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"Examining the Market Power and Impact of Proxy Advisory Firms"

Introduction

My name is Darla C. Stuckey and I am Senior Vice President, Policy & Advocacy, of the Society of Corporate Secretaries and Governance Professionals (the "Society"). The Society is a professional association, founded in 1946, with over 3,000 members who serve more than 1,500 public, private and non-profit organizations. Our members seek to develop corporate governance policies and practices that support our boards to foster the interests of long term stockholders. Our members generally are responsible for their companies' compliance with the securities laws and regulations, corporate law, and stock exchange listing requirements. More than half of our members are from small and mid-cap companies.

Background

The Subcommittee has asked for our testimony on the services provided by proxy advisory firms to shareholders and issuers to determine whether these entities are providing unbiased opinions and if conflicts of interest exist. The Subcommittee has also asked for our views on the market power of proxy advisory firms, and their ability to promote agendas supported by narrow or single-issue shareholders.

Beginning in the 1980s, regulators have pushed institutions to use their voting power, with limited regard for costs of voting from an informed fiduciary standpoint. Major regulatory landmarks in this regulatory push include a Department of Labor (DOL) letter (the "Avon Letter") in 1988, and 2003 SEC rules to require that every mutual fund and its investment adviser disclose "the policies and procedures that [they use] to determine how to vote proxies". The purpose of the SEC rules was to "encourage funds to vote their proxies in the best interests of shareholders" and to avoid conflicts of interest between those shareholders and the fund's "investment adviser, principal underwriter, or certain of their affiliates."

> Unfortunately, the rule became a classic case of unintended consequences. Many institutional investors largely outsourced their shareholder voting policies to a proxy advisory industry that relies on . . . "one-size-fits-all" policies. . . . Instead of eliminating conflicts of interest, the rule simply shifted their source. Instead of encouraging funds to assume more responsibility for their proxy votes, the rule pushes them to assume less. Instead of providing informed, sensitive voting on proxies, the incentive has been to outsource decision making to two small organizations that most investors have never heard of. These two firms have emerged as the most powerful force in corporate governance in America today, shaping the way that mutual funds and other institutions cast votes on proxy questions posed by about 5,000 US public companies.[1]

[1] James K. Glassman and J. W. Verret, *How To Fix Our Broken Proxy Advisory System*, George Mason University, 2013 at page 6.

I. A SIGNIFICANT PERCENTAGE OF INVESTORS ARE INDIFFERENT TO VOTING AND THUS OUTSOURCE THEIR VOTE

Shareholdings in public companies are increasingly held by individuals through mutual funds and other intermediaries who have the right, and obligation, to vote the shares held. For this reason there is an increasing lack of connection between beneficial ownership and voting decisions. "Institutional investors vot[e] . . . portfolio company shares [by] delegate[ing] all but the most obvious economically related voting decisions to either an internal or external corporate governance team that is largely, or all too often totally, separate from the investment policy decision making team— in effect, a parallel universe of voting decision makers."[2] "Over the past decade, the SEC and Congress have increased regulation focused on institutional investors voting. An explicit assumption in this regulation was that institutional investors would conduct the research necessary to vote in a manner that would maximize value for all firm shareholders. Unfortunately institutional investors face a classic free rider problem in conducting this research and may not have economic incentives to make such an investment."[3]

Reading and analyzing proxy statements is time consuming, requiring many hours of effort and analysis. A portfolio manager or his or her in-house governance analysts would need to expend significant resources to review individually the proxy materials of each company his or her fund owns. There are few investment managers who will allocate capital to voting decisions that they believe will not generate any return on investment. In short, proxy voting, other than in a contested election or similar "bet the farm" type scenario, is simply not worth the cost. A recent study titled *Outsourcing Shareholder Voting to Proxy Advisory Firms,* David F. Larcker and Allan L. McCall, Graduate School of Business, Stanford University, and Gaizka Ormazabal, IESE Business School, University of Navarra (Draft May 10, 2013), makes this point:

> The important public policy issue in this setting is whether the payments made by institutional investors are sufficient for the proxy advisory firms to engage in costly research to develop "correct" governance recommendations from the perspective of firm shareholders. If the institutional investors are only using the proxy advisor voting recommendations to meet their compliance requirement with the lowest cost, these payments will not compensate proxy advisors for conducting research that is necessary to determine appropriate corporate governance structures for individual firms.[4]

Added to this is the collective action problem inherent in the current structure of the proxy voting system. Generally, institutional investors have little incentive to give sufficient

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[2] Latham & Watkins, *Future of Institutional Share Voting Revisited: A Fourth Paradigm*, September 2011. See also, Nathan, Charles M. and Mehta, Parul, *The Parallel Universes of Institutional Investing and Institutional Voting*, April 2, 2013

[3] Larcker, David F., McCall, Allan L. and Ormazabal, Gaizka, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, May 10, 2013at 43.

