And Then A Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?

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February 25, 2013

THE ROLE OF PROXY ADVISORY FIRMS

Proxy advisory firms are independent, for-profit consulting companies that provide research and voting recommendations on corporate governance matters brought before investors at shareholder meetings. These matters include the election of the board of directors, approval of equity-based compensation programs, advisory approval of management compensation, and other management- and shareholder-sponsored initiatives regarding board structure, compensation design, and other governance policies and procedures.

There are many reasons why investors might choose to consult with third-party advisors when voting their position on these matters. Institutional investors are generally required by the Securities and Exchange Commission to vote all matters on the corporate proxy and disclose their votes to beneficial owners of their funds. Given the size and diversity of their holdings, it might be impractical for professional investors to have a thorough understanding of all items brought before them. Small investors, in particular, might not employ sufficient analytical staff to review all proposals in detail. For these reasons, reliable and valid third-party recommendations can contribute to a well-functioning market by improving information flow between issuers and investors leading to better decisions on compensation and corporate governance.

The proxy advisory industry in the United States is currently dominated by two major firms: Institutional Shareholder Services (ISS) and Glass Lewis & Co., whose clients manage $25 trillion and $15 trillion in investment assets, respectively. The research literature demonstrates the influence that these firms have over voting outcomes. Bethel and Gillan (2002) find that a negative recommendation from ISS on a management proposal can sway between 13.6 percent and 20.6 percent of the vote.[1] Cai, Garner, and Walking (2009) find that a negative ISS recommendation can influence 19 percent of the vote.[2] Research evidence also demonstrates the influence that proxy advisory firms have over the design of corporate governance policies. In a recent survey conducted by the Conference Board, NASDAQ and the Stanford Rock Center for Corporate Governance, over 70 percent of directors and executive officers report that their compensation programs are influenced by the policies or guidelines of proxy advisory firms.[3]

For these reasons, the quality of proxy advisory recommendations is critical to ensuring that shareholders, corporate officials, and regulators make appropriate decisions regarding compensation and governance policies. The clients of proxy advisory firms need to be diligent in their evaluation of the policies of these firms to ensure that these policies are “accurate” and aligned with their interest to maximize long-term shareholder value.[4] Accurate recommendations are those that successfully differentiate between good and bad future outcomes. Negative recommendations from proxy advisory firms should be correlated with negative future outcomes (e.g., poor future stock performance, increased risk of accounting restatement, etc.) and positive recommendations correlated with positive future outcomes.

POLICY DEVELOPMENT PROCESS

To assess the accuracy of proxy advisory firm policies, we can evaluate both the process by which they are developed and their consistency with neutral, rigorous empirical research. Glass Lewis provides little information to the general public on the development of their voting policies. According to a Glass Lewis discussion paper:

> *Glass Lewis' policies, tailored for each market, are formulated via a bottoms-up approach that involves discussions with a wide range of market participants, including investor clients, corporate issuers, academics, corporate directors and other subject matter experts, among others. The process takes into consideration relevant corporate governance standards, company, local regulations and market trends. Policy changes and report enhancements are driven by such discussions, as well as through consultations with the Glass Lewis Research Advisory Council.*[5]

Moreover, Glass Lewis does not provide clarifying detail on how general corporate governance concepts and standards are translated into codified policy. Without this information, it is difficult for investors to assess whether the process used by Glass Lewis leads to accurate recommendations.

Institutional Shareholder Services discloses more extensive information than Glass Lewis does about the firm's policy development process. According to their website:

> *ISS is committed to openness and transparency in formulating its proxy voting policies and in applying these policies to more than 40,000 shareholder meetings each year.… Our bottom-up policy formulation process collects feedback from a diverse range of market participants through multiple channels: an annual Policy Survey of institutional investors and corporate issuers, roundtables with industry groups, and ongoing feedback during proxy season. The ISS Policy Board uses this input to develop its draft policy updates on emerging governance issues each year. Before finalizing these updates, we publish draft updates for an open review and comment period.*[6]

Patrick McGurn, executive director at ISS, contends that the firm's "multi-tiered process" helps to mitigate "unintended consequences" by incorporating "fact-specific feedback" to shape final policies.[7] Martha Carter, director of research at ISS, believes that "our commitment to this approach enhances the value of the research we deliver to clients."[8]

However, there are several issues in ISS' approach which raise questions about the accuracy of its recommendations. First, the ISS data collection process relies on a very small number of participants. For example, ISS' most recent policy survey received responses from only 97 institutional investors.[9] This figure is down 69 percent from just four years ago.[10] A sample of this small size is unlikely to identify compensation and governance policies that should be applied uniformly to all publicly traded corporations.[11] The decline in respondents is particularly troubling because it suggests that ISS is not successful in contacting participants or in convincing them of the value of their participation. It also raises the concern that more strident viewpoints might be over-weighted in the sample if strongly opinionated investors are more likely to participate.

