Transatlantic Corporate Governance Dialogue

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Outsourcing Corporate Governance:

Conflicts of Interest and Competition in the Proxy Advisory Industry

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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

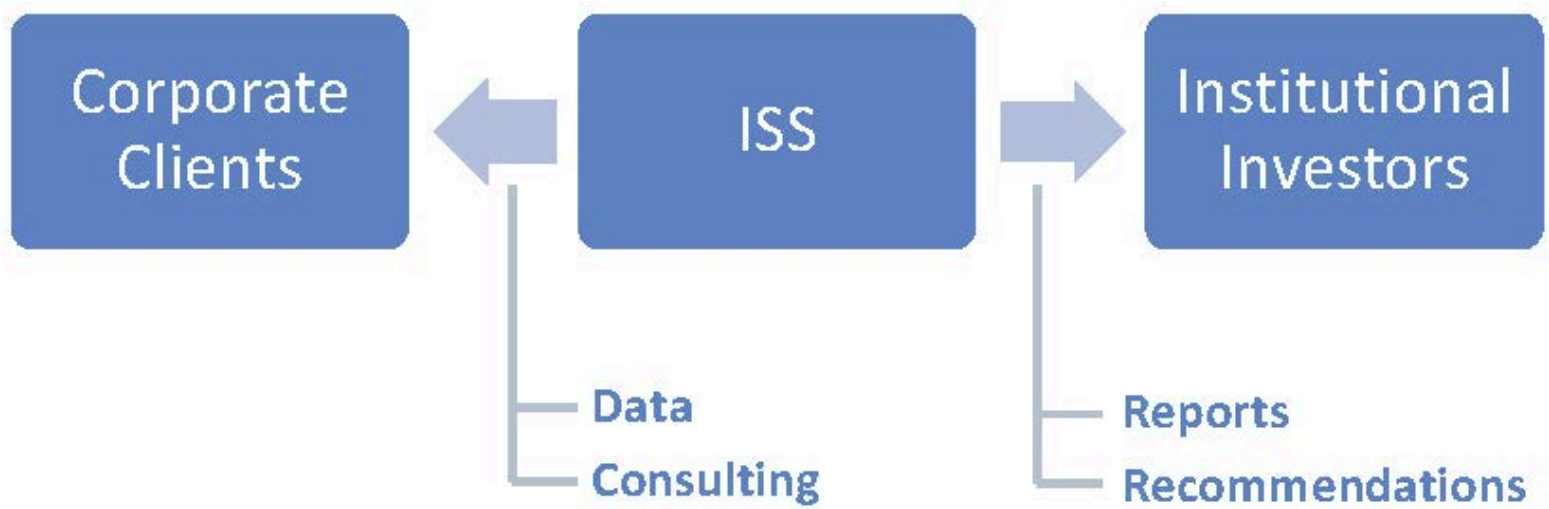
- *"Proxy advisers hold a position of unparalleled influence... 20-25% of the votes cast at ExxonMobil's most recent annual meeting were voted automatically in accordance with proxy adviser recommendations."*

— David Rosenthal, Vice President, Exxon Mobil Corporation, August 2012

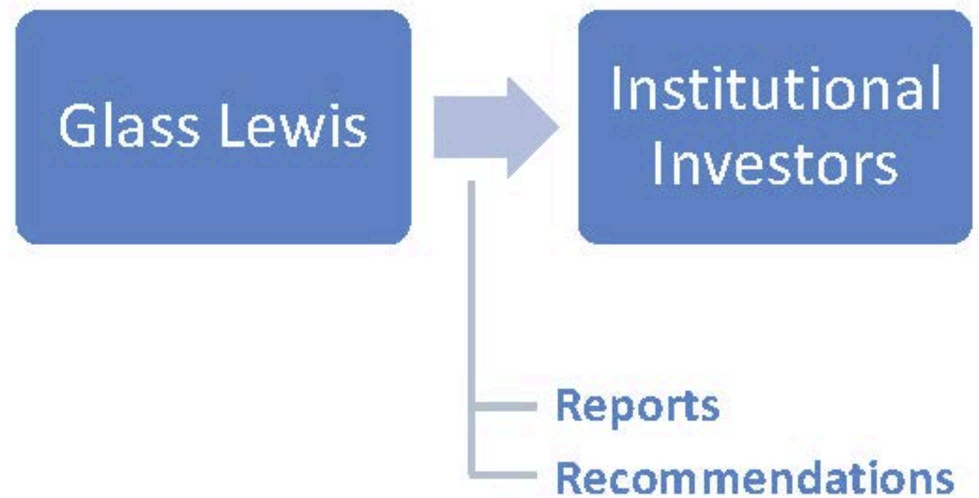
Background

- 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



Competitor (Entered in 2003)



