Outsourcing Corporate Governance:
Conflicts of Interest and Competition in the Proxy Advisory Industry

Tao Li
Assistant Professor, University of Warwick
Background

- What are proxy advisory firms?
- Third-party advisors:
  - Help institutional investors decide which way to vote on corporate governance issues
  - Provide research reports and voting recommendations
  - Fee usually is subscription based
- These advisors have become very powerful:
  - Growth in institutional ownership
  - 2003 SEC rule on funds’ fiduciary duty regarding proxy voting
  - Mandatory Say-on-Pay votes and other Dodd-Frank requirements
A Lot of Sway on Votes

• “In 2002, ISS's endorsement of the Hewlett-Packard/Compaq merger was widely viewed as a decisive factor in the 51% vote in favor of the merger.”
  — White & Case LLP, 2008

• “Proxy advisers hold a position of unparalleled influence...20-25% of the votes cast at ExxonMobil's most recent annual meeting were voted automatically in accordance with proxy adviser recommendations.”
  — David Rosenthal, Vice President, Exxon Mobil Corporation, August 2012
Background

- But, do proxy advisors (PAs) always provide accurate research and recommendations?
  - A leading advisor:
    - 40,000 companies globally
    - Over 300,000 recommendations last year (75% between Jan – Jun)
    - 260 analysts!
  - Lack of transparency
  - No fiduciary duties to clients
  - **Potential conflicts of interest** – provide services to both investors and corporate clients on the same governance issues
Potential Conflict of Interest

- Corporate Clients
- ISS
- Institutional Investors

Data Consulting
Reports Recommendations
Competitor (Entered in 2003)

Glass Lewis → Institutional Investors

- Reports
- Recommendations
Background

• The SEC issued a 2010 “concept release,” highlighting potential conflicts of interest
  • “Corporations could feel obligated to subscribe to ISS's consulting services in order to obtain favorable proxy vote recommendations on their proposals.”
    —Government Accountability Office (GAO), 2007
  • “Signing up for [ISS] consulting provides an advantage in how the firm assesses their governance.”
    —Millstein Center On Corporate Governance, 2009

• Concerns from other regulators: ESMA (disclosure and transparency), CSA and CAMAC
Research Questions

- Could PAs’ corporate clients receive more favorable recommendations than non-client firms, everything else being equal?
  - A trade-off between consulting revenue vs. reputation

- Can competition mitigate conflict of interest?
  - Competitor’s reports could enable investors to make a more informed guess about incumbent advisor's bias if any
  - Finding: ISS makes fewer positive recommendations for management proposals after Glass Lewis begins to cover the firm
Data Summary

Percent of “For” recommendations and votes for Russell 3000 companies (2004-2011)

<table>
<thead>
<tr>
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<th>ISS “For”</th>
<th>Glass Lewis “For”</th>
<th>Average “For” vote</th>
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</thead>
<tbody>
<tr>
<td>Equity compensation plans</td>
<td>80%</td>
<td>74%</td>
<td>83%</td>
</tr>
<tr>
<td>Say-on-Pay proposals (2011 only)</td>
<td>88%</td>
<td>79%</td>
<td>91%</td>
</tr>
<tr>
<td>Director elections (firm-level average)</td>
<td>88%</td>
<td>77%</td>
<td>95%</td>
</tr>
<tr>
<td>All management proposals (firm-level average)</td>
<td>85%</td>
<td>70%</td>
<td>93%</td>
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Influence of Proxy Advisors

- Significant correlation between voting recommendations and vote outcomes:
  - A positive ISS (Glass Lewis) recommendation is associated with 23.8% (12.6%) more votes for Say-on-Pay proposals
  - For director elections, the numbers are 21.7% (5.8%)

- ISS’s influence has declined over time, and Glass Lewis’ has risen
Glass Lewis' Market Share

Glass Lewis client assets ($trillion)

Glass Lewis's market share based on client assets
Competition & Convergence of Recommendations

• When Glass Lewis’ market share increases by 10 pps, the difference between recommendations from ISS and GL decreases by about 1.7 pps, controlling for company characteristics

• Has ISS become tougher with management or Glass Lewis loosened standards?
Impact of Glass Lewis' coverage

• A Glass Lewis executive: “When we get a new institutional client, we have to make reports for all the firms in their portfolio.”

• Glass Lewis’ coverage of a new company is *unlikely* to be related to factors that affect ISS’s recommendations for it
  • ISS’s average “For” recommendation decreases by 2 pps in the following year after Glass Lewis initiates coverage of the firm (controlling for industry trends and company characteristics)

• What does this suggest? Is it conclusive?
  • Need to compare changes in recommendations for corporate clients vs. non-client firms
Summary of Research

• Systematically analyzes potential conflict of interest and the effect of competition among proxy advisors
  • Convergence in recommendations as Glass Lewis' market share rises
  • ISS makes fewer positive recommendations for management proposals after Glass Lewis begins to cover the company

• Paper doesn't directly test potential conflicts of interest (due to data constraint)
Further Reading

Presentation is adapted from:

*Outsourcing Corporate Governance: Conflicts of Interest and Competition in the Proxy Advisory Industry (ECGI Finance Working Paper No. 389/2013, Tao Li)*