

MERCATUS ON POLICY

How Proxy Advisory Services Became So Powerful

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PROXY ADVISORY FIRMS (PAs) have become a powerful force in American corporate governance. These firms counsel pension plans, mutual funds, and other institutional investors about how to vote the shares of corporations they own. They have built their businesses, in large part, on demand generated by regulatory requirements and expansive staff interpretations of those requirements. This policy brief outlines the regulations that give PAs their power and the nature and adverse consequences of that power, and offers suggestions for reforms.¹

SOURCES OF PROXY ADVISORY FIRMS' POWER

TWO FIRMS DOMINATE the PA industry in the United States. Institutional Shareholder Services (ISS) and Glass Lewis share approximately 97 percent of the market.² These firms weigh in on issues such as the composition and operation of corporate boards, disclosure and compensation practices, and companies' policies on recycling, renewable energy, and political contribu-

tions. The firms' power derives from the growth in the proportion of shares owned by institutions, the growing number of proxy votes, and—importantly—the regulatory push toward reliance on outside proxy advice.

In 2011, institutional investors owned approximately 60 percent of publicly traded equities, up from well under 20 percent in the 1960s.³ Institutions with large, diversified portfolios can face hundreds of thousands of votes, mainly concentrated during the popular annual meeting months of March through June. Unions, pension funds, and individual shareholders push for votes on a range of issues from climate change to political spending.⁴ Dodd-Frank's provision mandating advisory executive compensation ("say-on-pay") votes every one to three years further increases voting volume.⁵

But regulation is the main impetus to vote proxies—and to rely on PAs. In the absence of regulatory encouragement to use PAs, institutional investors might rationally choose not to vote, to vote consistently with management, or to vote only on key matters. Critical to the rise of ISS is the 1988 "Avon Letter," where the Department of Labor underscored the fiduciary importance of voting shares in the interests of pension plan beneficiaries under the Employment Retirement Income Security Act of 1974.⁶ Another boon to PAs was a 2003 Securities and Exchange Commission (SEC) requirement that investment advisers vote proxies in their clients' best interest.⁷ The SEC allowed "an adviser [to] demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party," meaning a PA. Two subsequent staff letters further incentivized investment advisers to "cleanse" themselves of conflicts of interest in voting their clients' shares by using PAs—even ones paid by the companies about which they were giving advice.⁸

Seemingly forgotten is a note in the SEC's 2003 rule-making that "we do not mean to suggest that an adviser that does not exercise every opportunity to vote a proxy on behalf of its clients would thereby violate its fiduciary obligations to those clients under the Act."⁹ This important caveat recognizes that voting can be unduly costly, but investment advisers act as if the caveat does not exist.¹⁰ Investment advisers vote to satisfy a perceived regulatory mandate rather than to enhance the value of their clients' portfolios.¹¹ PAs are central to that compliance exercise.

PAs' INFLUENCE

THE WIDESPREAD RELIANCE on PAs by investment advisers, pension fund managers, and other fiduciaries that vote large blocks of stock means that PAs can wield great influence over corporations. PAs directly influence corporations by affecting voting outcomes and indirectly by causing companies to make changes in order to avoid running afoul of the PAs' preferences.

Understanding precisely how PAs' recommendations change voting outcomes is difficult, but studies repeatedly find at least a predictive link.¹² A recent study finds that PA "recommendations have a substantial impact on [say-on-pay] voting outcomes."¹³ Another study "show[s] that endorsement by either of the dominant advisors, ISS or Glass Lewis, substantially increased the percent of 'For' votes for management proposals, independent of ballot types and firm characteristics."¹⁴ Other studies show that when ISS issues a negative recommendation, management-sponsored proposals garner 13.6–20.6 percent fewer votes, individual directors receive 14–19 percent fewer votes, and say-on-pay proposals receive 24 percent fewer votes.¹⁵ The extent of PAs' influence may vary with a company's ownership structure, because shareholders with large holdings may do their own research.¹⁶ Conversely, smaller institutions with few in-house personnel may be especially likely to defer to PAs.

In addition to affecting votes, PAs can indirectly influence companies, which make changes in their governance policies in order to avoid running afoul of the advisors. A survey of 110 corporations finds that 70 percent of them altered their executive compensation plans in response to PAs.¹⁷ A recent study finds that companies make changes in response to adverse votes on compensation—especially if the adverse votes hit the thresholds ISS has identified as important.¹⁸ As a

corporate governance professional explained, "What will ISS say?" is regularly asked in the board rooms."¹⁹

ADVERSE CONSEQUENCES OF PAs' POWER

SHAREHOLDERS MAY NOT benefit from PAs' influence on corporate decision-making. PAs' limited capacity for making tailored recommendations lowers their value; one-size-fits-all recommendations miss the nuances of particular corporations. Moreover, the PAs' conflicts of interest could produce recommendations that do not enhance corporate value.

