Proxy Advisory Firms, Governance, Market Failure, and Regulation

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PROXY ADVISORY FIRMS, GOVERNANCE, MARKET FAILURE, AND REGULATION

Chester S. Spatt

Proxy advisory firms have arisen due to market failures underlying voting and the broader system of corporate governance. However, proxy advisory firms, which are not subject to mandatory regulation, reflect market failures of their own. This analysis highlights the underlying frictions, such as the scale economies and public goods aspects to information production, the import of incentive conflicts faced by the advisory firms, the power of the proxy advisory firms, and the implications of the recommendations of the advisory firms and votes by different types of investors. Asset managers who emphasize stewardship are more supportive of management than are the proxy advisory firms. This paper also highlights the limitations of one-size-fits-all recommendations.

1. INTRODUCTION

The role of public company shareholders in voting anchors our system of corporate governance. While a public company's day-to-day business decisions are the responsibility of management and the board of directors, shareholders vote on a number of important issues that can affect the value of their shares. Annual shareholder meetings typically include votes for or against candidates for director positions, questions related to executive compensation plans, and proposals put forth by other shareholders. Special shareholder meetings involve votes on important corporate structure matters, such as a takeover offer, that are especially time sensitive. A small number of shareholders cast their votes at the meetings in person, while the vast majority cast their votes "by proxy" (online, by mail, or by phone).

Asset managers hold most shares of US public companies—for example, mutual funds, exchange-traded funds (ETFs), and independent investment advisers—whose clients give them authority to vote proxies on their behalf.[1] This confers enormous voting power upon asset managers. Collectively, and in some cases individually, the number of votes controlled by large asset managers can affect the outcome of shareholder votes.[2] Asset managers are subject to a number of stringent investor protection regulations, including the fiduciary duty to vote shares in their clients' best interests and not subrogate client interests to their own.[3]

Due to the resource costs involved in underlying due diligence and the presence of considerable economies of scale, many asset managers retain the services of one of the few firms specializing in proxy-voting advice. The two largest proxy advisory firms[4] are Institutional Shareholder Services, Inc. (ISS) and Glass, Lewis & Co., LLC (Glass Lewis).[5] These two proxy advisory firms heavily influence a substantial portion of the voting power of millions of individual shareholders, which is managed by thousands of asset managers. Unlike asset managers, however, proxy advisory firms face modest regulation.

1 Typically, the investment portfolios of mutual funds and ETFs are managed by separate entities that are registered as investment advisers with the US Securities and Exchange Commission (SEC). In addition, mutual funds and ETFs themselves are registered with the SEC and subject to SEC regulation.

2 For example, the merger of Hewlett-Packard (HP) and Compaq received support from less than 51.5 percent of HP shareholders.

3 See, for example, "Proxy Voting by Investment Advisers," Investment Advisers Act Release No. 2106 (Jan. 31, 2003) [68 FR 6585-01 (Feb. 7, 2003)] (Final Rule).

4 In this report, I will use the term proxy advisory firms in contexts in which such terms as proxy-advisory firms, proxy advisors, and proxy-voting advisors also often are used.

5 A third, but considerably smaller, proxy advisory firm is Egan-Jones Proxy Services (Egan-Jones).

The investment process involves various facets of decision-making. The presence of agency conflicts and substantial economies of scale limits the ability to apply the standard competitive paradigm of economics to investment management. This has led to the emergence of proxy advisory firms as central inputs to institutional investors. These proxy advisory firms, in turn, have considerable influence on the outcome of corporate proxies as well as the governance decisions undertaken by companies.[6] For example, Alexander, Chen, Seppi, and Spatt[7] and Brav, Jiang, Li, and Pinnington[8] highlight that the recommendations of proxy advisory firms have a substantial influence on the outcome of proxy contests.[9] Malenko and Shen[10] show that a negative ISS recommendation on say-on-pay leads to a 25 percentage point reduction in support, using a statistical design that highlights a strong causal link between ISS recommendations and votes. The current paper highlights the role and impact of proxy advisory firms, describes the economics of the proxy advising industry, identifies the underlying sources of market failure that suggest the potential need for regulation, and shows how the role and performance of proxy advisory firms can be enhanced.

An analysis of available evidence on proxy voting by mutual funds and proxy advisory firm recommendations sheds an additional perspective on the performance of proxy advisory firms. While a typical approach to this question has been to benchmark the votes of asset managers against proxy advisory firm recommendations,[11] the focus on stewardship by some large index funds and other large asset managers suggests that their votes are an appropriate benchmark for evaluating the advisory firms' recommendations. From this perspective the empirical evidence suggests that the recommendations of the proxy advisory firms are less supportive of management than the large asset managers. This is consistent with the hypothesis that the value of proxy advisory firm services is enhanced when the underlying situation is more controversial, and the proxy advisory firm is less pro-management, which would be influenced by proxy advisory firm vote recommendations.

