THE BIG THUMB ON THE SCALE

AN OVERVIEW OF THE PROXY ADVISORY INDUSTRY

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INTRODUCTION

Proxy advisory firms have significant influence over the voting decisions of institutional investors and the governance choices of publicly traded companies. However, it is not clear that the recommendations of these firms are correct and generally lead to better outcomes for companies and their shareholders. This Closer Look provides a comprehensive review of the proxy advisory industry and the influence of these firms on voting behavior, corporate choices, and outcomes, and it outlines potential reforms for the industry.[1]

SHAREHOLDER VOTING

In the United States, the shareholders of most publicly traded corporations receive voting rights with their purchase of common shares. Although there are exceptions, voting rights are typically granted on a "one share, one vote" basis.[2] Corporations grant shareholders voting rights to allow them to voice their preferences on corporate matters and protect their economic interests as owners.

Some matters that require shareholder approval are mundane, such as the routine approval of the board, ratification of the auditor, and changes to bylaw provisions. Others are controversial, such as:

- *Contested Election*. An activist investor or competitor attempting to seize control of a company will nominate its own slate of directors as an alternative to the company's proposed slate. The winner determines the strategic direction of the company, with the potential for very different economic outcomes.
- *Approval of a Major Acquisition or Sale*. Takeover offers and certain acquisitions require shareholder approval. Investors determine whether acceptance of a deal is in their financial best interest.
- *Approval of Employee Equity Programs*. Companies cannot issue equity awards to employees (restricted shares or stock options) without first gaining shareholder approval to establish an equity program, because these programs dilute the ownership interest of investors. The structure of these plans can be complicated but they nevertheless provide important incentives to employees and executives. Shareholder approval or rejection has ramifications for employee motivation, workplace culture, strategy, and risk taking.
- *Advisory Approval of CEO Pay*. The Dodd-Frank Act of 2010 gives shareholders an advisory vote on the compensation plans offered to named executive officers (NEOs), including the CEO ("say on pay"). While the results of this vote are nonbinding, they send an important signal about shareholder satisfaction with CEO pay and performance.

IMPACT OF VOTING ON CORPORATE DECISIONS

Proxy voting serves as an important vehicle for shareholders to communicate their preferences to the board. While companies do not always take action in response to a shareholder vote—particularly when the vote is advisory rather than binding—research suggests that corporate directors pay attention to voting outcomes and, in many cases, incorporate the results of the vote in their decisions. This is particularly the case when shareholders register a strong "protest vote"—a material vote in opposition to a proposed action.[3]

Fischer, Gramlich, Miller, and White (2009) find that protest votes in uncontested director elections are associated with higher board turnover, higher management turnover, and increased corporate activity (such as major asset sale or acquisition) in the year following the vote.[4] Martin and Thomas (2005) find that when shareholders protest against executive-only stock option plans directors respond by reducing executive salaries.[5] Ferri and Marber (2013) study the impact of say-on-pay voting and find that companies that receive low levels of shareholder support are more likely to amend their executive compensation plans to make them more shareholder friendly.[6]

Research also shows that activist investors use the shareholder voting process to influence corporate policies. Klein and Zur

(2009) find that activist hedge funds have a 60 percent success rate in using their ownership position (including the threat of proxy contests) to meet their stated objectives, including board representation, replacing the CEO, increasing cash distributions to owners, altering strategy, terminating pending acquisitions, or agreeing to a proposed merger.[7] Together, these findings indicate that shareholder voting is an effective means of shaping corporate policy.

INSTITUTIONAL INVESTORS AND PROXY ADVISORY FIRMS

Shareholder voting is dominated by institutional investors. Broadridge and PricewaterhouseCoopers (2017) show that institutional investors—such as mutual funds, index funds, pensions, and hedge funds—own 70 percent of the outstanding shares of publicly traded corporations in the United States. Individual (or "retail") investors own only 30 percent. Institutional investors also have significantly higher voting participation rates, casting votes that represent 91 percent of the shares that they hold compared with only 29 percent for retail investors.[8] The combination of these factors gives institutional investors a disproportionately large influence over voting outcomes.

Two factors—one economic and one regulatory—have opened the door for third-party proxy advisory firms to play a substantial role in the proxy voting process.

Economic Demand for Proxy Advisory Firms. The proxy voting process is costly and requires significant time, expertise, and personnel. While large institutional investors—such as BlackRock and the American Funds—can dedicate significant resources to developing proprietary proxy voting guidelines and researching company-specific issues, most small and mid-sized funds lack the resources to conduct these activities. Third-party proxy advisory firms satisfy a market demand by centralizing these costs so they do not need to be duplicated across multiple investment firms.

