Report on Proxy Advisors – the Empirical Evidence

The Realities of Stewardship
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Overview

- Existing research on proxy advisors (mine and others)
- Correlation or causation?
- The market for advisory services
What do proxy advisors do?

• Issue a report and recommendation in connection with shareholder voting
• Operate on a subscription basis serving institutional investors
• Coverage continues to increase
  • ISS covers 40,000 meetings worldwide
  • Issues recommendations and reports for 10,000 US issuers
  • 3300 clients (institutional investors and issuers)
What do they do?

They also

• Provide voting services
• Assist institutions in formulating voting policies
• Advise issuers on corporate governance
Why do we care about them?

• Shareholder voting has become increasingly important

ISS wields "tremendous clout"
ISS sways up to 30% of the vote
The Bottom Line

- ISS recommendation is a significant predictor of voting outcomes
  - Unadjusted “effect” of ISS: 20%
  - Multivariate regression controlling for approximately 21 firm-specific factors
    - Effect of ISS after controlling for other factors: 6-10%
- Why uncontested elections?
  - Information intense, not event driven, reflective of ongoing governance oversight
Similar effect on other votes - shareholder proposals

- Cotter, Palmiter & Thomas (2010)
  (shareholder and management proposals - 2003-2008)

- Mutual funds followed ISS more often than other shareholders

- When ISS and management agreed, stockholders followed that recommendation more than 90% of the time.
Similar effect on other votes - Say on pay

- Ferri & Oesch (2012 working paper)
- Proxy advisor recommendations are the “key determinant of voting outcome”
- Negative ISS (GL) recommendations are associated with 24.7% (12.9%) more votes against the compensation plan
- When both recommend Against, voting dissent is higher by 38.3%.
Similar effect on other votes - Mergers

- Davidoff, Fisch & Griffith (2013 working paper)
- Completed 2005-2012 mergers with transaction value > $100 million
- ISS *for* recommendation correlates with approximately 8-9% more votes in favor
- The median percentage of *yes* votes as a percentage of all votes cast is 84.81% for a *no* recommendation compared to 99.55% for a *yes* recommendation
Causation or Correlation

• No question that ISS recommendations (as well as those of other proxy advisors, to a lesser degree) are correlated with voting outcome

• But only a small percentage of investors delegate voting decisions to ISS (following ISS blindly)

• These tend primarily to be smaller institutional investors
**Do Funds Follow ISS Blindly?**

from Choi, Fisch & Kahan (2013)

<table>
<thead>
<tr>
<th>Fund Voting and ISS Recommendations</th>
<th>Assets ($ millions)</th>
<th>% Assets in sample</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund Votes that Follow ISS &gt;.99</td>
<td>76,632</td>
<td>3.04%</td>
</tr>
<tr>
<td>Fund Votes that Follow ISS &gt; .975</td>
<td>255,874</td>
<td>10.16%</td>
</tr>
<tr>
<td>Fund Votes that Follow ISS &gt; .95</td>
<td>478,701</td>
<td>19.00%</td>
</tr>
<tr>
<td>Fund WH cond. on ISS WH rec. &gt; .9</td>
<td>80,664</td>
<td>3.20%</td>
</tr>
<tr>
<td>Fund WH cond. on ISS WH rec. &gt; .8</td>
<td>203,345</td>
<td>8.07%</td>
</tr>
<tr>
<td>Fund WH cond. on ISS WH rec. &gt; .7</td>
<td>208,719</td>
<td>8.28%</td>
</tr>
<tr>
<td>Fund WH follow ISS/tot. Fund WH &gt; .9</td>
<td>177,764</td>
<td>7.06%</td>
</tr>
<tr>
<td>Fund WH follow ISS/tot. Fund WH &gt; .8</td>
<td>334,244</td>
<td>13.27%</td>
</tr>
</tbody>
</table>

For comparison: Rel. WH < 0.1:

Funds that follow ISS with respect to more that 99% of all ISS recommendations account for only 10% of the sample assets. Blindly following ISS is less common than blindly following board.
Management Recommendations matter too

- Choi, Fisch & Kahan (2013) (To the extent they use a short-cut, investors are more likely to follow management blindly than to follow ISS blindly)
- Cotter, Palmeter & Thomas (mutual funds follow ISS more than other shareholders)
- Both prior to elimination of broker discretionary voting
Do Funds Follow ISS?