6 For example, this influence includes pre-empting proxy proposals as well as implementing proxy outcomes.

7 C. Alexander, M. Chen, D. Seppi, and C. Spatt, "Interim News and the Role of Proxy Voting Advice," *Review of Financial Studies* 23 (2010): 4419–4454.

8 A. Brav, W. Jiang, T. Li, and J. Pinnington, "Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests," (2019) unpublished manuscript.

9 The impact of proxy advisory firms on outcomes in various contexts is also documented, for example, by Cai, Garner, and Walkling (2009), Gillan and Bethel (2002), and Larcker, McCall, and Ormazabal (2015). More generally, the academic literature highlights the influence of proxy advisory firms on proxy outcomes.

10 N. Malenko and Y. Shen, "The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design," *Review of Financial Studies* 29 (2016): 3394-3427.

11 See, for example, Heath, Macciocchi, Michaely, and Ringgenberg (2019).

This paper is organized into 10 sections. Section 1 serves as the introduction. In Section 2, I address the actions, recommendations, and power of proxy advisory firms. Section 3 highlights the public goods aspect and scale economies to the production of information by the proxy advisory firm. I discuss why proxy advising may be a natural monopoly and lead to informational spillovers in Section 4. Section 5 addresses the conflicts of interest inherent in the proxy advisory firm model, and Section 6 addresses the comparison to credit rating agencies and auditing firms with respect to conflicts of interest and regulation. Section 7 discusses the nature of best practice and the advice of the proxy advisory firm. The potential importance of systematic and systemic risk and bias underlying the proxy advisory firm framework is addressed in Section 8. Challenging aspects of proxy advisory firm recommendations and the corporate governance model are discussed in Section 9. I offer a concluding perspective on regulation and the power of proxy advisory firms in Section 10.

2. ACTIONS, RECOMMENDATIONS, AND POWER OF PROXY ADVISORY FIRMS

While proxy advisory firms should make recommendations consistent with the objective of shareholder value maximization, their recommendations do reflect other considerations. For example, ISS recommended that Hewlett Packard (HP) shareholders support the 2001 merger between HP and Compaq, despite declining HP value when the transaction appeared more likely to be completed (both prior to the ISS endorsement as well as in response to the ISS recommendation in support).[12] This reflects the information set of ISS at the time of its recommendation, which therefore can be viewed objectively as suggesting that ISS did not act in alignment with the interests of value-maximizing HP shareholders.[13] Given the eventual slim margin of the HP shareholder vote, this example illustrates that outcomes can be influenced by the recommendation of the proxy advisory firm and that the advice may not serve the interests of all shareholders.[14]

Claims of mistakes in the detailed information that proxy advisory firms offer to asset managers are the frequent subject of considerable criticism, by both public companies as well as the US Chamber of Commerce. At times, the specific recommendations of these proxy advisory firms are quite contentious and reflect disputes with the public company.[15] This attention to factual and analytical errors,

12 See the introduction to Alexander, Chen, Seppi, and Spatt (2010) for more details.

13 Note that this observation is not based upon the subsequent lack of success of the merger from the perspective of HP shareholders.

14 These perspectives are part of the broader critique of the proxy advisory firms. For example, see Copland, Larcker, and Tayan (2018a, 2018b) and Verdam (2006).

15 Some of the disputes may simply reflect disagreements, as illustrated by the case of the appropriate industry benchmark for setting executive compensation. Of course, the management of public companies also has obvious conflicts with the choice of benchmark. Henderson (2019) reports that in a recent letter organized by Nasdaq more than 300 public companies called for the SEC to address potential conflicts of interest and the absence of transparency on proxy-voting recommendations.

as well as disputes over the basis for specific recommendations, reflects the power yielded by these firms and the extent of their influence upon outcomes because of their recommendations. The presence of errors and disputes highlights the potential importance of the absence of an explicit opportunity for the advisory firm to correct or justify its recommendation based upon the public company's input.[16] As part of this, it seems reasonable for the proxy advisory firm to provide the public company justification for its recommendation. While proxy advisory firms do not invest directly in public companies, their recommendations carry more clout than the votes of the largest asset managers or institutional investors. Empirically, the probability of changing the vote outcome is much greater for a proxy advisory firm than for a large institutional investor.[17]

Proxy advisory firms have so much influence because: (1) their recommendations influence the votes of many substantial asset managers, including most mutual funds and exchange-traded funds (ETFs), (2) there are only two major proxy advisory firms, and (3) their recommendations themselves are quite correlated. While many of the major fund complexes do not cede total autonomy to their proxy advisory firms and make their own voting decisions, the empirical findings suggest that the ISS and Glass Lewis recommendations have substantial impact upon voting decisions and outcomes. Typically, the votes are finalized by the asset manager shortly after the proxy advisory firm issues its report and shortly before the relevant voting deadline. In many instances, the asset manager is placing considerable weight upon the proxy advisory firm's analysis and recommendation. For example, while many asset managers follow customized policies, these policies often largely support the recommendations of one of the major proxy advisory firms.