Regulatory Demand for Proxy Advisory Firms. In 2003, the Securities and Exchange Commission (SEC) began to require that registered institutional investors (including mutual funds and index funds) develop and disclose their proxy voting policies, and disclose their votes on all proxy items.[9] The rule was intended to create greater transparency into the voting process and to ensure that institutional investors act without conflict of interest. Furthermore, the SEC clarified that institutional investors could satisfy this obligation by relying on voting policies developed by an independent, third-party agency—such as a proxy advisor.

The use of a proxy advisory firm has therefore become a cost-effective means of satisfying fiduciary and regulatory voting obligations for institutional investors.

PROXY ADVISORY INDUSTRY

There are five primary proxy advisory firms in the United States:

- *Institutional Shareholder Services (ISS).* ISS is the largest proxy advisory firm in the United States and globally.[10] Founded in 1985, ISS is based in Rockville, Md., and maintains offices in 13 countries. The firm employs approximately 1,000 individuals, serves 1,700 institutional clients, and provides proxy recommendations on 40,000 shareholder meetings in 117 countries. It is owned by Genstar, a private equity firm.[11]
- *Glass Lewis & Co.* Glass Lewis is the second largest proxy advisory firm in the U.S. and globally. Founded in 2003, the company is headquartered in San Francisco, CA. It employs 1,200 people and provides voting recommendations on 20,000 shareholder meetings in 100 countries. It is jointly owned by two Canadian pension funds: Ontario Teachers' Pension Plan and Alberta Investment Management Corporation.[12]
- *Egan-Jones Proxy Services.* Egan-Jones Proxy Services was founded in 2002 and is based in Haverford, Pa. The company is a subsidiary of the Egan-Jones Ratings Company, a credit-rating agency. It does not disclose the number of clients it serves or meetings it covers.[13]
- *Segal Marco Advisors.* Segal Marco Advisors was formed in 2017 by the merger of Segal Rogerscasey and Marco Consulting Group. Based in New York City, the organization is an investment consulting firm that provides proxy advisory services, with an emphasis on multiemployer benefits plans (ERISA compliant). It has 600 clients.[14]
- *ProxyVote Plus.* ProxyVote Plus was established in 2002. Based in Northbrook, Ill., it provides proxy voting services to 150 clients.[15]

Proxy advisory firms also exist that specialize in non-U.S. markets. Examples include Pensions & Investments Research Consultants (United Kingdom), Manifest (United Kingdom), Proxyinvest (France), GES Investment Services (Sweden), Nordic Investor Services (Sweden), and Institutional Investor Advisory Services (India).

ISS and Glass Lewis are by far the largest proxy advisory firms globally in terms of the number of corporate issuers covered, proxy voting recommendations provided, and the number and size of institutional investors served. Glass Lewis claims its clients collectively manage $35 trillion in assets.[16] ISS does not disclose client asset size but discloses that its clients vote on 8.5 million ballots representing 3.8 trillion shares.[17] Researchers at George Mason University estimate that these two firms together have a 97 percent market share.[18]

PROXY ADVISORY FIRM GUIDELINES

Given the reach and market share of ISS and Glass Lewis, it is important that shareholders know whether their voting guidelines and recommendations are accurate. Accurate recommendations are those that successfully differentiate between good and bad future outcomes and are aligned with shareholder interests to maximize long-term value.

ISS and Glass Lewis publicly disclose their policy guidelines. ISS also discloses information about the process by which its policy guidelines are updated. The ISS policy development process includes the following steps:

1. *Survey*. ISS conducts a survey of institutional investors and corporate issuers asking their preferences on selected policy positions. In 2017, they received responses from 121 investors and 382 corporate issuers.[19]
2. *Roundtable*. ISS conducts roundtable discussions with a subset of investors and issuers to discuss ways to enhance policy guidelines. In 2016, they conducted three roundtables in the U.S.[20]
3. *Comment Period*. ISS posts draft recommendations and solicits feedback from stakeholders.
4. *Final Guidelines*. ISS releases final policy guidelines for the subsequent proxy season.

Some researchers have questioned the rigor and objectivity of the ISS policy development process. Larcker, McCall, and Tayan (2013) argue that the ISS data collection process relies on too few participants and that the composition of the respondent pool is not well disclosed. They identify survey design errors that are "likely to confuse and/or bias respondents." They also question the extent to which final policy guidelines are based on the extensive body of peer-reviewed, third-party research on governance.[21]

In a 2016 report, the United States Government Accountability Office (GAO) highlights the concern that "although input is obtained from both corporate issuers and institutional investors, it does not necessarily make its way into the final general policy guidelines." The report cites a corporate issuer as saying "there has been a noticeable increase in outreach (a lack of outreach was evident in the past). But … there is a difference between proxy advisory firms soliciting input and using input to modify policies." Another corporate issuer is cited as saying that "it seemed like policies were sometimes developed in a vacuum."[22]

This suggests that ISS has room to either improve the rigor and objectivity of its policy development process or increase transparency about the steps it takes to review and incorporate evidence and feedback to demonstrate its rigor and objectivity.

