Proxy Advisors: a Double-Edged Sword for Institutional Investors

Jiyang Zhao1,a
1Law School, University of Edinburgh, Old College, South Bridge, Edinburgh, United Kingdom

Abstract: Institutional investors who own shares in hundreds of companies and have heavily diversified portfolios face significant challenges. More importantly, investee companies usually organise their annual general meetings at the same time, which creates a huge logistical and administrative workload for institutional investors. Also, the "free riding" is also a frequent problem, which greatly reduces the incentive for institutional investors to participate in corporate governance. Hence, the proxy advisors were introduced because of two factors: regulatory policies demand and market demand. Proxy advisors do have a lot to offer to corporate governance, and many empirical studies have demonstrated that proxy advisors play an important role in director elections, say-on-pay and ESG. However, there are some negative effects, such as the multiple conflicts of interest, ineffective and incomplete information and insufficient transparency, institutional investors' over-reliance on proxy advisors. In addition to having an impact on corporate governance, proxy advisors have a significant effect on the engagement of shareholders. There are three main points. Firstly, proxy advisors stimulate institutional investors' participation in corporate voting through lowering the costs. Secondly, proxy advisors mitigate the collective action dilemma of institutional investors, and the third one is about the robo-voting problem. From the discussion of the essay, the impact of proxy advisors on shareholder engagement is significant, and while there is a degree of negative impact, the positive impact of proxy advisors is more significant and should be sustained and improved.

1. INTRODUCTION

Institutional investors who own shares in hundreds of companies and have heavily diversified portfolios face significant challenges. Most prominently, investee companies often organise their annual shareholder meetings simultaneously, presenting a huge logistical and administrative workload for institutional investors. Moreover, the institutional investor may be in a situation where they have spent significant resources and costs to analyse a proposal, but 'other institutional investors are "free riding" on its efforts' and the benefits from the analysis and vote will be shared on a 'pro rata' basis. In these circumstances, why would institutional investors continue to exist?

The fact that not only do institutional investors exist, but their number is rising, is closely linked to the introduction of proxy advisors in 1972. Proxy advisors assist institutional investors in 'exercising their voting rights' by 'providing research, offering recommendations, handling the mechanics of the voting process', etc. As they can significantly reduce the process costs required for proxy voting, 'the use of a proxy advisory firm has therefore become a cost-effective means'.

In annual shareholder meetings, the main agenda items typically include the election of directors, the approval of executive compensation plans, the voting on other shareholder proposals and some special resolutions. Therefore, proxy advisors significantly influence corporate governance in these aspects. Also, in recent years, ESG (Environmental, Social and Governance) has become a popular topic, in which proxy advisors also provide recommendations. Today, two US-based companies, Institutional Shareholder Services (ISS) and Glass Lewis, lead the industry and have been the subject of many empirical studies. This article draws on the findings of these studies to analyse issues arising from the influence of proxy advisors on corporate governance.

Proxy advisors' firms do however face practical problems. In contrast to investment managers, proxy advisory firms 'face modest regulation', and 'do not have an economic interest in the outcome of votes'. Compounding this, investment managers often over-rely on the recommendations of proxy advisers. For example, the relationship between proxy advisory firms and investment managers may cause conflicts of interest, as some institutional investors rely too heavily on proxy advisor's advice. Many researchers have criticised this phenomenon via research data, and labelled this issue "robo-voting".

The proxy advisory industry also impacts meaningful shareholder engagement. Institutional investors are more active and conscientious in their voting, which prevents collective action problems. Conversely, proxy advisers bear a lower long-term cost while advising investors' voting. As investors may not analyse recommendations as carefully in these circumstances, their vote may become less meaningful.
The structure of this essay is as follows. Section B will discuss factors that influenced the development of the proxy advisory industry. Sections C and D will critically analyse the power of proxy advisors in corporate governance by means of some empirical research data and practical cases. Section E will discuss the effect this has on meaningful shareholder engagement, and Section F will conclude that although proxy advisors do have some negative impact, their positive contributions outweigh there and make proxy advisors a meaningful addition to the investment industry.