The power of the proxy advisory firm reflects not only its influence on the actual voting decisions of investors given their respective informational signals but also the potential ex-ante impact on information production. Malenko and Malenko[18] show theoretically that information production by the proxy advisory firm substitutes for and crowds out information generation by individual asset managers and limits the access of these managers to other sources.[19] This can weaken the incentives for individual managers to undertake their own due diligence, thereby resulting in poorer governance and limiting the generation of independent informational signals and its aggregation through the voting system. The resulting weaker governance is potentially an important effect, though not obvious from the lens of an individual asset manager who is focused upon the individual value to it of the ability to

16 See BlackRock (2018) comment letter. Interestingly, Glass Lewis is undertaking a pilot approach to enhance its ability to address mistakes in a timelier fashion.

17 For example, Alexander, Chen, Seppi, and Spatt (2010) show that the recommendation of the proxy advisory firm in contests has considerable impact on the outcome.

18 A. Malenko and N. Malenko, "Proxy Advisory Firms: The Economics of Selling Information to Voters," *Journal of Finance*, (2019) forthcoming.

19 Similarly, Sangiorgi and Spatt (2017) argue that credit rating agencies can "crowd out" independent information production by asset managers.

offload its decision-making or background analysis. This is especially important for smaller fund families, which are most responsive to the recommendations of the proxy advisory firms, as highlighted by the empirical analysis in Brav, Jiang, Li, and Pinnington.[20] During the SEC's roundtable on the proxy process held in November 2018, individual asset managers focused concern about greater regulation of proxy advisory firms upon the potential implications for the costs and resulting pricing of their services, rather than the equilibrium effects on the quality of governance. This concern was reiterated at a recent US Senate Banking Committee hearing.[21] Of course, the ultimate regulatory decisions should reflect broader societal interests, reflecting both benefits and costs of regulation, rather than solely the interests of the clients of the proxy advisory firms.

3. PUBLIC GOODS, MARKET FAILURE, SCALE ECONOMIES, AND THE PROXY ADVISORY FIRM

Proxy-voting advice is fundamentally an information production process. The costs of producing information are largely fixed so that there are few cost savings from excluding recipients. Moreover, it is difficult to exclude those who do not purchase the advice from receiving the benefits, which makes it a classic public good. A simple analogy is the case of a traffic light. Once the costs of the traffic light are incurred, one cannot exclude pedestrians or drivers from reaping the benefits. Public goods lead to market failure because the non-exclusionary aspect prevents voluntary market exchanges.

Just as all drivers benefit from the traffic light, proxy-voting recommendations are inherently available to everyone; they are a classic public good. An authoritative analysis of the market failure in information production is Arrow,[22] who highlighted the fundamental difficulty in selling information; it is hard to be credible about its potential value without revealing the information. Information is a public good; it is difficult to exclude market participants because, once information emerges, it will be reflected in asset prices, as highlighted in a portfolio theoretic equilibrium context by Grossman and Stiglitz.[23,24]

20 Brav, Jiang, Li, and Pinnington, "Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests."

21 See the written testimony of John Streur, president and CEO, Calvert Research and Management, at the US Senate Committee on Banking, Housing, and Urban Affairs hearing on "The Application of Environmental, Social, and Governance Principles in Investing and the Role of Asset Managers, Proxy Advisors, and Other Intermediaries" (April 2, 2019), available at https://www.banking.senate.gov/download/streur-testimony-4219.

22 K. Arrow, "Economic Welfare and the Allocation of Resources for Invention," *The Rate and Direction of Innovative Activity: Economic and Social Factors*, published by National Bureau of Economic Research (1962): 609–626.

23 S. Grossman and J. Stiglitz, "Information and Competitive Price Systems," *American Economic Review* 66 (1976): 246–253.

24 S. Grossman and J. Stiglitz, "On the Impossibility of Informationally Efficient Markets," *American Economic Review* 70 (1980): 393–408.

Economies of scale and agency issues arise throughout the investment and governance process. Asset managers and proxy advisory firms benefit from considerable economies of scale as information production and decision-making scale upward with relatively little additional cost. In effect, there are considerable fixed costs to the underlying information, as the information extends naturally to a broader set of assets. Many of the processes developed by proxy advisory firms, as well as such intermediaries as voting solicitors and proxy-vote counters, and even the asset managers themselves, have significant quasi-fixed costs.