Glass Lewis does not disclose the process for updating its policy guidelines. A 2018 proxy update report from Glass Lewis only states that, "Glass Lewis evaluates these guidelines on an ongoing basis and formally updates them on an annual basis."[23] According to the GAO, "Glass Lewis officials said that they work with an independent advisory council that provides guidance in the development and updating of its voting policies."[24] The proxy firm also solicits user feedback through an online form on its website. Beyond this, the process by which Glass Lewis formulates and revises policy guidelines is not disclosed.

The most important issue is whether the proprietary models of these firms are effective in identifying companies with governance problems. Neither ISS nor Glass Lewis discloses whether its voting guidelines or historical voting recommendations have been tested to ensure that they are associated with positive future corporate performance, in terms of operating results or stock price returns. This is a notable omission because it is standard practice for research firms to apply back-testing to validate the assumptions in their models. Without comprehensive evidence it is difficult to know whether their voting guidelines are consistent with increased shareholder or stakeholder value.

INFLUENCE OF PROXY ADVISORY FIRMS ON INSTITUTIONAL VOTING

There is considerable evidence that proxy advisory firms influence proxy voting outcomes. Nevertheless, there is disagreement about the *degree* to which they influence these outcomes.

The reason is largely due to measurement: It is impossible to know how institutional investors *would have voted* on the same ballot if proxy advisors did not issue a recommendation or if they made a different recommendation. Furthermore, it is impossible to know the degree to which institutional investors take into account *the same information* that ISS and Glass Lewis use to arrive at their recommendations, thereby reaching the same conclusion about how to vote on specific issues.

Choi, Fisch, and Kahan (2010) argue that researchers overstate the influence of proxy advisory firm recommendations for these reasons. Controlling for observable factors related to governance quality, they estimate that the recommendations of ISS shift 6 percent to 10 percent of investor votes. They conclude, "To the extent that the information provided by a proxy advisor affects the shareholder vote, the proxy advisor has some limited influence, but inferring from this correlation that the advisor has power over the shareholder vote is an overstatement."[25]

Institutional investors claim that they refer to, but do not rely on, the voting recommendations of proxy advisory firms. According to Rivel Research Group (2016), only 7 percent of institutional investors say that proxy advisory firms are the "most influential" contributors to their policies. Instead, they claim to be guided by "generally established best practices."[26] McCahery, Sautner, and Starks (2016) reach similar conclusions. Using a sample of 143 institutional investors, they find that just over half (55 percent) agree or strongly agree that proxy advisory firms help them make more informed voting decisions. The authors conclude that institutional investors rely on the advice of proxy advisors to *complement* their decision making, rather than rely on them exclusively as a substitute for their decision making.[27]

Actual voting outcomes, however, suggest that proxy advisors likely have a material influence over voting behavior, contradicting investors' self-assessment of their reliance on these firms. An extensive sample of the voting records of 713 institutional investors in 2017 shows that institutional investors are significantly likely to vote in accordance with proxy advisor recommendations across a broad spectrum of governance issues. For example, 95 percent of institutional investors vote in favor of a company's "say on pay" proposal when ISS recommends a favorable vote while only 68 percent vote in favor when ISS is opposed (a difference of 27 percent). Similarly, equity plan proposals receive 17 percent more votes in favor; uncontested director elections receive 18 percent more votes in favor; and proxy contests 73 percent more votes in favor when ISS supports a measure. While the evidence shows that ISS is the more influential proxy advisory firm, Glass Lewis also has influence over voting outcomes. Glass Lewis favorable votes are associated with 16 percent, 12 percent, and 64 percent increases in institutional investor support for say on pay, equity plan, and proxy contest ballot measures (see Exhibit 1).[28] Furthermore, some individual funds vote *in near lock-step* with ISS and Glass Lewis recommendations, correlations that suggest that the influence of these firms is substantial.

Survey data also supports this conclusion. A 2015 report by RR Donnelly, Equilar, and the Rock Center for Corporate Governance at Stanford University finds that portfolio managers are only moderately involved in voting decisions. Among large institutional investors with assets under management greater than $100 billion, portfolio managers are involved in only 10 percent of voting decisions.[29] This demonstrates that the individuals within investment firms who have the most detailed knowledge of specific companies are not very involved with actual proxy voting decisions.