Second, the composition of the respondent pool that ISS does reach is not well disclosed. Although ISS provides descriptive statistics of the types of institutions that participate in the survey, the investment objectives of these investors is not clear (see Exhibit 1). This matters because assessing policy outcomes will differ depending on whether they are tailored to *shareholder*-centric investors or *stakeholder*-centric investors. As it is, there is no way to determine whether ISS' response pool is representative of shareholder groups broadly or instead reflects the opinions of a narrower set of activists, hedge funds, passive investors, etc. (In the survey, ISS asks respondents whether their organizations are "mission-based" but does not disclose the resulting statistics. See the bottom of Exhibit 1)

Third, the survey suffers from design errors that are likely to confuse and/or bias respondents. For example, the ISS survey is flawed in how it frames certain questions and offers response choices (see Exhibit 2). These errors are important because they make survey results difficult to interpret and even more difficult to generalize into voting recommendations. Furthermore, the ISS survey does not seek to establish the precise thresholds or conditions under which a recommendation "for" or "against" will be triggered. Instead, the ISS survey uses vague qualifying words such as "excessive," "problematic," and "significant" whose exact meanings are open to interpretation by the respondents. As such, it is difficult to understand how responses to these questions ultimately lead to concrete voting policy decisions (e.g., a negative say-on-pay recommendation will be triggered if CEO compensation levels are above [*some specific threshold*]).

Fourth, it is unclear how ISS incorporates the feedback that it receives during the open comment period to finalize voting policies. For example, ISS recently proposed a draft rule that would recommend investors vote against directors of a company that failed to act on a shareholder proposal receiving majority support during the previous year. ISS justified the rule by citing its policy survey results which found that "86 percent of institutional investor respondents expect that the board should implement a shareholder proposal that receives support from a majority of shares cast." It claimed that the rule would "strengthen its policy to hold directors accountable for failure to respond."[12] In a comment letter, Pfizer opposed the change and pointed out that the rule can run counter to a board's fiduciary duties:

> *The Policy runs the risk that Boards would be coerced to abdicate their fiduciary duties, which do not disappear or become less significant when a majority of the votes cast at a meeting support a particular proposal. Boards should not feel compelled to act where they believe that such action is not in the best interests of the company. It certainly would make sense to disclose the Board's rationale, but an automatic vote against all directors is inappropriate and inadvisable.*[13]

Similar arguments were made by executives at Ball Corporation, Eli Lilly, FedEx, Honeywell, and Principal Financial Group and by the Business Roundtable and the National Association of Corporate Directors (NACD).[14] Still, ISS adopted the rule without specifying the conditions under which it would defer to a board's judgment of what constitutes a correct action given its fiduciary duties.[15]

Finally the linkage between the opinions proxy advisors collect through the solicitation process and the policies ultimately enacted is unclear. ISS solicits investor and issuer sentiment on general concepts relating to board structure, compensation, and governance matters and then somehow translates this into codified policies. For example, the firm's most recent policy survey asked institutional investors their view on the practice of allowing executives and directors to pledge company stock as collateral for a margin loan. Forty-nine percent responded that any pledging of shares is "significantly problematic;" 38 percent responded that pledging is concerning if it involves a "significant amount of shares;" and 13 percent responded that it is not a concern (see Exhibit 2 for the exact question and responses).[16] ISS cited these results in its 2013 policy document which was updated to recommend that investors vote against the election of directors of companies whose executives or directors have pledged shares, depending on the "magnitude of aggregate pledged shares in terms of total common shares outstanding or market value or trading volume."[17] Left unspecified is the threshold above which pledged shares will trigger an "against" or "withhold" vote. ISS did not solicit this information in the policy survey, nor did it publish the results of rigorous empirical testing to demonstrate the levels at which executive or director pledging of shares has been reliably shown to reduce shareholder returns or amplify enterprise risk. Without rigorous and transparent research, how can ISS ensure that its final policies are anything other than arbitrary?