The scale economies arise at a couple of levels. First, the analysis by a proxy advisory firm of a given governance vote and underlying information will be at least similar for all of the shareholders, even if not identical. The relevant preferences of the investors might vary, but the analysis and perhaps even the recommendation of the proxy advisory firm need not match those preferences. Second, many of the governance challenges and concerns at different public companies are similar. Consequently, proxy advisory firms develop a framework and generic recommendations around these issues. For example, the firms tend to approach various types of proposals from such a broad perspective, while addressing contests (such as opposition director candidates) from a much more firm-specific perspective. While there were approximately 28,000 ballot items for Russell 3000 companies in 2017,[25] there were a relatively small number of broad themes in proxy proposals.[26] Finally, it should be noted that a significant source of scale economy for the proxy advisory firms is their development of tools to process proxy information and implement voting decisions. This limits the costs of the asset manager in executing its proxy decisions. Given the various sources of economies of scale, it is not surprising that there are only a small number of proxy advisory firms.

4. COMPETITION, SPILLOVERS, AND MARKET FAILURE

The above discussion highlights that the proxy advising industry is far from competitive. Due to economies of scale, it is arguably much closer to a natural monopoly and consistent with the observed oligopoly market structure.[27] The contrast concerning the degree of competition in asset management highlights the potential nature of the market failure. It is interesting that there does not seem to be apparent criticism about the pricing of the services by the proxy advisory firms; complaints about pricing would tend to be a relatively standard feature of

25 See BlackRock's November 16, 2018, comment letter, https://www.sec.gov/comments/4-725/4725-4656351-176506.pdf (page 6, including footnote 15), which states that 98 percent of these proposals were routine, typically receiving 90 to 95 percent approval.

26 See Sullivan and Cromwell's 2018 Proxy Season Review, July 12, 2018, https://www.sullcrom.com/files/upload/SC-Publication-2018-Proxy-Season-Review.pdf.

27 Baumol (1977) defines "natural monopoly" as an industry in which production by multiple firms is costlier than production by a monopoly.

oligopolistic markets.[28] This may reflect the importance of the scale economies as perceived by asset managers. Comments at the SEC's November 2018 Roundtable on the Proxy Process suggest that asset managers are concerned that greater regulation of proxy advisory firms would lead to greater rather than reduced costs due to a heightened regulatory burden.[29]

It is worth noting an important variation of the issue of economies of scale in information production. In a collective context, individual participants may rely on information produced on behalf of others, leading to informational spillovers. Therefore, individual market participants under-produce such information because they cannot prevent it from flowing to other market participants. In short, the parties producing such information, leading to what economists call a free-rider problem, cannot internalize the full benefits of information production.

From that backdrop, it is very natural to view the use of proxy advisory firms to produce relevant information for proxy voting and to make recommendations as an efficient institutional response. In a sense, it helps to overcome the free-rider problem associated with an asset manager's input for the corporate governance of the public companies in which it invests. The benefit of improved corporate governance that an individual asset manager helps create does spill over to other investors, but this is not internalized in the decisions of the original asset manager. This challenge is somewhat distinct from the aspect of the free-rider problem associated with voting—small participants would be unwilling to incur the cost of voting, where much of the benefit of the voting would accrue to large market participants. In this extreme form, the free-rider problem is limited for large asset managers because they have material size, but the issue of duplicative costs and spillovers is nevertheless present.

The above discussion highlights the fundamental sources of market failure associated with the nature of information production in the general case and a specific case with respect to the proxy advisory firm. Like many features of corporate governance, the proxy advisory firm arises in response to this market failure and challenge to the free-rider problem. To the extent that governance decisions reflect the overall collective inputs of various institutional investors, the collective action reinforces the nature of the inherent market failure.

28 For example, this contrasts with complaints by broker-dealers about the pricing of proprietary data, connectivity/co-location, and trading by the three major stock exchange families.

29 A related point made by some asset managers, and an important consideration in developing regulations, is whether the benefits of any regulatory action are likely to justify any increased costs.

5. CONFLICTS OF INTEREST AND THE PROXY ADVISORY FIRM

One important difference between ISS and Glass Lewis is that ISS provides governance advice to the same public companies it provides shareholder voting recommendations and receives fees from them, while Glass Lewis avoids such conflicts. Another important difference is that ISS has voluntarily registered with the SEC and submits to some additional forms of regulation.[30] The emergence of Glass Lewis seems to have improved the quality of proxy advice from ISS.[31] This change may reflect the disciplining effect of the Glass Lewis approach to conflict of interest as well as traditional competition.[32] ISS has information available—its public company client list—that could be used to assess the possible conflict of interest directly. Such transparency of the client list could be voluntarily offered as a way to emphasize the lack of conflict of interest.[33] Currently, client information is only offered to other clients, but academics and regulators would be better positioned to undertake informative statistical analysis. For example, one simple empirical question is whether a public company's status as a client is a significant predictor of the recommendation that emerges in that operating company's context.