PAs cover many votes with a relatively small number of employees, limiting the depth and strength of their analysis. Glass Lewis, for example, covers 23,000 companies in more than 100 countries with 200 research employees.²⁰ PAs compile general guidelines,²¹ but these guidelines are not based on evidence of improved company performance. Instead, as ISS explains, guideline development is "a little bit art, a little bit science."²² The lack of resources devoted to developing recommendations also makes it difficult for PAs to tailor their efforts to local conditions, the idiosyncrasies of individual businesses, and the needs of particular clients, limiting the recommendations' value.²³

PAs' conflicts of interest also can affect recommendations. In addition to providing recommendations to institutional investors about how to vote, PAs may advise companies about corporate governance issues, rate companies on corporate governance, help companies improve those ratings, and advise proponents about how to frame proposals to get the most votes.²⁴ Ownership can also create conflicts. The Ontario Teachers' Pension Plan, which opines on issues about which Glass Lewis advises, owns a majority of Glass Lewis; another activist investor owns the rest.²⁵ ISS, which was recently acquired by a private equity firm,²⁶ also could face conflicts because of ownership. PAs do have conflicts policies,²⁷ and, unlike ISS, Glass Lewis does not advise corporations.²⁸ A recent SEC enforcement settlement—for ISS's alleged failure to "establish, maintain or enforce sufficient policies or practices reasonably designed to prevent certain ISS account managers from sharing ISS' clients confidential information in exchange for gifts"—illustrates the limits of some of those policies.²⁹

Given the imperfections in generating recommendations, it is not surprising that following them may be bad for companies and their shareholders. David F.

Larcker, Allen L. McCall, and Gaizka Ormazabal find that many companies change their compensation packages to pass muster with PAs, but those changes often result in a drop in the value of the companies' shares.³⁰ Yonca Ertimur, Fabrizio Ferri, and David Oesch find that PA compensation recommendations have neither a positive nor a negative effect on company value.³¹

Lauren M. Dreher finds that negative auditor ratification recommendations are correlated with only a 5.2 percent shift in votes (compared to the range of 13–25 percent for other types of PA recommendations).³² Dreher posits a possible explanation for the difference: analyzing whether to approve the company's independent auditor is not hard, so there is less reliance on PAs. If fiduciaries did their own work in other areas, they might more frequently reject the recommendations of PAs in those areas as well.

RECENT REGULATORY DEVELOPMENTS

CONCERN ABOUT PAS' undue influence has spurred reform efforts. Following a European Securities and Markets Authority directive, ISS, Glass Lewis, and four other PAs with European clients established principles—with which they agree to comply or explain their non-compliance—covering research, voting, conflicts, and communications policies.³³ In April 2014, the Canadian Securities Administrators proposed guidance for PAs on such topics as conflicts, avoidance of one-size-fits-all approaches, communications, and transparency.³⁴

PAs are also under scrutiny in the United States. They were the subject of a June 2013 congressional hearing.³⁵ In December 2013, the SEC held a roundtable on PAs,³⁶ which followed a 2010 call for public comment about PAs and their regulation.³⁷ SEC Commissioner Daniel Gallagher recently suggested revisiting the regulatory actions that have caused such widespread reliance on PAs.³⁸ News reports suggest that new SEC guidance on PAs may be imminent.³⁹

CONCLUDING RECOMMENDATIONS

IN CRAFTING ITS forthcoming guidance, the SEC needs to do more than mandate that PAs disclose their conflicts of interest and methodologies for formulating recommendations. While such disclosures are important, eliminating any direct or indirect regulatory imperative to rely on PAs—including eliminating the SEC's no-

action letters—is even more important. Mutual funds and pension funds should be the sole arbiters of when it makes sense to vote using active analysis of the question at hand. The SEC should embrace a principle that the Department of Labor has already underscored: If a fiduciary charged with voting its clients' shares determines that the costs of voting outweigh its *economic* benefits for that client, the fiduciary “has an obligation to refrain from voting.”⁴⁰ Also critical is the elimination of extraneous voting requirements, such as the say-on-pay vote. Absent such reform, government voting mandates will continue to benefit PAs at the expense of investors and pensioners.