[4] Larcker, McCall and Ormazabal at 3.

time and resources to intelligent voting, since the investor knows that with a small ownership interest in the company, the fund's vote will have limited direct impact at a company. (A fund investor that holds 1% of the vote seldom will change the outcome of a vote; those owning less of a company's shares have even smaller direct impact.) This dynamic creates downward pressure on the quality and thoroughness of analysis related to proxy votes, particularly those that have in the past been regarded as "routine" (e.g., election of directors in non-contested situations). As proxy voting in non-contested meetings has become more important, particularly with the advent of say-on-pay, this disconnect can result in damage to the long-term interests of the company.

Thus, outsourcing these reviews to proxy advisory firms is pragmatic and rational for institutional investors, many of which say they cannot analyze the hundreds of proxy statements for their portfolio companies, particularly given the ever-increasing length and complexity of such materials.[5] Some investment managers openly tell issuers that they follow proxy advisory firm recommendations without questioning them, and without shame or embarrassment. As one Society member notes: "Many hedge funds that are in our top 25 shareholders by holdings refuse to engage with us when we call because they say that they follow ISS recommendations." And, another Society member stated that "many mutual funds buy research from proxy advisory firms; certain firms are required to justify any vote that is NOT in accordance with the proxy advisory firm' recommendations". Investment firms openly use proxy advisory firm reports as substitutes for the actual proxy statements (think Cliff's Notes). Proxy statements are subject to '34 Act and 10b5-1 liability. Proxy advisory firm reports are not, yet they are being relied upon just as heavily, if not more so, by investors to make voting/investment decisions. Furthermore, many investment managers do not even read the proxy advisory firm reports; in fact there is a "recommendation only" service from one provider that investors can purchase at a lower price that will nevertheless satisfy their compliance obligation.[6]

Outside of a proxy fight context, proxy advisory firms tend to implement mechanical policies, including check-the-box approaches that clients can tweak in "custom policies" that still are severely constrained analytically. The proxy advisory firms have an interest in perpetuating the view that such check-the-box approach to proxy voting—a demand they can fill at low cost—is adequate. We believe simple-minded voting algorithms may be an appropriate way to approach certain issues. But this method does not work well in what have become the dominant and most consequential proxy voting decisions in routine elections in the wake of various reforms enhancing shareholder power – election of directors, and executive compensation (through the advisory vote on pay).

[5] The Society understands that some of the very largest investment managers develop their own voting guidelines and use proxy firms to "supplement" their own evaluation of agenda items. This fact notwithstanding, the influence of the proxy advisory firms is substantial.
[6] See Larcker, McCall and Ormazabal at 3.

II. PROXY ADVISORY FIRMS ARE NOT REGULATED AND HAVE NO OVERSIGHT ACCOUNTABILITY FOR THEIR RECOMMENDATIONS

As noted by the Commission in its concept release, proxy advisory firms are one of the few participants in the proxy voting process that are not generally required to be registered or regulated by the SEC. There is no accountability by proxy advisory firms even though, given the current structure of the proxy system, they control anywhere from 20-40% of the vote collectively on so-called "routine" matters at widely held companies.[7] When proxy advisory firm recommendations come out, large blocks of votes are cast almost immediately in automated voting decisions. These ripple out both from clients that follow the main policy of each advisory firm, and those that have so-called "custom policies" that are tweaked based on simplistic mechanical inputs. Proxy advisory firms are not beneficial owners of any company's shares.

Thus, the two largest proxy advisory firms each effectively control a portion of the vote that is much larger than the Schedule 13D threshold (5%), and even larger than the 10% affiliate status threshold, yet they are not subjected to any kind regulatory regime. Proxy advisory firms may produce reports with material misstatements and omissions without any legal consequences for the proxy advisory firm. One of the two dominant advisory firms, ISS, has registered as investment advisors, but no other firm has. Proxy advisory firm recommendations are tantamount to soliciting material in that they tell investors how to vote, but they are selectively disclosed only to paying customers and only sometimes to issuers.[8]

Proxy advisory firms voting policies are also unregulated. There is no regulatory regime that governs the manner in which these firms develop their policies or form the recommendations they make. The policy development process at proxy advisory firms is not sufficiently transparent.[9] It is not clear who actually participates in the process of policy development. Although ISS provides companies with an opportunity to weigh in on their policy survey, the questions often are skewed,[10] which create biased policies that seem to reflect

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[7] We believe there is a trend towards greater voting independence of large mutual fund complexes, but a large number of smaller investment managers (and some of the larger managers) continue to follow the proxy advisory firms closely, and sometimes without even reading the research.