2. MOTIVATIONS FOR THE DEVELOPMENT OF THE PROXY ADVISORY INDUSTRY

Institutional investors who own diversified portfolios are given the authority to vote on behalf of their clients. To prevent these institutional investors from abusing their power to the detriment of their clients and investee companies, they are legally required to fulfill their fiduciary duty, and have comprehensive knowledge of all companies before voting. These complex and time-consuming policy requirements influenced the introduction of proxy advisors into the industry, and can be summarised by two factors: regulatory policies demand and market demand. [4]

2.1. Regulatory policies demand

Before the 1980s, institutional investors rarely played a role in corporate governance, as the cost of voting was high. When investors realised that a company was not doing well, they took the action of ‘the sale of their shares’ instead of ‘exercising their voting rights’, [8] which is the "Wall Street Rule". [9]

Due to the foot voting behaviours of institutional investors, [10] the Securities and Exchange Commission (SEC) proposed voting restrictions for institutional investors to effectively meet their fiduciary obligations to their clients in 2003: institutional investors are now required to establish and disclose their proxy voting policies and to disclose their votes on all proxy items. [4] Accordingly, investment investors should exercise their voting in the best interests of their clients and proactively avoid conflicts between their own interests and those of their clients.

Moreover, the SEC listed methods to address conflicts of interest, including the situation when an institutional investor ‘votes securities in accordance with a predetermined policy, based upon the recommendations of an independent third party’. [11] As a result, for institutional investors, hiring a voting advisor as an independent third party is de facto "shield" from compliance requirements: if they do not vote, it is difficult to meet their fiduciary duty; whereas if they always vote in favour of a proposal, it is difficult to avoid accusations of conflict of interest. [12]

The SEC’s statement makes the engagement of the proxy advisors become a shortcut for institutional investors to fulfill their fiduciary duty and balance conflicts of interest.

2.2. Market demand

Due to the demands of regulatory policies discussed above, market demand factors become more comprehensible. For institutional investors, market demand generally reduces risk by diversifying their investments, causing them to have a very large number of shareholdings.

As discussed in the introduction of this essay, when one institutional investor spends a lot of time and resources on analysing a proposal without the guidance of a proxy advisor, other institutional investor may contribute to the return without spending anything. This “free-riding” phenomenon drives institutional investors to seek the help of proxy advisors.

Even from a market-wide perspective, there is demand for the proxy advisory industry. As for the proxy advisors, their research on a listed company’s proposals can be provided to multiple institutional investors holding shares at the same time, therefore significantly reducing many investors’ overall costs compared to independent research by individual investors. [13] Simultaneously, as proxy advisors have strong corporate governance teams, their experience and expertise in analysing motions greatly improves the efficiency of their market research.

3. THE INFLUENCE OF PROXY ADVISORS ON CORPORATE GOVERNANCE

Proxy advisors have two main functions for their clients:

First, they supervise their clients with the complex mechanics of managing their voting rights. Second, they provide research and analysis relevant to the issues on which their clients are entitled to vote and make recommendations. Although these two types of services are separate (and some institutions use one service, but not the other), they are highly synergistic. [14]

Supporting institutional investors to vote in their investee companies gives these proxy advisors a prominent position in corporate governance, as they can influence the decisions of institutional investors to a considerable extent. While the influence of proxy advisors has permeated through all aspects of corporate governance, the most significant areas of scholarly interest are the following: board diversity and director elections (1), say-on-pay (2) and ESG (3). Existing empirical studies provide valuable insight into the relevance of these areas.

3.1. Board diversity

In annual shareholder meetings, one of the most important items on the agenda is to elect the board of director, as shareholders govern the companies through the directors. The director elections can be divided into two types. Contested elections and uncontested elections. These will be discussed separately below.
3.1.1. Uncontested elections

An uncontested director election is an election in which the number of candidates for directorship is equal to or less than the required number of seats. In fact, 'almost all director elections in the United States are uncontested'.[16] The lack of contested elections means 'director nominees almost always prevail',[17] and the votes of shareholders is deemed to be meaningless.

However, shareholders are occasionally dissatisfied with directors even in uncontested elections. To express their dissent, shareholders may 'withhold votes for the relevant director' at the elections held during the shareholder meetings.[16] In these circumstances, proxy advisors usually therefore give recommendations to institutional investors to withhold their votes.