NOTES

1. For a more in-depth discussion of these issues, see James K. Glassman and J. W. Verret, “How to Fix Our Broken Proxy Advisory System” (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, April 16, 2013), <http://mercatus.org/publication/how-fix-our-broken-proxy-advisory-system>.
2. *Ibid.*, 8.
3. Serdar Çelik and Mats Isaksson, “Institutional Investors as Owners: Who Are They and What Do They Do?” (OECD Corporate Governance Working Papers No. 11, OECD, 2013), 7, <http://dx.doi.org/10.1787/5k3v1dvmfk42-en>.
4. For a discussion of the shareholder resolutions on corporate proxy ballots, see James R. Copland, “Companies Fight Back against Chevedden; Unions and Social Investors Ramp Up Push on Corporate Political Spending” (Proxy Monitor Report, Center for Legal Policy, Manhattan Institute for Policy Research, New York, Winter 2014), http://www.proxymonitor.org/Forms/pmr_07.aspx.
5. Dodd-Frank Wall Street Reform and Consumer Protection Act § 951, Pub. Law No. 111-203, 128 Stat. 1899 (2010) (codified at 15 U.S.C. § 78n-1).
6. David J. Berger and Kenneth M. Murray, “Practitioner Note: As the Market Turns; Corporate Governance Litigation in an Age of Shareholder Activism,” *NYU Journal of Law and Business* 5 (2009): 213n18 (citing Opinion Letter from Department of Labor to Helmut Fandl, chairman of the Retirement Board, Avon Products Inc., February 29, 1988).
7. SEC, Final Rule: Proxy Voting by Investment Advisers, 68 Fed. Reg. 6585 (2003).
8. “Investment Advisers Act of 1940—Rule 206(4)-6: Institutional Shareholder Services, Inc.,” SEC Letter to Mari Ann Pisari, September 15, 2004, <http://www.sec.gov/divisions/investment/noaction/iss091504.htm>; “Investment Advisers Act of 1940—Rule 206(4)-6: Egan Jones Proxy Services,” SEC Letter to Kent S. Hughes, May 27, 2004, <http://www.sec.gov/divisions/investment/noaction/egan052704.htm>.
9. SEC, Final Rule: Proxy Voting by Investment Advisers, 68 Fed. Reg. at 6588.
10. The SEC's director of the Division of Investment Management noted at the proxy advisory roundtable that although “there were examples given in the adopting release about advisers not having to vote every share,” “obviously it seems like a consensus now that most people feel like they do have to vote every proxy.” See, for example, SEC, “Proxy Advisory Firms Roundtable,” December 5, 2013 (statement of Norm Champ), <http://www.sec.gov/spotlight/proxy-advisory-services/proxy-advisory-services-transcript.txt>.
11. SEC, “Proxy Advisory Firms Roundtable” (statement of Michael S. Piwowar, commissioner, SEC).
12. For summaries of a number of these studies, see Glassman and Verret, “How to Fix Our Broken Proxy Advisory System.”
13. David F. Larcker, Allen L. McCall, and Gaizka Ormazabal, “Outsourcing Shareholder Voting to Proxy Advisory Firms” (working paper, May 10, 2013), 44, <http://www.niri.org/Other-Content/sampledocs/David-Larcker-Stanford-University-et-al-Outsourcing-Shareholder-Voting-to-Proxy-Advisory-Firms.aspx>.