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

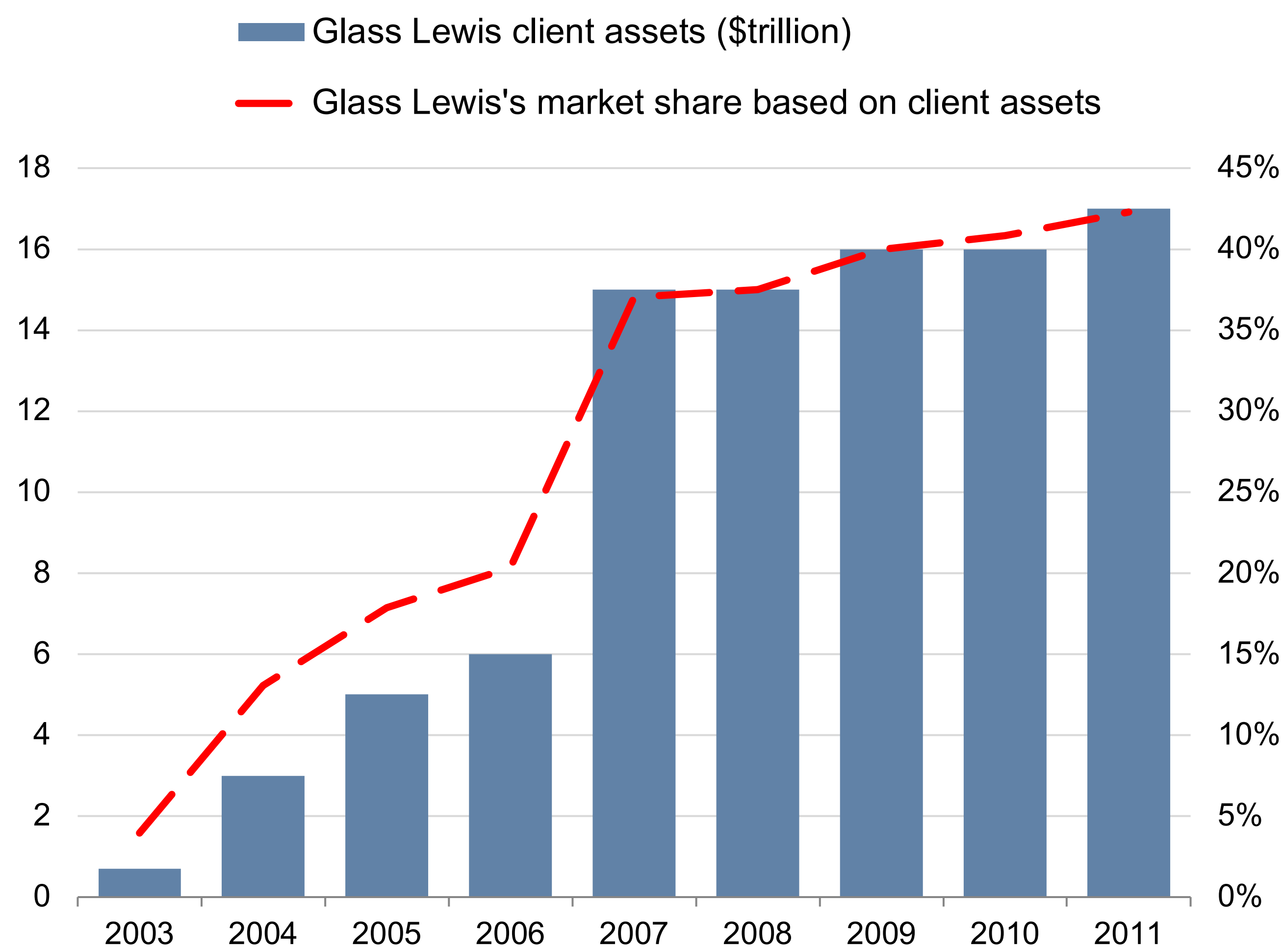
Percent of “For” recommendations and votes for Russell 3000 companies (2004-2011)

	ISS “For”	Glass Lewis “For”	Average “For” vote
Equity compensation plans	80%	74%	83%
Say-on-Pay proposals (2011 only)	88%	79%	91%
Director elections (firm-level average)	88%	77%	95%
All management proposals (firm-level average)	85%	70%	93%

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



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)

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2287196