[8] We note that there are differences between Institutional Shareholder Services ("ISS") and other proxy advisory firms such as Glass Lewis. We have tried to be specific in this letter, but the majority of the examples raised herein relate to ISS, primarily because of its dominant market share and our members' interaction with ISS. Importantly, we note that Glass Lewis only recently has begun to engage consistently with issuers and, for this reason, the interaction of the Society members with Glass Lewis as it relates to vote recommendations has been limited.

[9] See Stanford Closer Look Series (February 25, 2013) for a critique of the policy development process at ISS and Glass Lewis.

[10] The questions too often biased and the choice of responses are not appropriate for companies that complete the survey. Society comment letters and other member comment letters explain the biases, the lack of transparency and the design flaws in ISS's survey process. For example, ISS asked this question in its 2011 Policy Survey with options for a "yes" or "no" response: "In 2011,a handful of issuers required that, in order to call a special meeting, a shareholder or group of shareholders must hold the requisite ownership threshold in a net-long position. This requirement prevents shareholders seeking to call a special meeting from, for example, borrowing shares from another shareholder to satisfy the ownership criterion. Does your organization find this restriction to be sufficiently onerous to raise board responsiveness concerns?" See also, Larcker, McCall, and Brian Tayan, "And

narrow agendas of certain types of investors. Moreover, while ISS points to its survey as proof that their policies are representative, it appears that only a small number of investors respond to the surveys, and ISS has not recently provided information on the percentage of institutional clients responding.

The rise of proxy advisory firms as intermediaries in the voting process has come directly from government regulation, with ISS establishing its market position in the years following the Avon letter, and Glass Lewis formed at the time of the SEC reforms. Both firms have gained significant traction since then. As noted above, regulation from the SEC,[11] well-intentioned at the time, coupled with DOL pronouncements that have contributed to the belief for many funds that they are required to vote (which they aren't) from a fiduciary perspective. Because of the position that the DOL and the SEC have taken, they have created an opportunity (the need) for proxy advisory firms. The SEC, the DOL, and other agencies should revisit these interpretive positions.

The Society believes that proxy advisory firms should be registered with the SEC. Moreover, if government regulation continues to put an onus on institutions to vote in nearly all cases, regardless of their direct economic interest, then the government also should provide some oversight to ensure that institutions are not simply taking a lowest-cost, lowest-common-denominator approach that essentially shirks rather than embraces their fiduciary obligations. Voting has become more consequential in the life of companies, and with this comes a need for increased investor responsibility.

The SEC should reconsider whether proxy advisory firms should be exempt from the proxy solicitation rules (Exchange Act Rule 14a-2(b)(3)). This would help ensure that fiduciary obligations of good faith and due care are properly carried out by all participants in the process. Greater oversight of the entire proxy voting system would facilitate transparency, reduce conflicts of interest, and provide greater discipline in the way vote recommendations are determined, thereby ensuring that votes are cast in the financial best interests of the beneficial owners.

Our concerns about the current proxy advisory firm business, along with our suggestions for potential improvements to the current model, are described below. Our comments are organized as follows. First, we describe the influence of proxy advisory firms. Second, we discuss the harm to the integrity of the vote as a result of proxy advisory firms' factual inaccuracies, as well as the application of "one size fits all" policies applied without

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Then A Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?", Stanford Closer Look Series, February 25, 2013.

[11] See, Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106 (Jan. 31, 2003). However, the SEC did note that failure to vote would not mean breach of fiduciary duties. It stated, "We do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client. An adviser may not, however ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies."

judgment about what is in the economic best interests of the shareholders of a particular company on a particular issue. Third, we set forth suggested improvements in the procedures of proxy advisory firms to: (i) increase transparency in the formulation of voting policies, (ii) mitigate the potential for factual mistakes, and (iii) give issuers more time to review voting recommendations and allow issuer comments on reports. Finally we set out proposed regulation that would require SEC oversight of proxy advisory firms and require registered investment advisors to oversee the work of such firms to ensure accuracy and transparency.