In 2013, former SEC commissioner Daniel Gallagher expressed concern that "it is important to ensure that advisors to institutional investors … are not over-relying on analyses by proxy advisory firms." He cautioned that institutional investors should not "be able to outsource their fiduciary duties."[30]

From his position as long-time vice-chancellor (and now chief justice) of the Delaware Supreme Court, Leo Strine characterized the influence of proxy advisory firms as follows:

> *[P]owerful CEOs come on bended knee to Rockville, Maryland, where ISS resides, to persuade the managers of ISS of the merits of their views about issues like proposed mergers, executive compensation, and poison pills. They do so because the CEOs recognize that some institutional investors will simply follow ISS's advice rather than do any thinking of their own.*[31]

The evidence therefore suggests that proxy advisors have a material, if unspecified, influence over institutional voting behavior and therefore also voting outcomes. An extensive review of the empirical evidence shows that an against recommendation is associated with a reduction in the favorable vote count by 10 percent to 30 percent. A detailed review of the research by governance topic is provided below.

PROXY INFLUENCE ON PLAN DESIGN AND GOVERNANCE CHOICES

Empirical studies have also examined the extent to which proxy advisory firm recommendations influence *corporate* choices. This is a different question from their influence on institutional voting patterns and seeks to measure the degree to which companies make governance decisions—pay structure, board structure, the adoption of antitakeover defenses, etc.—explicitly with the voting guidelines of proxy advisory firms in mind and in order to win their approval.[32]

The evidence suggests that proxy advisors have significant influence over corporate choices, particularly compensation choices.

A 2012 survey by The Conference Board, NASDAQ, and the Rock Center for Corporate Governance at Stanford University finds that approximately three-quarters (72 percent) of publicly traded companies review the policies of a proxy advisory firm or engage with a proxy advisory firm to receive feedback and guidance on their proposed executive compensation plan. Companies report making a broad range of changes in response to proxy advisory firm policies:

- 32 percent change disclosure practices
- 24 percent reduce or eliminate certain severance benefits
- 16 percent reduce other benefits

- 13 percent adopt stock ownership guidelines or retention guidelines
- 9 percent introduce performance-based equity awards (as opposed to straight equity-grants).[33]

Larcker, McCall, and Ormazabal (2015) examine the influence of proxy advisor guidelines on executive pay design in the first year that "say on pay" took effect. They find that a substantial number of firms change their compensation design to be more consistent with the published guidelines of ISS and Glass Lewis "in an effort to avoid negative voting recommendations" by these firms.[34]

Furthermore, Gow, Larcker, McCall, and Tayan (2013) study the influence of ISS on equity compensation plan design. They analyze 4,230 equity compensation plans between 2004 and 2010 and find that companies design their plans to closely meet the limits for the maximum number and value of shares included (i.e., dilution limit) and still earn ISS approval. Over a third (34 percent) of plans include shares that are within 1 percent of ISS limits. Furthermore, company plans are significantly more likely to be *just below* the limits rather than just above them. Specifically, 96 percent of equity plans that are within 1 percent of ISS limits are just below the limit while only 4 percent are just above (see Exhibit 2). The authors note that this is highly unlikely to occur based on chance alone. These results are even more surprising because ISS dilution limits are not publicly disclosed. A company needs to *pay* ISS to access their equity plan limits. The authors conclude, "These figures suggest that companies are acquiring their allowable cap figure from ISS and designing their equity plans to fall just below this number."[35]

The evidence therefore suggests that proxy advisory firm guidelines not only affect the voting behavior of institutional investors but also the governance decisions that companies make, particularly in regards to compensation.

INFLUENCE OF PROXY ADVISORS BY GOVERNANCE TOPIC

As the data in Exhibit 1 suggests, the influence of ISS and Glass Lewis is not uniform and instead appears to vary depending on the matter put before shareholders. Bethel and Gillan (2002) study the impact of ISS recommendations on proxy voting across governance issues. Using a sample of over 1,300 companies in the S&P 1500 Index, they find that an unfavorable recommendation from ISS is associated with 13.6 percent to 20.6 percent fewer affirmative votes for management proposals, depending on the type of proposal. They include in their analysis proposals about compensation, antitakeover protections, mergers, and other bylaw-related items but do not disclose the details.[36]

DIRECTOR ELECTIONS

The research generally shows that proxy advisory firms have a modest influence on uncontested director elections.

