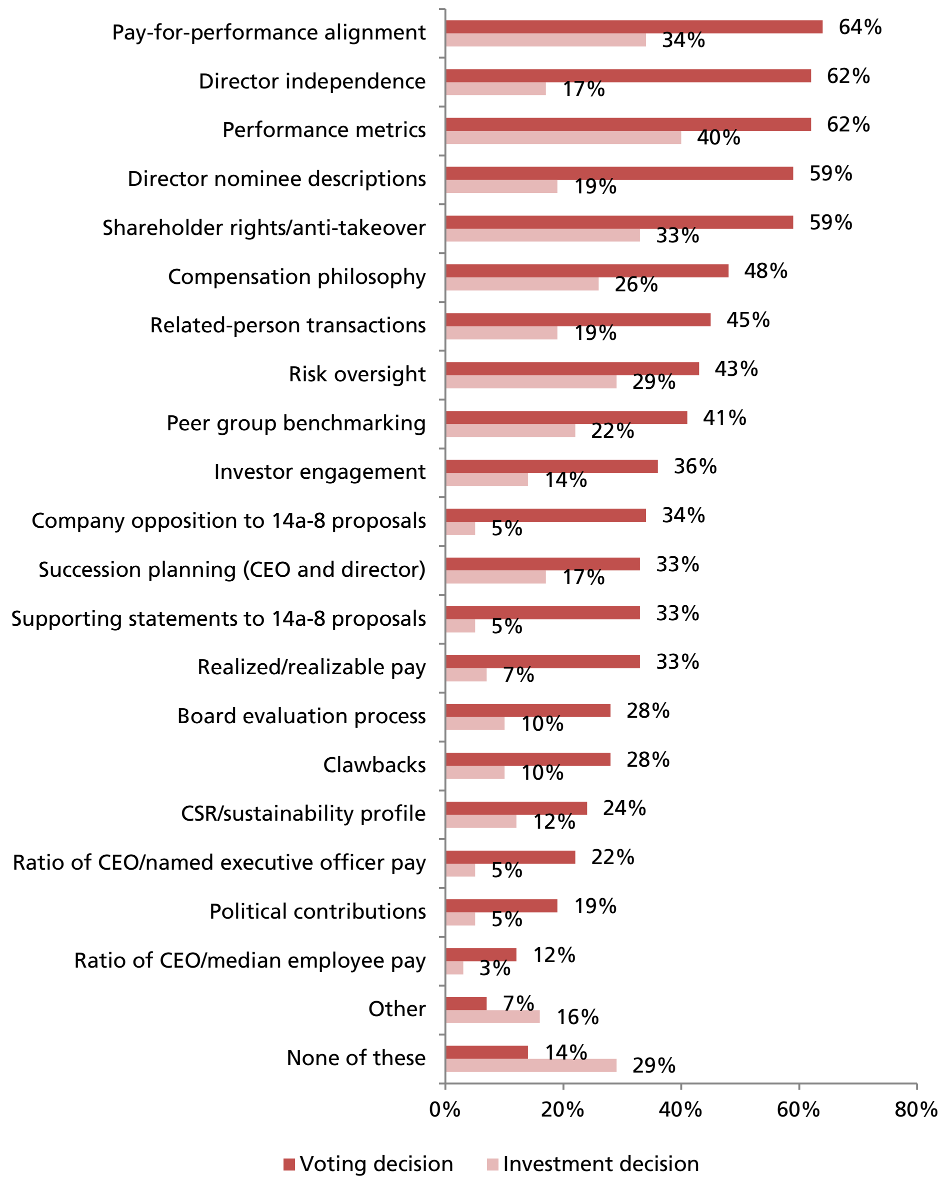


EXHIBIT 2 — CONTINUED

WHICH OF THE FOLLOWING SECTIONS OF THE PROXY DOES YOUR FIRM READ AND RELY ON TO MAKE VOTING AND INVESTMENT DECISIONS? (SELECT ALL THAT APPLY)



Source: RR Donnelley, Equilar, and the Rock Center for Corporate Governance at Stanford University, "2015 Investor Survey: Deconstructing Proxies—What Matters to Investors" (2015).