Some research data provides valuable visual indications of the impact of proxy advisors on the uncontested director elections. For example, Cai, Garner and Walking (2009) examined the effect of ISS recommendations on director elections by using a sample of more than 13,300 uncontested director elections during 2003 to 2005. They found that directors who did not receive a positive ISS recommendation received 19 percent fewer shareholder votes (77% vs. 96%).[18] Aggarwal, Dahiya and Prabhala (2018) likewise examined uncontested director elections held between 2003 and 2014. Their sample analysed nearly 194,000 directorships. Their findings indicated that directors who face more negative votes while on the board are more inclined to leave the board before the end of the next financial year.[17]

In fact, shareholders appear to use proxy advisors' votes in uncontested director elections to 'allow directors to listen to and address specific problems, rather than to vote them off the board'.[19] In this respect, proxy advisors function more as a warning system during uncontested director elections, to help institutional investors better remind directors of their duty of care.

3.1.2. Contested elections

In a 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'.[20] As institutional investors represent a very large portion of shareholders in listed companies, they have consequently become the main target of lobbying from both sides of the competition. As a result, these institutional investors are turning to proxy advisory firms such as ISS for fair and objective voting recommendations.

The research of Alexander, Chen, Seppi, and Spatt (2018) studied 198 proxy contests between 1992 and 2005. In 55% of the cases, ISS recommended support for management nominations to the board; 45% recommended support for dissidents. The authors found that ISS recommendations for dissident lists increased the probability of winning by between 14%-30%.[4] Therefore, proxy advisors can contribute meaningfully to 'informed proxy voting'.[4]

3.2. Say-on-pay

Say-on-pay, a non-binding shareholder vote, has progressively increased its influence on corporate governance and the advice of proxy advisors.[20] Although it is a non-binding vote, the companies tend to change their compensation plans if the objection rate is high.[21]

A large number of studies demonstrate that proxy advisors have significant impact on shareholders' say-on-pay votes. For example, the research of Ertimur, Ferri and Oesch (2013) found that: [R]ather than identifying and promoting superior compensation practices, proxy advisors' key economic role is processing a substantial amount of executive pay information on behalf of institutional investors, hence reducing their cost of making informed voting decisions...[20]

Furthermore, the research of Larcker, McCall and Ormazabal (2015) similarly found that proxy advisors' recommendations play a meaningful role in say-on-pay voting results, since:

- a substantial number of firms change their compensation programs in the time period before formal shareholder votes in a manner consistent with the features known to be favored by proxy advisory firms in an effort to avoid negative voting recommendations...

Therefore, the recommendations of the proxy advisors are of great importance to the board, but a potential problem arises: the board is likely to give too much weight to the preferences of the proxy advisors rather than to the interests of shareholders.

3.3. Environmental, Social and Governance

Proxy voting is considered to be greener and more ecologically sustainable, especially since the onset of COVID-19.[22] Indeed, large institutional investors tend to 'vote against the reelection of directors at portfolio companies where ESG management was perceived as ineffective'.[22] Furthermore, as institutional investors increasingly consider more ESG factors in their voting behaviours, the criteria by which they 'reach and support those decisions may need to shift to include an ESG-focused analytical approach'.[23]

This trend has therefore given proxy advisors a wider focus when providing advice and doing research. As ESG is a relatively new element of corporate governance, and given that ESG is, in itself, a more controversial issue, the impact of proxy advisors in this area is not yet very thorough, and more work remains to be done in considering ESG factors in investment.

Some advanced understanding has been achieved, however. Mitchell and Tomson (2020) helpfully found that ISS were more supportive of ESG factors than investment managers. In their study sample, 'only 35% of asset managers voted “For” these resolutions more or equally often than they were recommended to, with 65% showing less support than their proxy advisor'.[24]

Although available evidence is limited, it is increasingly clear in contemporary practice that proxy advisors have an optimistic and supportive attitude.
towards ESG, unlike institutional investors. Consequently, it can also be argued that without the advice of proxy advisors, institutional investors would be much less likely to vote in favour of such resolutions.