Cai, Garner, and Walkling (2009) study the impact of ISS recommendations on director elections. They use a sample of over 13,300 uncontested director elections (i.e., they exclude proxy contests) between 2003 and 2005. They find that directors who do not receive a positive recommendation from ISS receive 19 percent fewer shareholder votes (77 percent versus 96 percent). They do not estimate how much of this reduction is due to the impact of ISS's recommendation versus overall poor performance by the director or company that might lead to a negative ISS recommendation.[37]

Choi, Fisch, and Kahan (2010) also study the impact of proxy advisory firm recommendations on uncontested director elections. As noted earlier, they control for external factors (such as director attendance or company performance) that might trigger a negative recommendation. In doing so, they aim to isolate the influence of proxy firm recommendations by excluding factors that might confound the results. Before controlling for these factors, they find that a negative recommendation from ISS is associated with a 20.3 percent reduction in "for" votes; a negative recommendation from Glass Lewis with a 6.2 percent drop; and a negative recommendation from Egan Jones with a 4.7 percent drop. However, when controlling for governance factors, the ISS influence is much less. They estimate that a negative recommendation from ISS is associated with a 6 percent to 13 percent reduction in shareholder support. They find similar reductions to the influence of the other proxy-advisor recommendations.[38]

SAY ON PAY

The research generally shows that proxy advisors have a moderate to large impact on shareholder votes approving executive compensation packages. It also shows that they have a significant influence on pay design and that this influence is harmful to shareholders.

Ertimur, Ferri, and Oesch (2013) examine the impact of proxy advisory firm recommendations on say-on-pay votes. Using a sample of companies from the S&P 1500 Index in 2011, they find that a negative recommendation from ISS is associated with a 24.7 percent reduction in shareholder support, a negative recommendation from Glass Lewis is associated with a 12.9 percent reduction in support, and a negative recommendation from both firms with a 38.3 percent reduction in support. The authors argue that much of this decline is due to the fact that proxy firms aggregate useful information about a company and its pay plan, and not because they are actually influencing the vote to this extent. Controlling for factors, they estimate that the influence of ISS might be as low as 5.7 percent. According to the authors:

> *Our findings suggest that, rather than identifying and promoting superior compensation practices, [proxy advisory firms] play a key economic role is processing a substantial amount of executive pay information on behalf of institutional investors, hence reducing their cost to making informed voting decisions.*[39]

Malenko and Shen (2016) also examine the impact of ISS recommendations on say-on-pay votes. The authors focus of the impact of ISS recommendations on companies whose pay packages and historical performance put them just around (above or below) certain thresholds that subject them to additional scrutiny. They find that for similar firms near the cutoff a negative recommendation from ISS leads to a 25 percent reduction in voting support. Furthermore, they find that the influence of ISS is stronger in firms that have higher institutional investor ownership and a less concentrated shareholder base. They conclude that "the recommendations of proxy advisory firms are a major factor affecting shareholder votes" and that investors "rely on ISS instead of performing independent governance research."[40]

As discussed above, Larcker, McCall, and Ormazabal (2015) study the impact of proxy advisory firm recommendations on pay design. Because the policy guidelines of the proxy advisory firms were published prior to the first say-on-pay votes in 2011, they were also known to boards of directors and those who advise corporations on executive pay design. The authors find that companies that were likely to receive a negative recommendation from ISS made changes to their pay plan to make them more consistent with ISS guidelines. Furthermore, they find that shareholders react negatively to these changes. They conclude that:

> *[The influence of] proxy advisory firms appears to have the unintended economic consequence that boards of directors are induced to make choices that decrease shareholder value.*[41]

EQUITY COMPENSATION PLANS

The research shows similar influence over equity compensation plans.

Morgan, Poulsen, and Wolf (2006) study the influence of ISS recommendations on equity compensation plans for executives and directors. They find that an unfavorable recommendation from ISS is associated with a 20 percent decrease in shareholder support.[42]

Larcker, McCall, and Ormazabal (2013) examine the impact of ISS guidelines on stock option repricing plans. Not all decisions to reprice stock option awards require shareholder approval. The authors find that plans that require shareholder approval are significantly more likely to conform to ISS criteria than those that the board can implement without a shareholder vote. Furthermore, they find that shareholders react negatively to the disclosure of plans that meet ISS criteria, and that companies whose plans conform to ISS criteria exhibit lower future operating performance and higher employee turnover. According to the authors, "These results are consistent with the conclusion that proxy advisory firm recommendations … are not value increasing for shareholders."[43]

PROXY CONTESTS

The research generally finds that proxy advisory firm recommendations are beneficial to shareholders in the area of corporate control. Alexander, Chen, Seppi, and Spatt (2010) study the role of ISS recommendations in proxy contests. Their sample includes 198 proxy contests between 1992 and 2005. In 55 percent of cases, ISS recommends in favor of management's nominations to the board; in 45 percent, they recommend in favor of the dissident slate. The authors find that ISS recommendations for the dissident slate increase the probability of victory by 14 percent to 30 percent. They also find that ISS recommendations in these situations are associated with positive shareholder returns. The authors conclude that "proxy advice may facilitate informed proxy voting."[44]

RESEARCH SUMMARY

The research literature therefore shows mixed evidence on the degree to which proxy advisory firms influence firm voting and the impact they have on corporate behavior and shareholder returns. For the most part, their influence on voting is shown to be—at a minimum—moderate and their influence on corporate behavior and shareholder value is shown to be negative. Nevertheless, conflicting evidence exists.