More broadly, ISS and Glass Lewis should demonstrate that they engage in testing to ensure that their final policies are accurate—i.e., that they produce outcomes that are, on average, superior to the outcomes observable under alternative policies or no policy at all. Since proxy advisory firms have the data used to make their recommendations, it should be easy for them to back-test results to verify that their past voting recommendations were correct.

A review of the research literature uncovers numerous instances where proxy advisory policies are either in conflict with research results or not directly supported by them. For example, research suggests that proxy advisory firm voting recommendations for management "say on pay" are not value enhancing but instead value destroying.[18] Similarly, research suggests that proxy advisory firm voting recommendations for stock option exchanges also decrease shareholder value.[19] To our knowledge, there is no research evidence to support ISS criteria for equity compensation plans or the firm's calculation of proprietary metrics such as the "annual burn rate" and "shareholder value transfer" which are used to determine whether shareholder dilution is excessive. In contrast, proxy advisory firm guidelines on other matters, such as certain anti-takeover protections, do have empirical support.[20]

WHY THIS MATTERS

1. ISS claims that its process for developing proxy voting guidelines is "open and transparent." However, a careful examination does little to clarify the information they rely on in deciding to adopt a policy. How exactly do ISS and Glass Lewis determine that a policy is "correct?" How do they determine that a specific policy is in the best interest of shareholders?
2. Proxy advisory firms obtain feedback from a diverse set of market participants in the policy formulation process. However, the most recent ISS survey contained responses from only 97 institutional investors. Who participates in the policy development process with both ISS and Glass Lewis? How do we know that these participants validly represent the objectives and opinions of all market participants?
3. Investors and corporate issuers often have very different perspectives on corporate governance matters. How does ISS weigh these competing perspectives? Do they "favor" the investor perspective over the issuer perspective? If so, when is this approach justified and when is it not?
4. Ultimately, the accuracy of a recommendation can only be determined by rigorous statistical analysis showing positive impact of a governance choice on shareholder value. What rigorous empirical research supports each of the voting recommendations promulgated by proxy advisors? Why don't ISS and Glass Lewis disclose the specific research (either that they have conducted or conducted by third-parties) that justifies each of their recommendations? ■

[1] Jennifer E. Bethel and Stuart L. Gillan, "The Impact of Institutional and Regulatory Environment on Shareholder Voting," *Financial Management* (2002).

[2] Jie Cai, Jacqueline J. Garner, and Ralph A. Walking, "Electing Directors," *Journal of Finance* (2009).

[3] The Conference Board, NASDAQ, and Stanford Rock Center for Corporate Governance, "The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions," (2012). Available at: http://www.gsb.stanford.edu/cldr/research/surveys/proxy.html.

[4] In a recent speech, former SEC Commissioner Daniel M. Gallagher warns of the potential problems that can arise from overreliance on the advice of proxy advisory firms. In particular, he emphasizes the need to ensure that their policies are accurate and free from conflict of interest: "It is important to ensure that advisers to institutional investors… are not over-relying on analyses by proxy advisory firms. We learned a significant lesson about overreliance on the diligence of others in the run up to the financial crisis, as investors and regulators relied on credit rating agencies with disastrous results. As with credit rating agencies, it is important for policymakers to understand, evaluate, and if necessary address the practices and business models of proxy advisory firms. Of particular interest should be accountability for accuracy as well as potential conflicts of interest…." See: Daniel M. Gallagher, "Remarks before the Corporate Directors Forum," Jan. 29, 2013, Available at: http://www.sec.gov/news/speech/2013/spch012913dmg.htm.

[5] Glass Lewis & Co., "Discussion Paper—An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options," (Jun. 25, 2012). Available at: http://www.glasslewis.com/assets/uploads/2012/12/062512_glass_lewis_comment_esma_discussion_paper_vf.pdf.

[6] ISS, "Policy Formulation and Application." Available at: http://www.issgovernance.com/policy/process.