III. PROXY ADVISORY FIRMS HAVE SIGNIFICANT INFLUENCE ON VOTING OUTCOMES AND CORPORATE BEHAVIOR

The influence of proxy advisory firms is no longer questioned. Proxy advisory firms exert a significant influence on matters presented for shareholder votes. Our Survey of Society members in 2010 indicated that 50% of respondents believe that at least 20% of their shares are voted in line with proxy advisory firm recommendations. Asked differently, 82% of our respondents indicated that proxy advisory firms have a "material impact" (defined as influencing 10% or more) on the vote.

As noted above, our members witness votes cast in line with proxy advisory firm recommendations immediately when the report and vote recommendations are distributed. For example, one of our Society members stated that one year when ISS was very late in releasing its report, the member's company's vote levels were similarly delayed but running 96% in favor of directors. When ISS did release the report, the company's quorum increased from 24% to 37% (13%) within a day (the short time frame suggesting little independent deliberation by the funds using ISS) and the vote in favor of directors dropped to 80% following the ISS recommendation.

Similarly, as noted in a comment letter from IBM[12], in 2009 and 2010, an estimated 13.5% and 11.9% of the total votes cast in each year for IBM's annual meeting were cast lock-step with ISS's recommendations within one business day after the release of ISS's report. For the previous five business days, no more than 0.20% and 0.27% of the total IBM votes were cast in any one day. "**To put that into proper perspective, the IBM voting block essentially controlled by ISS has more influence on the voting results than IBM's largest shareholder. And this voting block is controlled by a proxy advisory firm that has no economic stake in the company and has not made meaningful public disclosures about its voting power, conflicts of interest or controls."** To be clear, many companies believe that the ISS influence is far greater than the significant "one business day" impact noted above; however, that additional influence is difficult to quantify because institutional investors are not required to publicly disclose when they in essence "outsource" decision making over proxy matters to ISS or other third parties.

[12] International Business Machines, Comment Letter, *Concept Release on the U.S. Proxy Season*, October 15, 2010
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One Society member faced the same shareholder proposal in 2012 and 2013, advocating an independent chair. In 2012, ISS supported the proposal, which received 39% support. In 2013, ISS changed its position to oppose the proposal, which then received 19% support. There had been no change in the company's practices that would merit such a change; rather, a mechanistic and simple-minded trigger for the ISS policy caused a 20% swing in the vote.

Another Society member stated this year that Glass Lewis controlled 8% of the vote which was evident from a recommendation made a against a proposal and the vote count coming in immediately following the issuance of the report.

The influence of proxy advisory firms is reflected not only in voting totals. The threat of an "against" or "withhold" vote by a proxy advisory firm often causes companies to adopt practices in order to ensure that they will get the favorable vote. Half of the Survey respondents noted that their companies have withdrawn or modified a proposal based on the expected voting recommendation of a proxy advisory firm and of those, 63% stated that the primary reason for the change or withdrawal was because they believed the adverse recommendation could materially impact the vote results.

Corporate boards and committees spend an inordinate amount of time ensuring their policies and practices fall neatly within proxy advisory guidelines in order to avoid unfavorable vote recommendations these firms. This is particularly the case with respect to decisions on executive compensation design, a key driver in the achievement of corporate success and long-term shareholder return.[13] Society members say that in considering executive compensation, directors increasingly ask, "What will ISS say?" And evidence suggests that this influence does not enhance shareholder value. A recently published study found, "proxy advisory firms . . . induce the boards of directors to make compensation decisions that *decrease* shareholder value." The authors write:

> We examine the shareholder value implications of outsourcing to proxy advisory firms on the recent requirement to implement Say-on-Pay. . . . [W]e confirm that proxy advisory firm recommendations have a substantive impact on SOP voting outcomes. We also find that . . . a significant number of boards of directors change their compensation programs in the time period *before* the formal shareholder vote in a manner that better aligns compensation programs with the recommendation policies of proxy advisory firms. . . . We interpret our result as evidence that boards of directors change executive compensation plans in order to avoid a negative SOP recommendation by proxy advisory firms, and thereby increase the likelihood that the firm will not fail the vote (or

[13] In a recent survey conducted by The Conference Board, NASDAQ and the Stanford Rock Center for Corporate Governance, over 70% of the director and executive officer respondents indicated that their compensation programs were influenced by the policies of and/or guidance received from proxy advisory firms during their evaluation of say-on-pay. The increase in the use of relative TSR over a 3-year time horizon as a performance metric is directly attributable to the methodology used by ISS to evaluate performance plan design.