The contradictions in this evidence can be reconciled. It might be the case that proxy advisory firms customize their standards and use research teams with greater expertise when evaluating complex proxy issues, such as proxy contests and mergers and acquisitions.[45] When it comes to general issues common across the broad universe of companies—such as compensation design and director elections—resource and time constraints might compel proxy advisory firms to employ more rigid and therefore arbitrary standards that are less accommodating to situational information that is unique to a company's situation, industry, size, or stage of growth.[46]

ADDITIONAL ISSUES REGARDING THE PROXY ADVISORY INDUSTRY

Market participants and researchers have raised additional concerns about the proxy advisory industry, beyond their direct influence over voting and corporate behavior:

- *Fiduciary Duty*. Proxy advisory firms are not held to a fiduciary standard, which would require them to demonstrate that their recommendations are in the best interest of shareholders and the corporation. Furthermore, proxy advisory firms might not have financial incentive to issue accurate or correct recommendations because they do not have an economic interest in the outcome of votes.[47]
- *Conflicts of Interest*. Some proxy advisory firms, such as ISS, receive consulting fees from the same companies whose governance practices they evaluate. The terms of these arrangements are not disclosed, including whether paid clients are given special access to information about the models underlying the firm's recommendations.
- *Resource Constraints*. Proxy advisory firms might have insufficient staff to accurately evaluate the full scale of proxy items on which they provide recommendations each year. ISS, which is the largest firm, employs 1,000 individuals company-wide including non-research (administrative) personnel. By contrast, Moody's Corporation, which includes the agency that rates credit instruments worldwide, employs 11,700 individuals.[48] Small proxy advisory firms are likely more resource constrained.

There is little research to evaluate the validity of these claims. One study shows that conflicts of interest within proxy advisory firms are a legitimate concern. Li (2016) finds that proxy advisory firms that also engage in consulting arrangements with corporate issuers exhibit favoritism toward management. The author shows that when a competitor firm initiates recommendations on these companies, the original firm becomes tougher on management in future recommendations. Li concludes that the evidence "is consistent with our theory [that] the incumbent is subject to conflicts of interest by serving both investors and corporations."[49]

POLICY CONSIDERATIONS

Proxy advisory firms are not subject to material oversight by the Securities or Exchange Commission or other regulatory bodies in the U.S.[50] Nevertheless, regulation of the proxy advisory industry might improve their contribution to the voting process. The dominance of ISS and Glass Lewis, *despite* evidence that their recommendations are not necessarily accurate or value-enhancing, suggests that a market failure has occurred. In a properly functioning market, companies with a poor service record are driven from the market. Proxy advisory firms, however, are insulated from these forces, primarily because many institutional investors rely on their services as a cost-effective method to satisfy the obligation imposed by the Securities and Exchange Commission to develop guidelines that are free from conflict and to vote all items on the proxy. Institutional investors do not appear to use their services to improve investment decisions.

Two means of correcting this market failure suggest themselves. One, regulators could take steps to compel proxy advisory firms to improve the quality of their product. Examples include requirements to:

- Maintain adequate resources
- Improve the reliability of recommendations
- Require reliability testing
- Provide past recommendation data for third-party evaluation[51]
- Increase transparency about model and guideline development
- Develop reliable mechanisms for incorporating market feedback on models and guidelines
- Disclose commercial relationships with issuers
- Impose an explicit fiduciary-duty standard[52]

Two, the SEC could eliminate the requirement that institutional investors vote all items on the proxy. This action would free investors to decide whether to pay for the voting recommendations of proxy advisory firms based on an evaluation of their price and value. These reforms need not be mutually exclusive.

WHY THIS MATTERS

1. Research shows that proxy advisory firms are influential over the voting decisions of institutional investors and the governance choices of corporations. However, there is little empirical evidence to suggest that their voting recommendations lead to improved future value for shareholders. Just how accurate are the voting recommendations of these firms? How influential are they over corporate choices? Should steps be taken to reduce this influence, or to improve the reliability of their recommendations?
2. Proxy advisory firms are not transparent about the process they use to develop their guidelines, the models they use to determine recommendations, the accuracy of their recommendations, or potential conflicts of interest. Would greater transparency improve the functioning of the market for proxy advisory services?
3. Proxy advisory firms do not disclose their historical recommendation data, arguing that this data is proprietary. Over time, however, the value of previously issued recommendations greatly diminishes and perhaps approaches

zero. Should they be required to release this data after a sufficient amount of time has elapsed? Would back-testing by independent third parties improve the validity of proxy advisory firm models? Would it lead to more reliable future recommendations and improved shareholder outcomes?