4. THE CRITICISM OF PROXY ADVISORS

Although the analysis and empirical evidence above show that proxy advisors can provide a degree of supervision, and regulation of corporate governance can facilitate the development of companies in a more ESG-compatible direction, these developments have also been subject to many criticisms. Firstly, when institutional investors are involved in voting, proxy advisory firms and investment managers are prone to a "conflict of interest". Secondly, proxy advisors may not have sufficient information and transparency, meaning their recommendations may be unreliable. Thirdly, some institutional investors may follow the advice of their proxy advisors without due diligence. The first and second problems will be discussed in Section D; the third will be discussed in Section E since it involves issues of shareholder engagement.

4.1. Conflicts of interest

The first common criticism of proxy advisors concerns conflicts of interest. Ideally, the proxy advisors’ recommendations are aimed at maximizing the long-term value of all shareholders’ investment, yet in reality many challenges arise.

Potential conflicts of interest come from many aspects. First, shareholders of voting advisors are often also private financial institutions. For example, ISS’s current shareholder, Genstar Capital, is a private equity fund. A situation exists where the viability of the proxy advisor’s recommendations may be compromised if the shareholder proposal analysed by proxy advisor happens to be made by one of its shareholders, or if its shareholders have a significant interest in the public company that the proxy advisor is researching. Secondly, when a proxy advisor, while delivering voting recommendations to investors, also sells governance rating and advisory services to issuers subject to proxy analysis, conflicts of interest naturally arise. Thirdly, if a proxy advisor researches a shareholder proposal to be voted on by its institutional client, the proxy advisor may sacrifice the independence of its research in order to preserve its relationship with that institutional client.

When several of these situations arise, it is unlikely that the acting advisor will be truly fair and impartial in analysing the problem and making recommendations without taking personal interests into account.

4.2. Insufficient information and transparency

Compounding this, proxy advisory firms may not have enough staff to accurately assess the full range of proxy projects they advise on each year. This means that the information provided by proxy advisors is potentially incorrect or incomplete. One relevant survey found that 65% of institutional investor respondents have experienced at least one voting recommendation based on materially inaccurate or incomplete information, or where the proxy advisory firm reported incorrect or incomplete factual information; 57% of these errors were not rectified. In another survey, 'there were 107 filings from 94 different companies citing 139 significant problems', and 'serious disputes were expressed in 49 filings'.

A significant reason for this comes from the ‘one-size-fits-all-approach’, if a company's proposal does not meet the proxy advisor's criteria, they will recommend a vote against the proposal, irrespective of local market conditions and other company-specific aspects, thereby significantly reducing its probability of passage. For example, if a proxy advisor is dissatisfied with certain corporate governance arrangements, he may recommend that institutional shareholders vote against all of a public company's board of directors. The uniformity of this rigid approach can limit the flexibility of the company's governance, causing many mistakes.

Prevailing issues of transparency remain. Although proxy advisors ostensibly publicise their voting guidelines, a methodological and formulaic approach nonetheless remains behind voting recommendations that makes it difficult for institutional investors to understand the basis and rationale of recommendations. It is therefore difficult for investors to assess the true quality of the service. Also, 'the absence of observation by the public makes it easier for proxy advisors to consider extraneous matters and raise inappropriate demands', which can exacerbate conflicts of interest.

5. THE EFFECT ON MEANINGFUL SHAREHOLDER ENGAGEMENT

Proxy advisors are involved in corporate governance by influencing the decisions of institutional investors. As proxy advisors can reduce information search costs, they can attract institutional investors to participate in corporate governance. However, because some institutional investors rely too much on the advice of proxy advisors, the negative phenomenon of robo-voting can occur.

5.1. Reduce costs and facilitate institutional investors' participation in corporate voting

As discussed in Section B, a significant reason why proxy advisors developed their prominence was due to economic considerations: they could help institutional investors save costs and mitigate the ‘free-rider’ problem. Furthermore, ‘compliance and stewardship pressure’ for greater shareholder engagement and active voting may lead to increased use of proxy advisors.