will garner a sufficient level of positive votes). The stock market reaction to these compensation program changes is statistically *negative*. . . . [W]e believe the most . . . plausible conclusion is that the confluence of free rider problems in the voting decision, regulation of voting in institutional investors, and the decision by the SEC to regard proxy advisor policies as appropriate for purposes of institutional investor compliance with regulation has led to policies of proxy advisory firms that induce the boards of directors to make compensation decisions that *decrease* shareholder value.[14]

As a result of the role proxy advisory firms play in formulating and establishing governance standards and the extent to which institutional fund managers follow those standards, proxy advisory firms have become the "de facto" arbiters of corporate governance practices. The New York Stock Exchange ("NYSE") Commission on Corporate Governance issued a report on September 23, 2010, that explicitly recognized the influence that proxy advisory firms have on the market. The NYSE Commission on Corporate Governance also recommends that the SEC should "require [proxy advisory] firms to disclose the policies and methodologies that the firms use to formulate specific voting recommendations, as well as material conflicts of interest, and to hold themselves to a high degree of care, accuracy and fairness in dealing with both shareholders and companies by adhering to strict codes of conduct."

IV. PROXY ADVISORY FIRMS HARM THE INTEGRITY OF PROXY VOTING BECAUSE THEY ARE SUBJECT TO CONFLICTS OF INTEREST

The Society believes that proxy advisory firm voting influence undermines the integrity of the voting system for a number of reasons: (1) proxy advisory firms are subject to conflicts of interest; (2) proxy advisory firms make factual mistakes (sometimes material or egregious) in their analysis, with the effect that their voting guidelines are erroneously applied to the company's proposal and the voting recommendation is inaccurate; and (3) proxy advisory firms have no economic interest in the shares they vote and therefore have no economic interest in the outcome.

Proxy advisory firms are subject to four types of conflicts of interest. The first occurs as a result of proxy advisory firms selling services to both institutional clients and issuers. The second conflict arises when proxy advisory firms make favorable recommendations on proposals submitted by their own investor clients. The third conflict stems from proxy advisory firms' interest in recommending certain proposals that are likely to expand their influence and future market. The fourth may arise when an owner of a proxy advisory firm takes a position on a proxy voting issue and the firm also issues a voting recommendation on that issue (this applies to Glass Lewis only).

A. Proxy advisory firms offer services to both institutions and issuers

[14] Larcker, McCall and Ormazabal at 43-45

Most notably, ISS provides advisory services to issuers on corporate governance structures or compensation plans, and then makes voting recommendations based on the same structures and plans on which it has advised. Many Society members subscribe to ISS's service in an effort to ensure they design compensation plans that will get a favorable recommendation from ISS. Indeed, some Society members report that they believe they have *no choice* but to subscribe to ISS's service in order to gain sufficient visibility into the ISS model to understand what will gain a favorable ISS recommendation.

The Society is aware that ISS believes its consulting services are walled off from vote recommendation decisions. Nevertheless, it appears that the consulting side uses the same compensation plan models that the analysts use when making voting recommendations. Accordingly, the Society does not believe this conflict can be adequately mitigated by "Chinese Wall" procedures between the consulting and voting sides of the business.

It has long been the case that Glass Lewis does not offer services or advice to issuers. However, this year, we have been made aware that Equilar, a service provider with whom Glass Lewis has a financial relationship, is marketing its service to companies that receive a negative recommendation from Glass Lewis.

One large-cap midwestern company member received a call from an Equilar sales representative two business days after Glass Lewis issued its report on the company which recommended against the say on pay proposal. The Equilar representative wanted to sell the company its consulting services so the company could learn more about the background of the Glass Lewis recommendation. The Society member asked about the basis for the number Glass Lewis had used for the CEO's compensation for 2012, as its CEO changed and GL had used a composite of the former CEO's compensation and the new CEO's compensation. It was not clear to the company how Glass Lewis had derived the number since it was about 45% higher than the amount reported in the summary compensation table for the current CEO. The Equilar sales representative was unwilling to discuss the number unless the company agreed to subscribe to the service, which was about $30,000. This same scenario was reported to us from other proxy solicitors and law firms.

The Society is very concerned about the apparent conflict of interest. As one member put it: "After all the years of GL criticizing ISS for taking consulting fees from corporate issuers, it seems that now they've adopted the same business model, except that the fees are laundered through Equilar."