4. The impact of proxy advisory firms recommendations on shareholder value and corporate actions is direct and significant. Should these firms be held to a fiduciary standard to ensure their recommendations are in the best interest of shareholders? ■

[1] This Closer Look is based on a report by the Manhattan Institute titled "Proxy Advisory Firms: Empirical Evidence and Case for Reform," (May 21, 2018), available at: https://www.manhattan-institute.org/html/proxy-advisory-firms-empirical-evidence-and-case-reform-11253.html. David Larcker and Brian Tayan contributed research and writing to the report under a grant from the Manhattan Institute.

[2] Approximately 10 percent of publicly traded companies in the United States have more than one class of shares with unequal voting rights (i.e., dual-class or multiple-class shares).

[3] David Yermack, "Shareholder Voting and Corporate Governance," *Annual Review of Financial Economics* (2010).

[4] Paul E. Fischer, Jeffrey D. Gramlich, Brian P. Miller, and Hal D. White, "Investor Perceptions of Board Performance: Evidence from Uncontested Director Elections," *Journal of Accounting and Economics* (2009).

[5] Kenneth J. Martin and Randall S. Thomas, "When Is Enough, Enough? Market Reaction to Highly Dilutive Stock Option Plans and the Subsequent Impact on CEO Compensation," *Journal of Corporate Finance* (2005).

[6] Research in this area is not conclusive. Armstrong, Gow, and Larcker (2013) find that shareholder protest votes against equity pay plans have little impact on future compensation. See Fabrizio Ferri and David A. Maber, "Say on Pay Votes and CEO Compensation: Evidence from the UK," *Review of Finance* (2013); and Christopher S. Armstrong, Ian D. Gow, and David F. Larcker, "The Efficacy of Shareholder Voting: Evidence from Equity Compensation Plans," *Journal of Accounting Research* (2013).

[7] April Klein and Emanuel Zur. "Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors." *The Journal of Finance* (2009).

[8] Broadridge and PricewaterhouseCoopers, "Proxy Pulse: 2017 Proxy Season Review," (September 2017).

[9] Securities and Exchange Commission, "Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies," 17 C.F.R., pts. 239, 249, 270, 274 (2003).

[10] ISS has also participated in an industry that assigns governance ratings to individual companies, analogous to the practice of credit rating agencies assigning ratings to reflect the creditworthiness of individual companies. This industry has not gained wide reception in the market. For an early study on the governance ratings industry, see Robert Daines, Ian D. Gow, and David F. Larcker, "Rating the Ratings: How Good Are Commercial Governance Ratings?" *Journal of Financial Economics* (2010).

[11] ISS was founded in 1985, launched a proxy advisory service in 1986, and launched a voting service in 1992. In 2006, ISS was purchased by RiskMetrics for an undisclosed amount. In 2010, MSCI acquired RiskMetrics for $1.55 billion. In 2014, private-equity Vestar acquired ISS for $364 million. In 2017, Genstar acquired ISS for $720 million. See Institutional Investor Services, "About ISS," available at: https://www.issgovernance.com/about/about-iss/.

[12] Glass Lewis was founded in 2003. In 2006, Xinhua Financial of China acquired 20 percent of Glass Lewis for an undisclosed amount. Later that year it acquired the remaining 80 percent for $45 million. In 2007, the Ontario Teachers' Pension Plan of Canada acquired Glass Lewis for $46 million. In 2013, Alberta acquired a 20 percent stake in Glass Lewis for an undisclosed amount. See Glass Lewis, "Company Overview," available at: http://www.glasslewis.com/company-overview/.

[13] Egan Jones Proxy Services, "Independent Proxy Recommendations and Voting Services," available at: http://www.ejproxy.com/.

[14] Segal Marco Advisors, "About Us: Who We Are," available at: http://segalmarco.com/about-us/who-we-are/.

[15] ProxyVote Plus, "About ProxyVote Plus," available at: http://www.proxyvoteplus.com/.

[16] Glass Lewis, "Company Overview," available at: http://www.glasslewis.com/company-overview/.

[17] Institutional Investor Services, "About ISS," available at: https://www.issgovernance.com/about/about-iss/.

[18] James K. Glassman and Hester Peirce, "How Proxy Advisory Services Became So Powerful," Mercatus on Policy Series, Mercatus Center at George Mason University (June 18, 2014).

[19] ISS, 2017-18 Policy Survey Summary of Results.

[20] ISS, Executive Summary of 2016 Proxy Voting Guidelines Updates.

[21] David F. Larcker, Allan L. McCall, and Brian Tayan, "And Then a Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?" Stanford Closer Look Series, Stanford University (February 25, 2013).

[22] United States Government Accountability Office, "Corporate Shareholder Meetings: Proxy Advisory Firms' Role in Voting and Corporate Governance Practices," GAO-17-47 (November 2016).

[23] Glass Lewis, "Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice," (2018).

