“Proxy Advisory Firms, Governance, Market Failure, and Regulation”

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Broad Challenge of Governance

- Governance based upon voting
  - Information, analysis required for voting
- Increasing returns in inform. production
  - All firm shareholders face same questions
  - Similarity in questions across firms
- Underinvestment in voting analysis since a shareholder obtains benefit only on *x*% of shares—forms “free-rider” issue
- Larger scale (*x*) mitigates “free-rider”
  - Common ownership (variation on above)
- Proxy advisors “solve” free-rider problem

Questions

- What are the sources of market failure underlying the role and actions of proxy advisory firms?
- Are proxy advisor recommendations a benchmark for evaluating asset manager votes or the reverse or …?
- How should we recast the interpretation of existing voting evidence?
- What is the goal of a proxy advisory firm?
- How can the role of proxy advisory firms be improved?

Economic Framework and the Proxy Advisory Firm

- Information production, recommendations and voting tool mechanics
- Single entity can address the duplication of effort across asset managers
- Addresses increasing returns to scale
- Natural monopoly (source of support by asset managers)
  - Duopoly market structure (ISS, Glass Lewis)
- Public goods problem with information production—Non-exclusion

Disputes, “Mistakes”

- Disputes between proxy advisors and firm
- Anecdotes
  - Gender of director (voting on board diversity)
  - Benchmark for firm—import for governance
- Little time to fix when “mistakes”
  - Like journalists, often do not check with firm
  - Useful tweaks possible
- Glass Lewis setting up approach to address “mistakes”

Impact of Proxy Advisors

- Influence outcome on compensation issues, contests, takeovers, proposals
- Valuation response on supporting dissidents in contests
  - Alexander, Chen, Seppi and Spatt; *RFS*, 2010
- ISS negative recommend on say-on-pay leads to 25 percentage reduction in support (causal link)
- Impact is much bigger than that of a large asset manager, such as BlackRock

Power of the Proxy Advisor

- "Crowding out" and due diligence by individual asset managers
  - Malenko and Malenko (*JF*, 2019)
- Bias (performance can be enhanced)
  - Mistakes/Disputes
  - Philosophical views rather than cost-benefit or empirics at the heart of recommendations
- Influence on outcome, reaching thresholds
- Influence on votes, especially smaller asset managers--limited governance focus
  - Brav, Jiang, Li and Pinnington

Conflicts of Interest

- ISS sells governance ratings, proxy advice
  - Sell governance advice to operating firms
  - Opaque client list (prevents matching to recommendations)
- Glass Lewis, owned in part by Canadian unions (proxy agenda), only recommends
- Some proposals from clients (CalPERS, ..)
- Huge incentive to support ongoing relationships & *controversies* generally
- Very anti-management vs. index & large funds, who do considerable stewardship!

More on Conflicts

- Several types of informational intermediaries
- Selling to multiple activities and incentives
  - Auditing firms (restrictions on consulting; rotation of audit partners)
  - Credit rating agencies (structured product advising; rating shopping)
- Other activities more heavily regulated than proxy advisors
  - S-Ox (auditors), Dodd-Frank (CRAs), Asset managers

Mutual Fund Voting

- Theoretical principles suggest that larger asset managers should spend more on stewardship and achieve outcomes more removed from the proxy advisor
- Asset managers are more likely to follow the proxy advisor recommendations when they have small holdings in a firm
  - When more critical they have smaller holdings
- Power and influence of the proxy advisors derives primarily from the influence on the voting of smaller asset managers

More on Mutual Fund Voting

- Much voting right after the ISS recommendation that is aligned with it
- Large funds, including index funds, invest heavily in stewardship
- Presumption is that their votes are more sophisticated and informed
- Small funds vote very strongly w/ advisors
- ISS very anti-management in voting, compared to firms investing in stewardship

(sensible for ISS to promote *controversy*)

Benchmarking

- Proxy advisor isn’t the right benchmark for the larger asset managers—instead, perhaps the reverse
- We should evaluate the recommendation of the advisor against the votes of the larger managers
- For smaller managers it is more reasonable to expect proxy recommendations to heavily influence asset manager votes

“Truth” and the Proxy Advisor

- “Investor Ideology” (Bolton et. al)—ISS more ideological than Glass Lewis
- Mistakes—important to offer timely fixes
- Bias (and ideology) in recommendations—can lead to poor governance outcomes
- Stronger foundation desirable than idiosyncratic philosophical assertions
- Empirical or cost-benefit foundation useful
- Tie back proxy-advisor votes compared to large and index funds

Systematic/Systemic Risk Potential

- Proxy advisor acting like a regulator, so can be the source of “system risk”
- Proxy advisor can suppress creation of heterogeneous signal
- Suggests another motive for market failure and regulation
- Importance of oversight of proxy process

“One-Size-Fits-All”

- Proxy advisors make a single recommendation
  – Among investors, sometimes industries too!
- Yet fiduciary obligation to owners of each fund implies that the same conclusion would not apply to all funds in a complex
  – Different objectives (e.g., ESG)
  – Tax contexts
  – Ownership of other assets (e.g., in M&A)
- Complexes don’t typically distinguish by investor

Withdrawal of SEC Staff “No-action Letters” (Sept. 2018)

- Previously, asset managers absolved from the conflicts of interest by the proxy advisor and not have any responsibility.
- Withdrawing these letters leads to a more level playing field
- Could support more independent oversight over the proxy advisors
- Relatively recent development (9/2018)

New SEC Guidance (Aug 2019)

- Liability to proxy advisory firms for false statements
- Fair process for correcting errors
- No obligation for shareholders to vote shares, so less reliance on proxy advice
- Shareholders need sufficient processes for due diligence and oversight of proxy advisory firms

Potential SEC Rulemaking (?)

- Operating companies to receive two chances to review proxy voting materials before sending to shareholders
- Require registration as investment advisor without exemption from proxy solicitation rules (e.g., on false and misleading statements)
- Higher "resubmission thresholds"—now 3%/6%/10%, potentially to 6%/15%/30%. This would limit access to the ballot.

Do Proxy Advisors Get it Right?

- Examples (Content and Process)
  - ISS recommended that HP shareholders support the merger with Compaq – despite price declines in HP when it appeared that the deal was more likely to go through
  - Support of anti-pledging policy on executive compensation rather than flexibility
  - Negative stock reaction to comp recommend from proxy advisers
  - More robust to mitigate “mistakes” & disputes
  - Sufficient empirical foundation (?)
  - “One-size-fits-all” (?) across issuers, investors

Sources of Market Failure

- Increasing returns/natural monopoly
- Industry is duopoly
- Spillover and public goods
- Systemic/systematic risk potential
- Selling information and advice is a classic market failure—hard to be credible about the value of information without providing it—but then the information would be revealed (Arrow, 1962)

Mitigating Market Failure

- Broad principles--BlackRock comment let.
  - Cost-benefit (economic) analysis should underlie recommendation
  - Transparency in the process
  - Opportunity to correct mistakes (timing, etc.)
- Deeper underlying challenge (free-rider, …
- Alternative procedural routes
  - Legislation
  - SEC rules (*)
  - SEC guidance (**)
  - Best Practices