At the same time, one of Glass Lewis's two owners is a Canadian labor union pension fund.[34] It is well known that unions have strong views and even an agenda concerning proxy questions. This fact points to the most fundamental of all the conflicts. It would appear to serve the interest of the proxy advisory firms to provide advice that enhances the value of these enterprises to their owners and, subsequently, to the potential detriment of their clients. The most striking example of this conflict of interest is in cases where Glass Lewis provides a recommendation on a proxy issue put forward by one of its owners, encouraging its owners, as well as other special-interest investors with similar agendas, to put forward more contentious proxy issues. A fundamental source of conflict that is inherent in the business model of any proxy advisory firm is the implicit incentive to stir controversy to increase the value of advice about proxy questions. This incentive is illustrative of the broader incentive of firms to undertake actions that raise the value of their services.

30 ISS has voluntarily registered as an investment adviser with the SEC under the Investment Advisers Act of 1940.

31 See Li (2018).

32 In contrast, the introduction of an additional credit rating agency, as in Becker and Milbourn (2011), does not necessarily enhance competition as it may instead lead to more aggressive rating shopping and amplification of conflicts of interest.

33 Disclosure of client lists also could be mandated by law or regulation.

34 The Ontario Teachers' Pension Plan Board and Alberta Investment Management Corporation own Glass Lewis. See https://www.glasslewis.com/company-overview/.

BlackRock's (November 16) 2018 comment letter to the SEC highlights that asset managers support a much smaller fraction of shareholder proposals than ISS recommends supporting.[35] The letter states that "While ISS recommended in favor of more than 70 percent of the shareholder proposals, the [four large] asset managers supported between 14 and 33 percent of these proposals." The letter recommends that the SEC study the extent that different asset managers rely upon proxy advisory recommendations[36] and the nature of correlation in the voting choices of various asset managers.[37] The nature of correlation or agreement in voting among asset managers and the major proxy advisory firms—and between the two major proxy advisory firms themselves—should be of considerable interest in evaluating and understanding the role and influence of proxy advisory firms and the underlying market failure that they address.

The typical approach to comparing voting recommendations to actual voting behavior is to view the proxy advisory firm recommendations as a benchmark to evaluate asset managers. However, given the significant resources that large asset managers devote to stewardship, and the proxy advisory firm incentives to be contentious with management and promote proxy controversy, it would be more suitable to view the votes of large asset managers as a benchmark for evaluating the proxy advisory firms.[38] The resources devoted to stewardship by the larger asset managers should result in improved governance decisions relative to smaller asset managers. Not surprisingly, the voting behavior of smaller asset managers reflects the fact that they heavily rely on proxy advisory firms to a much greater degree. Similarly, asset managers with small positions relative to their portfolio rely to a greater degree upon the proxy advisory firms,[39] which is a key source of the power of the proxy advisory firms. Brav, Jiang, Li, and Pinnington[40] provide evidence that smaller fund families are more responsive to the recommendations of the proxy advisory firms, which points to an aspect of the mechanism through which proxy advisory firms are influential.

35 One interpretation is that the recommendations of ISS reflect its own agenda.

36 See also Brav, Jiang, Li, and Pinnington (2019) for related analysis of the reliance of different asset managers upon proxy advisory firms.

37 See also Matvos and Ostrovsky (2010) and Bolton, Li, Ravina, and Rosenthal (2018).

38 For example, the asset management firms may also have conflicts of interest in seeking retirement plan business from public operating companies. Davis and Kim (2007) find a positive correlation between a fund family's business ties and the propensity to vote with management at the fund family level.

39 For example, see Iliev and Lowry (2015) and Gilje, Gormley, and Levit (2019).

40 Brav, Jiang, Li, and Pinnington, "Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests."

6. COMPARISON TO AUDITING FIRMS AND CREDIT RATING AGENCIES

Two of the important informational intermediaries for capital market investments are auditing firms and credit rating agencies. In these cases, like the proxy advisory firms, there is an inherent conflict of interest due to the desire to preserve and continue the ongoing relationship with their clients. These entities can be involved in multiple relationships with the underlying firms that can create conflicts.

For example, auditors are restricted with respect to the types of services that they can provide an audit client to ensure their objectivity in the audit engagement. Furthermore, the audit partner on an engagement must periodically turn over, despite the benefits of continuity. In contrast, there are no current restrictions on a proxy advisory firm, such as ISS, being retained by public companies for governance advice. The substantive rules regarding the financial statements that auditors certify are very transparent and determined by the Financial Accounting Standards Board, a standard-setting body that is independent of the auditing firms. The specific work of the auditing firms is also subject to review by the Public Company Accounting Oversight Board, a nonprofit corporation subject to SEC oversight, created by the Sarbanes-Oxley (2002) Act.