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[35] The cost to access ISS equity-plan models is between $23,500 and $29,500, according to proxy filing disclosures, depending on the size of the company. Firms are prohibited by the terms of the contract with ISS from disclosing to shareholders that they used ISS models to determine their plan design. See Ian D. Gow, David F. Larcker, Allan L. McCall, and Brian Tayan, "Sneak Preview: How ISS Dictates Equity Plan Design," Stanford Closer Look Series (October 23, 2013).

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[50] The SEC issued a concept release on the U.S. proxy system in 2010 and a staff legal bulletin on the responsibilities of investment advisors in voting proxies and hiring proxy advisory firms in 2014. In 2017, the U.S. House of Representatives voted to approve a bill to reform the proxy advisory industry, although this act was not taken up by the Senate. See National Investor Relations Institute (NIRI), "U.S. House Approves Proxy Advisor Reform Bill," Executive Alert (December 21, 2017).

[51] Proxy advisory firms consider their recommendations proprietary because they sell them. However, over time their value extinguishes. Proxy advisory firms could disclose past recommendations after a certain amount of time has elapsed so that third parties can study the effects of these recommendations and determine their impact on shareholder value. Credit rating agencies engage in this type of activity, which has contributed to the improvement of their models over time.

[52] H.R. 4015 would require many of these recommendations. See NIRI, loc. cit.

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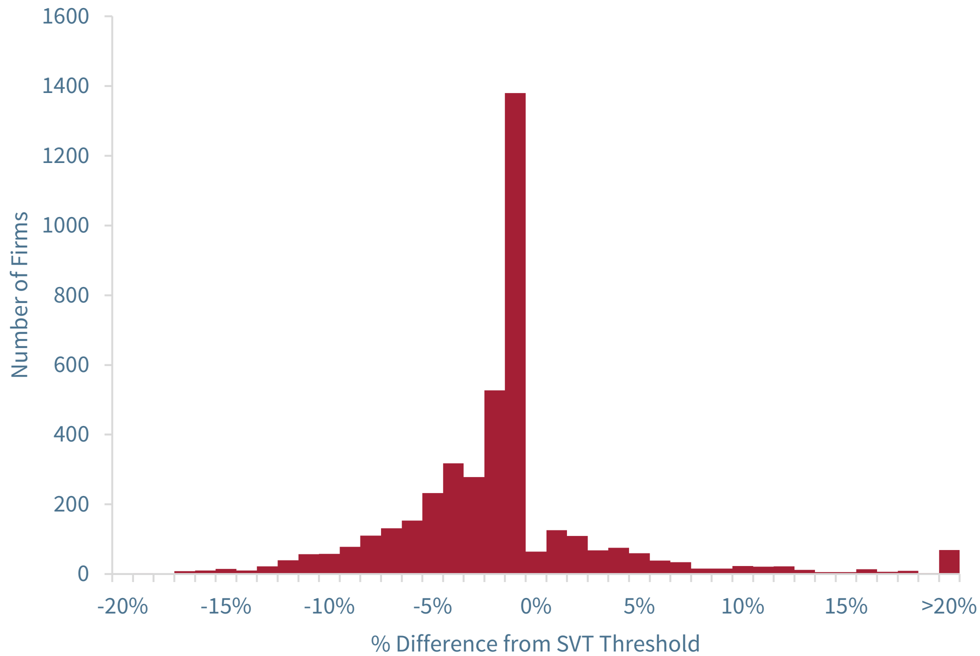
EXHIBIT 1 — RELATION BETWEEN PROXY ADVISOR RECOMMENDATION AND INSTITUTIONAL INVESTOR VOTING RECORD

AGGREGATE PERCENT OF VOTES IN FAVOR OF PROPOSAL, BY PROPOSAL TYPE (2017)

PROPOSAL TYPE	SAY ON PAY		EQUITY PLANS		DIRECTORS		PROXY CONTEST	
	For	Against	For	Against	For	Against	For	Against
ISS Recommendation	95.3%	67.6%	92.7%	75.4%	97.2%	78.9%	90.0%	17.0%
Glass Lewis Recommendation	94.2%	77.9%	90.1%	78.5%	96.0%	85.9%	81.8%	18.2%
Both ISS and Glass Lewis	96.4%	63.8%	93.2%	74.3%	97.5%	71.0%	90.0%	18.2%
# of Observations (Proxy Votes)	2,835		1,014		20,910		37	

Source: Data and calculations by Proxy Insight.

EXHIBIT 2 — RELATION BETWEEN EQUITY PLANS AND ISS ALLOWABLE LIMITS



Source: Ian D. Gow, David F. Larcker, Allan L. McCall, and Brian Tayan, “Sneak Preview: How ISS Dictates Equity Plan Design,” Stanford Closer Look Series (October 23, 2013)