Insight

Proxy Advisory Firms: A Primer

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Executive Summary

- Proxy advisory firms guide institutional investors on how they should vote at corporate shareholder meetings, as institutional investors typically do not have the resources to vote knowledgeably on the thousands of shares they may own.
- Proxy advisors have been criticized for a lack of competition in the market, little transparency in the process by which proxy advisory firms make recommendations, and potential conflicts of interest that may arise.
- Lawmakers and industry groups have been pushing for heightened oversight of proxy advisory firms. Congress is considering legislation, and the Securities and Exchange Commission is also engaged in this issue.

What are proxy advisory firms?

Investors in a publicly traded company are entitled to certain rights regarding the corporate matters of the company they partially own. Any shareholder who owns either at least $2,000 in a company's stock or 1 percent of its total shares may vote or introduce corporate proposals. At a company's annual general meeting, often held in April, shareholders are given the opportunity to vote on the proposals. Topics of discussion usually involve votes on the company's board of directors, executive compensation, and mergers or acquisitions.

Shareholder rights apply not only to retail investors but also to institutional investors such as pension funds, hedge funds, mutual funds, or endowments. Institutional investors typically invest in thousands of shares across thousands of companies, and as a result do not physically attend shareholder meetings or introduce shareholder proposals. Instead, investors contract with proxy advisory firms that exercises the rights of the shareholders on their behalf. Investment managers rely heavily – if not entirely – on the recommendations of proxy advisors for how they should cast their ballots.

The business of providing proxy advice first sprang into being in the late 1980s and is the product of two agency rulemakings. Critical to the formation of the first proxy advisory firm was the 1988 "Avon Letter," in which the Department of Labor (DOL) emphasized the fiduciary importance of voting in the interests of pension plan beneficiaries under the Employment Retirement Income Security Act (ERISA Act) of 1974. Subsequently, in 2003 the Securities and Exchange Commission (SEC) imposed the *Proxy Voting by Investment Advisers* rule, requiring investment funds to disclose how they vote on behalf of their shareholders. When the SEC later confirmed that relying on third party proxy advisors was acceptable to comply with this rule, the reliance on proxy advisory firms significantly expanded. A 2017 report conducted by PriceWaterhouseCoopers indicated that institutional investors now own 70 percent of all shares publicly traded in the United States. Institutional

investors (or rather the proxy advisors on their behalf) also have significantly higher voter participation rates, casting votes representing 91 percent of all the shares they hold, compared to only 29 percent for retail investors.

Is the proxy advisory process working?

While proxy advisory firms have served an important role in improving shareholder representation in corporate governance, their business activities and lack of oversight have prompted both lawmakers and regulators to explore opportunities for reform.

Their concerns largely focus on three major issues. First, there exists little to no transparency as to the guidelines and methodologies used by proxy advisory firms when making their recommendations. Second, the proxy advisory firms often face conflicts of interests between their own shareholders and the investment funds and other clients they serve. Third, only two firms dominate the proxy advisory market, leading to significant competition concerns.

Proxy advisory firms do not have to disclose the methodologies used in their research and recommendations, and as a result their clients are left in the dark as to how the proxy firms arrived at a particular conclusion. Firms that believe a proxy firm's recommendations are flawed are not able to challenge the recommendations. Meanwhile, regulators are similarly ignorant of how to examine proxy advisors' recommendation rationales or ensure they're in compliance with preexisting financial laws.

A recent report from Squire Patton Boggs looked at these concerns with proxy advisor transparency and analyzed existing data on proxy voting. Of the 107 filings from 94 different companies that made up the research sample, they found "139 significant problems including 90 factual or analytical errors in the three categories that we analyzed." While it's one thing for the firms to keep their proprietary analytical tools private, it's clear that they're flawed to some degree – a cause of concern for investors who rely on their research to make important decisions on matters of corporate governance.

Furthermore, many in the corporate world are unaware of potential conflicts of interest for proxy advisors and instead see the proxy advisory firms as neutral arbiters who are working on their behalf. Unfortunately, that isn't the case. Institutional investors have a fiduciary duty to their clients, but the proxy advisory firms that act as a third party are not held to the same obligation. Therefore, the proxy advisory firms do not have to act in the best interest of the institutional investors they serve. As a result, if a conflict of interest between a firm and a client were to arise, the firm has no legal obligation to resolve that conflict.

These conflicts of interest have been well-documented, most notably in a case this past summer which involved the pharmacy Rite Aid. Proxy advisory firm Glass Lewis recommended against a $24 billion merger between Rite Aid and Albertsons, despite Glass Lewis being partially owned by the Alberta Investment Management Corporation, one of Rite Aid's largest shareholders. Under any other circumstance, the SEC or Federal Trade Commission would likely have moved quickly to remove any suspected conflicts of interest, but proxy advisory firms are not currently held to the same standard.

Conflicts of interest may also be ideological. The recommendations of the proxy advisory firms frequently relate to environmental, social, or governance demands that are likely at odds with the firm's prime directive of returning value to shareholders.

Two proxy advisory firms, Glass Lewis and Institutional Shareholder Services (ISS), control an astonishing 97 percent

of the proxy advisory market. The proxy advisory business is an instance of a high volume / low fee model, which makes it easier for only a handful of companies to dominate the market. In addition, Glass Lewis operates a proxy advisory platform and ISS a consulting business to ensure that they remain a "one-stop shop" for institutional investors. If this concentration were not troubling enough, it is questionable whether ISS, with a company headcount of only a thousand people, has the resource capacity to give each firm and recommendation the time it requires, given that ISS has indicated that its clients vote on 8.5 million ballots representing 3.8 trillion shares.

While these questions may feel remote, consider this: the pension funds that manage the pensions of the vast majority of Americans are potentially receiving inadequate – or even incorrect – advice on how to exercise voting rights on behalf of those Americans.

Reform

Both congressional Republicans and Democrats have expressed frustration with the proxy advisory process and have worked towards increasing oversight.

Representative Sean Duffy (R-WI) and Representative Gregory Meeks (D-NY) have put forward the *Corporate Governance Reform and Transparency Act*, which passed the House last year. The bill would require proxy advisory firms to register with the SEC, disclose potential conflicts of interest, and disclose analytical methodologies.

Most recently, a bipartisan group of Senators unveiled the *Corporate Governance Fairness Act*, a measure aimed at regulating proxy advisory firms in accordance with the Investment Advisers Act. This law requires investment advisors to register with the SEC and mitigate any potential or existing conflicts of interest.

Regulators have also taken steps. The SEC recently hosted a roundtable on the issue with various stakeholders, and the agency last month rescinded two guidance letters from 2004 that assured institutional investors that proxy advisory firms were not prone to conflict of interests, misleading some into assuming the impartiality of the firms. Many see this move by SEC Chairman Jay Clayton as the first step in the SEC placing proxy advisory firms further under their regulatory purview.

Conclusion

The proxy advisors' lack of transparency and potential conflicts of interest have real-world consequences. A 2009 study from Stanford concluded that "when boards altered course to implement the compensation policies preferred by proxy advisors, shareholder value was measurably damaged." Assuming that the sole responsibility of a business or investment fund is to increase shareholder profits, the proxy advisory firms hired by these businesses and funds are actively undermining their very existence.