Credit rating agencies, like proxy advisory firms, produce information for asset managers that is relevant for making investment decisions.[41] Outsourcing of both these types of services is consistent with the broad criteria that these entities apply, as well as the economies of scale and free-rider difficulties in information production. The credit rating agency evaluates the creditworthiness of a firm for investors in bonds, while the proxy advisory firm focuses upon voting recommendations for shareholders. Both proxy advisory firms and credit rating agencies can indirectly suppress the creation of heterogeneous signals and due diligence undertaken by the investors, and their asset managers, by crowding out such efforts due to common judgments. This crowding out can enhance the systemic consequence in both situations. Regulators have played a non-trivial role in leading to the demand for these respective services. For example, former SEC Commissioner Daniel Gallagher[42] suggests that in both circumstances regulators were "essentially, mandating the use of third-party opinions."

In both the credit rating and proxy advisory contexts, these intermediaries can sell ancillary products to the firm being evaluated. Several provisions in the Dodd-Frank (2010) Act led to heightened regulation and scrutiny of the credit rating agencies. At the same time, another provision mandated much less reliance upon credit ratings by federal regulators. Taken together, these provisions reflect recognition of the systemic importance of these regulations.

41 See the discussion in Sangiorgi and Spatt (2017).

42 D. Gallagher, "Remarks at Society of Corporate Secretaries and Governance Professionals," (2013) https://www.sec.gov/news/speech/spch071113dmghtm.

7. BEST PRACTICES AND THE PROXY ADVISORY FIRM

The notion of good governance is worthy of further reflection. One wonders whether there is an objective truth that underlies these recommendations. This is closely related to the potentially problematic nature of the concentration of power in the hands of proxy advisory firms. One usually thinks of voting and shareholder decisions as reflecting the aggregation of information, but the import of the proxy advisory firm undercuts that considerably, as there is relatively little aggregation arising in light of the common underlying advice.[43] The proxy advisory firms sometimes act as if they know what is best and, in turn, our system gives them considerable power because they provide recommendations to so many voting investors. It is important that there be a strong empirical foundation rather than just subjective judgments for the perspective of the proxy advisory firm in light of the central role that these play in corporate governance. One way to strengthen the foundation of best practice is to conduct a rigorous cost-benefit analysis when feasible. While there are diverse perspectives on many matters, the proxy advisory firm often acts as if there is a generally accepted best practice. This is an important motivation for adequate regulation. This is not to suggest that the judgments of the proxy advisory firms are inherently incorrect, but that the systematic aspects of these judgments and lack of competition highlight the need for effective regulation.

Concerning the issue of whether proxy advisors know the correct decisions and follow best practice in their recommendations, a significant challenge is the empirical findings in Bolton, Li, Ravina, and Rosenthal,[44] pointing to the ideological component in proxy advisory recommendations and fund votes. They suggest that the recommendations of ISS are to the left of most mutual funds, while those of Glass Lewis reflect a more conventional governance perspective. The ideological aspect points to a lack of unanimity among fund shareholders and at least modest segmentation among the proxy advisory firms.[45]

In addition to the specific case of the merger of HP and Compaq discussed in Section 2, recent academic research challenges the quality of the governance advice provided by the proxy advisory firms. An interesting example is the analysis by Larcker, McCall, and Ormazabal[46] of say-on-pay voting required in the aftermath of the passage of the Dodd-Frank Act. They show that proxy advisory firm recommendations have a substantial impact on say-on-pay voting outcomes. However, when companies adjust the compensation program to the form recommended by proxy advisory firms, the stock market reaction to these changes is statistically negative.

43 This is somewhat related to the analysis in Malenko and Malenko (2019).

44 P. Bolton, T. Li, E. Ravina, and H. Rosenthal, "Investor Ideology," Columbia Business School Research Paper No. 18-21 (2018).

45 The absence of complete agreement may encourage asset managers to retain both services.

46 D. Larcker, A. McCall, and G. Ormazabal, "Outsourcing Shareholder Voting to Proxy Advisory Firms," *Journal of Law and Economics* 58 (2015): 173–204.

Another concrete example that questions the governance directions advocated by proxy advisory firms is the analysis of ISS's anti-pledging policy by Bae and Zhang.[47] The pledging of shares refers to the practice of using shares as collateral (as opposed to selling them) to diversify equity exposure. ISS has determined that share pledging by corporate insiders to diversify equity-based compensation is a problematic pay practice and, therefore, considers the presence of an anti-pledging policy—a policy that prohibits future pledging activity—in its proxy voting recommendations. To satisfy the ISS anti-pledging policy, public companies restrict the use by executives of pledging shares as collateral, limiting the flexibility to diversify equity-based compensation. Such a policy requires not only a substitution of other forms of compensation but also what economists call a compensating differential, which is incremental compensation to make up for the additional risk imposed upon the executive. By limiting the ways managers can manage personal risk, the firm itself is less willing to invest. The authors question the benefit associated with a one-size-fits-all approach that reduces compensation flexibility. The example illustrates the potential value of greater emphasis on economic principles and cost-benefit analysis for assessing the underlying basis of voting recommendations about compensation and other governance matters.