Without the support of proxy advisors, before voting, institutional investors with large, diversified portfolios need to know the annual accounts, the operating conditions, the personnel structures of hundreds of
companies before voting, and the specific issues they would need to discuss at the meetings. The extremely high cost and complexity of these administrative tasks leaves institutional investors with neither the time nor the inclination to deal with the large number of votes in the portfolios they manage.\[^{12}\]

Accordingly, after a proxy advisor has been engaged, their recommendations are used as 'a source of information' for the institutional investor's analysis when deciding how to vote.\[^{28}\] Investors use this information to gain a deeper understanding of the different proposals and to make informed voting decisions, thereby enabling them to optimise their limited resources.\[^{28}\]

Even for those institutional investors who invest in various companies across different countries, they can also use proxy advisors to participate in and influence the governance of overseas companies, which are subject to different corporate legal systems and different rules of governance.\[^{28}\] Within this framework, proxy advisors may provide valuable information of corporate governance specifics in a certain country of which investors are not necessarily aware.\[^{28}\]

In addition, most shareholder meetings around the world are clustered together at certain times of the year. In such circumstances, it is inefficient and impractical for institutional investors to gather information about each company simultaneously, and it would obviously be difficult to attend and vote at all annual general meetings.\[^{28}\] Increased access to proxy advisors means that institutional investors do not even have to attend in person, but can simply appoint a proxy advisor to attend and vote.

Simply put, proxy advisors can attract more institutional investors to corporate governance from a wider range of information sources and at a lower cost.

5.2. Overcoming the collective action dilemma of institutional investors

Proxy advisors can help overcome the collective action dilemma of institutional investors, by making it more likely that they will be able to restrain company management.\[^{12}\] According to Guo and Zhao, before the advent of proxy advisors, given the limited number of shares held in a single company, institutional shareholders who disagreed with a listed company's management proposal or business strategy did not generally have the cost of persuading other institutional shareholders to join them in putting pressure on management through a vote.\[^{12}\]

Instead, by giving the same recommendations to the clients, institutional investors do not need to 'take action itself and seek contact with other shareholders'.\[^{8}\]

5.3. Robo-voting problem

In fact, the issue of robo-voting is a widespread, generalized issue, since many institutional investors may automatically rely on proxy firm's recommendations without evaluation or due diligence.\[^{27}\] According to the report of Placent, 'companies often complain that there is an immediate spike in voting after proxy advisors issue recommendations',\[^{27}\] which means that the institutional investors may not fully review the value of recommendations of proxy advisors. In these circumstances, the interests of investee companies and other shareholders may be damaged.

In these cases, the participating behaviour of institutional investors seems to indicate an irresponsible lack of due diligence. In practice, however, robo-voting is a difficult phenomenon to avoid, as proxy advisors exist to enable institutional investors to reduce costs and therefore actively participate in corporate governance.

6. Conclusion

This essay has primarily evaluated the relationship between proxy advisors and institutional investors. Since institutional investors are holding an increasingly high number of shares in capital markets, their views and actions are becoming increasingly important. Before the creation of the proxy advisory industry, institutional investors faced several major problems. The two most significant problems were: (i) the high costs of participating in corporate governance; and (ii) the problem of 'free-riding' among institutional investors. In addition, the higher demand for institutional investor participation and transparency in regulatory policies also accelerated the creation and value of proxy advisors. Therefore, in 1972, the proxy advisory industry was introduced.

Proxy advisors do have a lot to offer to corporate governance, and this value primarily comes from proxy advisors giving their recommendations to institutional investors. A compelling amount of valuable empirical studies have demonstrated that proxy advisors play an important role in director elections, say-on-pay and ESG. In these three domains, proxy advisors always play a role in monitoring the company's board of directors, alerting shareholders and promoting sustainable development.

Although the proxy advisor industry has contributed significantly to corporate governance, there are nonetheless some negative effects: (i) proxy advisors are faced with multiple conflicts of interest; (ii) ineffective and incomplete information, and insufficient transparency; (iii) institutional investors’ over-reliance on proxy advisors. These three problems are widely criticised by researchers.

In addition to having an impact on corporate governance, proxy advisors have a significant effect on the engagement of shareholders. There are three main viewpoints: (i) proxy advisors stimulate institutional investors' participation in corporate voting through lowering the costs; (2) proxy advisors mitigate the collective action dilemma of institutional investors; (3) robo-voting problem. Overall, the impact of proxy advisors on shareholder engagement is significant, and while there is a degree of negative impact, the positive impact of proxy advisors is more significant and should be sustained and improved.
References