14. Tao Li, "Outsourcing Corporate Governance: Conflicts of Interest and Competition in the Proxy Advisory Industry" (ECGI Working Paper No. 389, November 2013).
15. SEC, "Proxy Advisory Firms Roundtable" (statement of Mark Chen).
16. Yonca Ertimur, Fabrizio Ferri, and David Oesch, "Shareholder Votes and Proxy Advisors: Evidence from Say on Pay," *Journal of Accounting Research* 51, no. 5: 951–96.
17. David F. Larcker, Allan L. McCall, and Brian Tayan, "The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions" (Director Notes No. DN-V4N5, Conference Board, March 2012), <http://www.gsb.stanford.edu/sites/default/files/documents/TCB-DN-V4N5-12%20Proxy%20Survey%20results.pdf>.
18. Ertimur, Ferri, and Oesch, "Shareholder Votes and Proxy Advisors."
19. *Examining the Impact of Proxy Advisory Firms: Hearing Before the Subcommittee on Capital Markets and Government Sponsored Enterprises of the House Committee on Financial Services*, 113th Cong. 16 (2013) (statement of Darla C. Stuckey, Senior Vice President, Policy & Advocacy, Society of Corporate Secretaries & Governance Professionals).
20. Glass Lewis & Co., "About Us," accessed May 19, 2014, <http://www.glasslewis.com/about-glass-lewis/>.
21. See, for example, "Proxy Paper Guidelines: 2014 Proxy Season; An Overview of the Glass Lewis Approach to Proxy Advice" (Glass Lewis & Co., 2014), http://www.glasslewis.com/assets/uploads/2013/12/2014_GUIDELINES_United_States3.pdf; "2014 U.S. Proxy Voting Summary Guidelines" (ISS, March 12, 2014).
22. SEC, "Proxy Advisory Firms Roundtable" (statement of Gary Retelny, President, ISS).
23. More than half of corporate survey respondents reported mistakes in 2009 or 2010 proxy advisor reports on their executive compensation programs. *A Case for Greater Oversight of the Proxy Advisory Firm Industry: Hearing for Examining the Market Power and Impact of Proxy Advisory Firms, Subcommittee on Capital Markets and Government Sponsored Enterprises, House Committee on Financial Services* (2013) (statement of Timothy J. Bartl, President, Center on Executive Compensation), <http://www.execcomp.org/Docs/c13-33%20House%20Subc%20on%20Capital%20Markets%20Bartl%20Testimony%20PAF%206-5-13%20Final.pdf>.
24. Some of these conflicts are discussed in SEC, Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42,982, 43,009 (July 22, 2010).
25. To get a sense of the potential for conflicts, see, for example, Letter from Michael Wissel, Senior Vice President, Public Equities, Ontario Teachers' Pension Plan, February 4, 2014, <http://www.otpp.com/news/article/-/article/709887>. The letter lays out the pension plan's views on key corporate governance issues. The Ontario Teachers' Pension Plan recently sold a 20 percent stake to Alberta Investment Management Corporation (AIMCo), a "like-minded" investor. Ontario Teachers' Pension Plan, "Teachers' Sells 20% Stake in Glass Lewis to AIMCo," August 20, 2013, <http://www.otpp.com/news/article/-/article/697097>.
26. ISS, "Vestar Capital Partners Completes Acquisition of Institutional Shareholder Services," April 30, 2014, <http://www.issgovernance.com/vestar-capital-partners-completes-acquisition-of-institutional-shareholder-services/>.
27. ISS, "Business Practices and Principles," accessed May 19, 2014, <http://www.issgovernance.com/compliance/business-practices-principles/>; Glass Lewis & Co., "Conflict of Interest Statement," accessed May 18, 2014, <http://www.glasslewis.com/about-glass-lewis/disclosure-of-conflict/>. "Glass Lewis is a portfolio company of the Ontario Teachers' Pension Plan Board ('OTPP') and Alberta Investment Management Corp. ('AIMCo'); further, both OTPP and AIMCo are clients of Glass Lewis. However, Glass Lewis operates as an independent company separate from OTPP and AIMCo." Ibid.
28. Glass Lewis & Co., "Conflict of Interest Statement."
29. In the Matter of Institutional Shareholder Services, Inc., Administrative Proceeding File No. 3-15331, May 23, 2013, ¶ 13, <http://www.sec.gov/litigation/admin/2013/ia-3611.pdf>.
30. Larcker, McCall, and Ormazabal, "Outsourcing Shareholder Voting to Proxy Advisory Firms." The negative relationship between proxy recommendations and shareholder value is consistent with Larcker's earlier work, which is cited in Glassman and Verret, "How to Fix Our Broken Proxy Advisory System."
31. Ertimur, Ferri, and Oesch, "Shareholder Votes and Proxy Advisors."
32. Lauren M. Dreher, "Proxy Advisor Recommendations on Auditor Ratification: Who Is Listening?" (working paper, March 2014), 28–29, <http://papers.ssrn.com/abstract=2408573>.
33. European Securities and Markets Authority, "Final Report: Feedback Statement on the Consultation Regarding the Role of the Proxy Advisory Industry," February 19, 2013, <http://www.esma.europa.eu/system/files/2013-84.pdf>; Best Practices Principles Group, "Best Practice Principles for Providers of Shareholder Voting Research & Analysis," March 5, 2014, p. 11, <http://bppgrp.info/wp-content/uploads/2014/03/BPP-ShareholderVoting-Research-2014.pdf>.
34. Canadian Securities Administrators, "CSA Notice and Request for Comment: Proposed National Policy 25-201 Guidance for Proxy Advisory Firms," April 24, 2014, http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20140424_25-201_rfc-proxy-advisory-firms.htm.
35. *Examining the Impact of Proxy Advisory Firms: Hearing Before the Subcommittee on Capital Markets and Government Sponsored Enterprises of the House Committee on Financial Services*, 113th Cong. (2013).
36. SEC, "Proxy Advisory Firms Roundtable."
37. SEC, Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42,982, 43,009–14 (July 22, 2010).
38. Daniel M. Gallagher, Commissioner, SEC, Speech, October 30, 2013.
39. Andrew Ackerman et al., "Proxy Firms Pressed to Disclose Conflicts," *Wall Street Journal*, June 4, 2014, B1.
40. Interpretive Bulletin Relating to the Exercise of Shareholder Rights and Written Statements of Investment Policy, Including Proxy Voting Policies or Guidelines, 29 C.F.R. § 2509.08-2 (2008).

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