One interpretation of the various evidence cited in this section is that the proxy advisory firms are oriented to maximize their value[48] rather than shareholder value of the companies for which they are making recommendations.

8. BIAS, SYSTEMIC RISK, AND THE PROXY ADVISORY FIRM

Empirical support for bias in proxy-voting recommendations, whether ideological or otherwise, ties closely to the theoretical framework in Malenko and Malenko.[49] The proxy advisory firm crowds out the production of independent signals but indirectly highlights to a greater degree the possibility of inherent bias in the views of the proxy advisory firms. The framework in Malenko and Malenko[50] highlights the power of proxy advisory firms, but not the bias that could be intrinsic in their recommendations. Bias in the judgments of a proxy advisory firm, in conjunction with its tremendous influence, can create the possibility of poor or even misguided governance outcomes. This reinforces the rationale for regulation of proxy advisory firms.

47 J. Bae and R. Zhang, "Anti-Pledging Policy, CEO Compensation, and Investment," Erasmus University and Frankfurt School of Finance and Management (2019) working paper.

48 For example, one form would be for the proxy advisory firm to promote controversy to increase the value of its services.

49 Malenko and Malenko, "Proxy Advisory Firms: The Economics of Selling Information to Voters."

50 Ibid.

Information production by proxy advisory firms, asset managers, and third parties is costly and not pre-determined. Thus, it is important to understand the incentives and processes of these relevant decision makers who are at the heart of our system of corporate governance, potentially reinforcing the case for regulation.

There is an important conceptual point in the previous paragraph that goes somewhat beyond Malenko and Malenko. It highlights the potential for systematic bias in recommendations of the proxy advisory firms. There is also a related empirical point as to whether, how, and to what extent the judgments of the proxy advisory firms—across proxy advisory firms, public companies, or proxy subject matters—reflect bias as compared to independent underlying views. The judgments can be correct or impose systematic/systemic costs. From a societal perspective, more heterogeneity is a good feature due to the long-run benefits of experimentation and learning and reduced systemic costs. One of the lessons from the global financial crisis that has not been adequately reflected in our financial system is the potential risk to the system from incorrect regulatory judgments on a system-wide basis.[51]

9. CHALLENGING ASPECTS OF RECOMMENDATIONS AND GOVERNANCE

Proxy advisory firms provide asset managers perspective on corporate governance and recommendations on proposals using a broad framework while developing specific recommendations for contests. The approach of the proxy advisory firms does not directly distinguish how different investors, such as different types of mutual funds and ETFs, should vote. In effect, it is a one-size-fits-all approach, implicitly assuming unanimity among all the investors.[52] In some corporate governance contexts, there may not be a single unified objective across all shareholders, and the preferences among shareholders would therefore not be identical. For example, there might be differences in the objectives of hedge funds and mutual funds that are operated by the same asset management company; environmental, social, or governance (ESG) considerations; tax considerations that would influence preferences on certain matters; or ownership of other assets.[53] It is not obvious that different funds in the same fund complex should want to vote their shares identically on all questions.[54]

Ultimately, it is the responsibility of the mutual fund managers to vote the shares of their various holdings—possibly voting differently for distinct funds in the same complex—consistent with their fiduciary duty to the ultimate shareholders. This discussion ties to the question of whether the proxy advisory firms can formulate robust prescriptions to evaluate the various matters that are considered in the proxy process. It also highlights a reason for fund complexes to make the final voting

51 See, for example, Spatt (2016).

52 For example, this would be consistent with an objective of shareholder value maximization.

53 The latter would be especially germane in evaluating a merger and acquisition situation.

54 See also the related discussion by SEC Commissioner Elad Roisman (2019).

decisions, as opposed to simply outsourcing those decisions to proxy advisory firms, to allow possible differentiation by fund. This is an inherent limitation of a one-size-fits-all system of recommendations both at the level of the proxy advisory firm and at the level of implementation of recommendations by asset managers.

Governance itself has not always been a top priority in the asset management world. Better voting decisions often are not viewed as a large potential source of competitive advantage because the benefits also flow to the other investors in the particular underlying asset and because of the modest impact of an institutional investor's vote upon the outcome. The financial scandals almost two decades ago (Enron, WorldCom, Adelphia, etc.) and the subsequent passage of the Sarbanes-Oxley Act highlighted the importance of governance, which was reinforced by the SEC's adoption of Regulation N-PX.

Regulation N-PX required disclosure by mutual funds of their votes beginning in 2004. As a result of the transparency of mutual-fund votes created by Regulation N-PX, mutual fund managers have internalized to a greater degree the importance of their voting decisions, heightening the importance of proxy advisory firms and helping to lead to the emergence of Glass Lewis. The transparency created by Regulation N-PX also has led to a range of interesting evidence about fund voting decisions.

10. FINAL PERSPECTIVE ON POWER, MARKET FAILURE, COST-BENEFIT ANALYSIS, AND REGULATION

Despite the widespread competition in asset management, there is very limited competition in the proxy advisory industry. There are many asset managers, but there are just two major proxy advisory firms.