- Vanguard rejected (60%) of ISS’s withhold recommendations and 76% of Vanguard’s withhold votes were cast on directors for which ISS recommended a “for” vote.
Do Funds Follow ISS?

• Dodge & Cox (5th largest fund family in sample)

• Zero withhold votes
Why are the correlations so high?

- ISS formulates its policies based on customer preferences
ISS description of policy development process

- Policy survey
- Global outreach
- Survey results released
- Comment period
- Final policy updates released
Cotter, Palmiter & Thomas (2010)

• Mutual funds follow ISS more on particular proposal types such as declassifying board and adopting majority voting
• These are the issues where institutions have taken the lead, often sponsoring as well as supporting
• Supposedly “independent” institutions vote similarly
Why are the correlations so high?

- ISS formulates its policies based on customer preferences
- ISS flags issues for shareholder attention
Do Funds Follow ISS?
from Choi, Fisch & Kahan (2013)

ISS Recommendations
For: 93.2%
Withhold: 6.8%

<table>
<thead>
<tr>
<th></th>
<th>Average</th>
<th>Asset-weighted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund For/ISS For</td>
<td>94%</td>
<td>95.6%</td>
</tr>
<tr>
<td>Fund Withhold/ISS Withhold</td>
<td>47%</td>
<td>26.5%</td>
</tr>
</tbody>
</table>

Withhold recommendations matter more!
Why are the correlations so high?

- ISS formulates its policies based on customer preferences
- ISS flags issues for shareholder attention
- ISS provides information specifically tailored to its voting policies
  - See Ertimur, Ferri & Maber (2012) on options backdating and withhold votes
What explains high withhold votes?
ISS only goes so far from Choi, Fisch & Kahan (2013)

<table>
<thead>
<tr>
<th>Withhold vote &gt; 30%</th>
<th>ISS withhold only</th>
<th>ISS withhold plus one of four factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>21%</td>
<td>48%</td>
<td></td>
</tr>
<tr>
<td>Withhold vote &gt; 40%</td>
<td>7%</td>
<td>19%</td>
</tr>
<tr>
<td>Withhold vote &gt; 50%</td>
<td>.5%</td>
<td>5%</td>
</tr>
</tbody>
</table>

The Four Factors Are:
- Fidelity withhold vote
- Attendance at less than 75% of board meetings
- Ignoring a shareholder resolution that received majority support
- Vanguard withhold vote on outside linked director
Some Thoughts on the Market for Advisory Services

- Competition and the market for proxy advice
- Transparency
- Conflicts of Interest
- The maturation of the market
All proxy advice is not the same

- Choi, Fisch & Kahan (2009) (differing withhold recommendations by then-four major firms (ISS, Glass Lewis, Proxy Governance, Egan Jones)

- Ferri & Oesch (Glass Lewis issued almost twice as many no recommendations on executive compensation as ISS)
But market discipline is limited

- Investors need a low cost comprehensive source of proxy information
- Hard to measure (or even conceptualize) quality

Some studies are attempting to measure the relationship between ISS recommendations and outcome/performance variables, but these studies are preliminary and present challenges. See, e.g., Larcker, McCall & Ormazabal (working paper 2012) (“proxy advisory firm recommendations regarding stock option repricings are not value increasing for shareholders”)

Proxy Advisors and Transparency

- The pros and cons of one-size-fits-all
- A uniform approach prevents less-transparent advisor discretion
- A uniform approach reduces costs
- But the same approach may not be right at all issuers

- ISS 2013-14 policy guidelines announce a greater emphasis on case-specific analysis
Proxy advisor transparency

- Policy development process (described earlier)

- Increasing disclosure of underlying methodology – See, e.g., Evaluating Pay for Performance Alignment *ISS’ Quantitative and Qualitative Approach* Published December 2012 Revised: January 2013
Conflicts – Real or Imagined

• At least with respect to ISS, its “good governance” metric is fairly well known
• Possible value of disclosing in the report whether an issuer purchases advisory services
• Given widespread use of ISS by investors, disclosure of proponent’s customer status is of questionable value
Maturation of the market for advisory services

• We haven’t been doing this very long –
  • SEC mandated mutual fund voting disclosure – 2003
  • NYSE eliminated broker discretionary voting
    • For uncontested director elections - 2010
    • For non-routine shareholder proposals - 2012
  • Dodd-Frank mandates say on pay - 2011

• Most limitations of proxy advisors result from uncertainty or disagreement about “best” governance practices
Thank you!