[7] Patrick McGurn, participant in: US Chamber of Commerce, "Examining the role of Proxy Advisory Firms," (Dec.5, 2012). Available at: http://www.uschamber.com/webcasts/examining-role-proxy-advisory-firms.

[8] ISS, "Institutional Shareholder Services Releases 2013 Proxy Voting Policies," (Nov. 16, 2012).

[9] ISS, 2012-2013 Policy Survey Summary of Results (September 2012).

[10] RiskMetrics Group, 2008-2009 RiskMetrics Group Policy Survey: Summary of Results (October 2008).

[11] ISS, Proxy Advisory Services (2013). Available at: http://www.issgovernance.com/proxy/advisory.

[12] ISS, "Board Response to Majority-Supported Shareholder Proposals (U.S.). Available at: http://www.issgovernance.com/BoardResponseMajorityShareholderProposals2013.

[13] Letter from Matthew Lepore, Vice President and Corporate Secretary, Chief Counsel, Pfizer Inc (November 7, 2012). Available at: http://www.issgovernance.com/files/PfizerInc..pdf.

[14] ISS, 2013 Draft Policies for Comment. Available at: http://www.issgovernance.com/policycomment2013.

[15] Following the open comment period, ISS amended the final rule to include the condition that "less than full implementation will be considered on a case-by-case basis;" however, this qualification raises more questions than it answers on how ISS will decide whether to defer to the board's judgment. See: ISS, U.S. Corporate Governance Policy: 2013 Updates (Nov. 16, 2012).

[16] ISS, 2012-2013 Policy Survey Summary of Results (September 2012), loc. cit.

[17] ISS, 2013 Updates, loc. cit.

[18] David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "The Economic Consequences of Proxy Advisory Say-on-Pay Voting Policies," Rock Center for Corporate Governance at Stanford University working paper (May 2012). Available at: http://ssrn.com/abstract=2101453.

[19] David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "Proxy Advisory Firms and Stock Option Exchanges: The Case of Institutional Shareholder Services," Stanford Rock Center for Corporate Governance at Stanford University working paper (Apr. 15, 2011). Available at: http://ssrn.com/abstract=1811130.

[20] Proxy advisory firm opposition to staggered boards is supported by John Pound, "The Effects of Antitakeover Amendments on Takeover Activity: Some Direct Evidence," *Journal of Law and Economics* (1987); Lucian Arye Bebchuk, John C. Coates IV, and Guhan Subramanian, "The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy," *Stanford Law Review* (2002); and other papers. Proxy advisory firm opposition to dual class shares is supported by Ronald W. Masulis, Cong Wang, and Fei Xie, "Agency Problems at Dual-Class Companies," *Journal of Finance* (2009).

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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 Center for Leadership Development and Research 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/cldr.

EXHIBIT 1 — ISS POLICY SURVEY: RESPONDENT PROFILE (2012-2013)

More than 370 total responses were received. A total of 97 institutional investors responded. Approximately 71 percent of investor respondents were located in the United States, with the remainder divided between U.K., Europe, Canada, and Asia-Pacific. 237 corporate issuers responded, with 79 percent of them located in the United States and the remainder divided between U.K., Europe, and Canada.

Institutional Investor	
Investment manager or asset manager	62%
Government or state sponsored pension fund	8%
Mutual fund or mutual fund company	8%
Commercial or investment bank	4%
Insurance company	3%
Foundation or endowment	2%
Labor union-sponsored pension fund	2%
Alternative asset management	1%
Investor industry group	1%
Private bank, wealth management, or broker	1%
Other	8%

Size of Organization	Institutional Investor	Corporate Issuer
Over $100 billion	32%	5%
$10 billion - $100 billion	22%	29%
$1 billion - $10 billion	30%	31%
$500 million - $1 billion	4%	7%
$100 million - $500 million	6%	7%
Under $100 million	5%	2%
Not applicable	2%	19%

Notes: Size of institutional investors measured by equity assets under management or assets owned; size of corporate issuers measured by market capitalization.

Results not reported to the question: “Is your organization a mission-based or socially-responsible investor?”

Results also not reported to the question: “Is your organization a UN Principles for Responsible Investing (PRI) investor signatory?”

Source: ISS, 2012-2013 Policy Survey Summary of Results (September 2012).