Proxy advisory firms play a key role for asset managers in the ecosystem for corporate governance. Their voting recommendations can have a huge impact on proxy-voting outcomes. The power of proxy advisory firms may make it difficult for the public companies that are subject to their recommendations, as well as the asset managers that rely on them, to challenge their advice and perspective.

The role of the proxy advisory firms is arguably among the most crucial for corporate governance, yet proxy advisory firms are subject to very little regulation.[55] The issue is not just about the regulation of the proxy advisory firms in a vacuum. Their situation is striking when compared to the heavy regulation applied to other investment advisers (asset managers) and intermediaries (auditors and credit rating agencies) that provide crucial inputs to the investment process.

55 Despite the absence of mandatory regulation, which can act as a barrier to entry, the proxy advising industry is already very concentrated.

The underlying advice from proxy advisory firms is not very diverse, reflecting the underlying public goods aspect of information production. Furthermore, in some cases, the business model of the proxy advisory firms involves a conflict of interest. Selling consulting services to public companies on which these proxy advisory firms also provide voting recommendations can, at least in principle, allow the proxy advisory firms to retaliate through their recommendations against operating companies that do not purchase their services. The transparency of client lists could offer reassurance that proxy recommendations are not being distorted by this conflict for this important issue.[56]

In the broader proxy context, BlackRock's November 2018 comment letter highlights the value of applying general principles throughout the proxy ecosystem, such as the principle of transparency and the principle that cost-benefit analysis should underlie proxy recommendations. These are important principles to apply to the substance of reform of the proxy-advisory system. Because the current time windows are very tight, improvements in the response mechanism in the case of proxy disputes to allow enough time for the proxy advisory firm to adjust its recommendation would be welcome. Many approaches to reform could be utilized, such as legislative action, SEC rulemaking, SEC guidance, industry-led development of best practices, or some combination thereof.

It also is interesting that the Egan-Jones (2014) and ISS (2004) no-action letters exempted mutual funds from evaluating the conflicts of interest of their proxy advisory firms while needing to tread carefully with respect to the mutual funds' own conflicts. For mutual funds, this provided a considerable regulatory advantage to engaging a proxy advisory firm and is illustrative of the increase in importance in proxy advisory firms over the last 15 years.[57] For mutual funds that ultimately view their own proxy decisions as not relevant to their financial success (in part due to the free-rider problem), the no-action relief that had been available until the repeal of these letters last September highlighted a lack of independent market oversight of the conflicts of interest of proxy advisory firms. This provided a huge advantage versus other approaches to due diligence in corporate governance. The removal of these no-action letters reinforces some independent market oversight of the potential conflict of interest of the proxy advisory firms and levels the playing field with respect to how mutual funds, as well as other asset managers, can approach due diligence. To a modest degree, it may also reduce the significance of the policy guidelines, on issues such as executive compensation, promoted by the proxy advisory firms.

56 There is suggestive evidence to the contrary in Li (2018) based upon time series and changes in market share by Glass Lewis, which does not sell services to the operating companies. However, the transparency of ISS client lists could provide direct evidence of whether the conflict distorts recommendations.

57 See, for example, Gallagher (2013), and Glassman and Peirce (2014).

While this analysis has highlighted the nature of the underlying market failures and hence why regulation of proxy advisory firms seems appropriate and necessary,[58] it also is important to recognize that widespread use of proxy advisory firms reflects an attempt to find a solution to the inherent problems surrounding the role of shareholders in corporate governance.[59] These include economies of scale and duplicative costs (across both shareholders and issues among firms) and free-rider issues in information production and voting implementation as well as limited competition. In that sense, proxy advisory firms are an important market institution. Concurrently, their use can crowd out other sources of due diligence and bias corporate governance outcomes given the prejudices of the proxy advisors in ways that do not serve the interests of investors or the economy. While proxy advisory firms play an essential (perhaps even central) role in our governance system, given the aforementioned underlying frictions, this discussion illustrates the potential problem that can arise whenever the judgment of institutions (which are not inherently right) can lead to systemic consequences for our economy.[60]

58 Tett (2019) provides a recent call for reform.

59 Two approaches that have been suggested in recent legislative proposals are H.R. 4015 (115th Congress) Corporate Governance Reform and Transparency Act of 2017 available at https://www.congress.gov/bill/115th-congress/house-bill/4015 and S. 3614 (115th Congress) Corporate Governance Fairness Act available at https://www.congress.gov/bill/115th-congress/senate-bill/3614. A recent statement about the importance of proxy reform by SEC Commissioner Elad Roisman (2019) is at https://www.sec.gov/news/public-statement/statement-roisman-020619.

60 In other contexts, actions of traditional regulators or supervisors can similarly lead to systemic consequences. See, for example, Spatt (2016).

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