EXHIBIT 2 — EXAMPLES OF QUESTION DESIGN FLAWS

The ISS 2012-2013 Policy Survey contains three types of question design flaws:

1. The assumptions that frame some questions are not adequately defined.
2. Some questions contain leading or biasing comments.
3. Some questions contain response selections that bind respondents to multiple answers or to answers that might not match their opinion.

Consider the following questions.

Question 14. Currently, ISS has a policy on overboarded directors (directors serving on an excessive number of boards) which counts only public company boards. Should ISS include other significant directorships in its policy (e.g., private companies, national non-profit organizations, subsidiary company boards)?	Institutional Investors	Corporate Issuers
Yes	59.0%	17.8%
No	23.1%	71.3%
It depends (please specify)	17.9%	10.9%

Design flaws:

- The policy on "overboarded directors" is referred to but not provided.
- The term "excessive" is not quantified.
- The question binds respondents to multiple responses. E.g., an investor who believes that private company directorships should be included in the policy but not nonprofit directorships is not permitted to express this opinion.

Pay for Failure. Question 22. During the past decade, shareholder have witnessed a series of CEOs who have received sizable termination packages at a time of significantly lagging shareholder returns. Does your organization consider the following actions to be problematic in such a scenario?	Institutional Investors		Corporate Issuers	
	Yes	No	Yes	No
A severance settlement when the executive is stated to be retiring or resigning	81.3%	18.8%	40.3%	59.7%
Immediate acceleration of all unvested equity upon termination without cause	84.4%	15.6%	44.8%	55.2%
Cash severance exceeding 3x base salary and target bonus	93.8%	6.2%	81.1%	18.9%
Cash severance exceeding 1x base salary and target bonus	35.9%	64.1%	11.0%	89.0%
New severance agreement entered immediately prior to departure	89.6%	10.4%	61.7%	38.3%
Large pension / SERP payouts	80.6%	19.4%	32.5%	67.5%

Design flaws:

- The heading "pay for failure" biases respondents that the termination packages in question are not merited.
- The terms "sizable packages" and "significantly lagging returns" are not quantified.
- The term "problematic" is vague. It could be interpreted to mean anything from a minor annoyance to a critical issue.
- The question is not clearly tied to a policy decision.

EXHIBIT 2 — CONTINUED

Pledging of Shares. Question 24. Some shareholders have raised concerns about the practice of executives or directors pledging company stock (e.g., shares used as collateral for margin accounts or other loans). What is your organization's view of suck practice?	Institutional Investors	Corporate Issuers
Any pledging of shares by executives or directors is significantly problematic	49.2%	45.0%
Concerning if it involves a significant amount of shares (e.g., > 500,000 or a value exceeding 10% of the company's market value)	37.7%	34.9%
Not a concern	13.1%	20.1%

Design flaws:

- The first sentence of the question biases respondents that pledging is negative.
- The scale is not properly structured. It does not sufficiently allow for moderate opinions.
- The second response combines different conditions. 500,000 shares is very different from shares representing 10% of a company's market value.
- The question is not clearly tied to a policy decision.

Question 25. A number of issuers have adopted compensation metrics that are tied to non-financial performance such as environmental goals or regulatory compliance. Similarly, some shareholder proponents submit proposals requesting adoption of environmental or other sustainability-related metrics for executive compensation. Which of the following statements best represents your organization's view on this topic?	Institutional Investors	Corporate Issuers
The decision to use environmental or other sustainability-related metrics is best left to the members of a compensation committee. Calls for use of such metrics constitute undue micromanagement of the executive pay process	27.9%	72.5%
Calls for a board to adopt environmental or other sustainability-related metric may be appropriate at companies where there have been significant problems in the past. A case-by-case approach is best suited to determining if the use of such metrics would benefit shareholders.	35.3%	19.6%
Environmental or other-sustainability-related compensation metrics are appropriate tools for boards to use to focus executives on managing significant risks. Use of such relevant non-financial metrics in pay programs would benefit shareholders.	32.4%	5.8%
Other (please specify)	4.4%	2.1%

Design flaws:

- The question biases respondents that the adoption of these performance metrics is positive.
- The choices bind respondents to multiple answers. It is possible to agree with the first sentence of each but not the second.
- The question is not clearly tied to a policy decision.

Source: ISS, 2012-2013 Policy Survey Summary of Results (September 2012).