The Society notes that its members increasingly engage with their shareholders on various corporate governance and compensation matters—indeed in the say-on-pay world, companies are compelled to do so. Shareholders do not charge for this consultation. The Society believes that proxy advisory firms who are acting as voting agents for the institutional investors have a conflict of interest in charging companies for consulting services that the institutional shareholders themselves are providing free of charge.

B. Proxy advisory firms make recommendations on proposals submitted by their own investor clients

Second, some proxy advisory firms make voting recommendations in favor of proposals that are being submitted by investors that are clients of the proxy advisory firm. The Society believes that the only way to mitigate this conflict is to require the proxy advisory firm to specifically disclose in their voting recommendation that the subject proposal has been submitted by a client—and for the client to disclose to the company and the other shareholders as part of its proposal in the proxy statement that the client utilizes ISS. We believe not having this information is harmful both to the other clients of ISS and to the company's other shareholders because, without this information, they have no idea of the extent of, or types of, conflicts to which the proxy advisory firm is subject. Corporate issuers and their shareholders have a right to know that they are subjected to voting recommendations that have been proposed and paid for by the proxy advisory firms' clients.

C. Proxy Advisory Firms Have an Interest in Recommending Proposals that Sustain and Expand Demand for their Services

Proxy advisory firms are in the business to make a profit. For this reason they must keep their services relevant, and necessary. This is clearer today since the say on pay vote has been mandated: "As so many predicted when Say on Pay was being debated, the outcome of mandatory Say on Pay advisory votes will be the ascendency of the proxy advisory firms' executive compensation models, whether or not the proxy advisors have any expertise or knowledge about executive compensation, whether or not their executive compensation metrics are well founded conceptually and fairly and accurately applied in practice and whether or not those metrics are at least more often than not applicable to specific companies facing specific issues in terms of management retention, management incentives and shareholder value creation."[15]

Therefore, proxy advisory firms will make recommendations that will increase demand for the services they or affiliated companies offer to the same institutional clients. In such instances, the proxy advisory firm has a specific interest in the outcome of the vote on the issue. For example, annual—rather than tri-annual—say-on-pay votes increase the frequency of proxy voting for institutional investors, thereby increasing dependence on the proxy advisory firms. As another example, MSCI, corporate parent of ISS, has an interest in generating demand for its environmental services; at the same time, ISS provides voting recommendations on shareholder proposals that advocate expanded environmental disclosures, such as the Global Reporting Initiative.

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[15] Nathan, Charles, Barrall, James D.C. and Chung, Alice, *Say on Pay 2011: Proxy Advisors on Course for Hegemony*, New York Law Journal, November 28, 2011

Furthermore, ISS 2012 voting policies for 2012 "make clear that ISS views a favorable vote of less than 70% as an indication of sufficient investor concern with a company's executive pay policies to require that either the company take what ISS considers appropriate corrective action or face a potential withhold vote recommendation for some or the company's directors. In the ISS Say on Pay universe, the new 50% passing grade for Say on Pay is now 70%."[16]

This is troubling when ISS alone has the ability to sway about 20% of the average company's vote (and Glass Lewis about 10%). A negative recommendation in year one can result in a forgone conclusion that in year two, it may take action against your board. Because they control 30%, they can recommend against say on pay and then withhold against a board the following year. Also, it sometimes happens that Glass Lewis recommends against a director with a low vote the previous year, when in fact that low vote was due to ISS against recommendations.

D. Glass Lewis is owned by an Investor That May Take a Position on a Matter for which it then Makes a Recommendation

There can be an appearance of a conflict of interest on the part of Glass Lewis because it is owned by an investor, the Ontario Teachers' Pension Plan, which itself engages in activism and takes positions in some proxy fights. While there is no evidence that OTPP exerts pressure on Glass Lewis to recommend in favor of its own agenda, the appearance of a potential conflict remains. This should be mitigated.

V. PROXY ADVISORY FIRMS HARM THE INTEGRITY OF PROXY VOTING BECAUSE THEY TAKE A "ONE SIZE FITS ALL APPROACH"

Proxy advisory firms often do not take into account the specific circumstances of the issuer, but instead follow a one-size-fits-all approach to their vote recommendations. Society members have reported situations where the proxy advisory firm recommended against a governance practice that had been approved in a prior vote by the company's shareholders--thus disregarding the will of shareholders. As a corollary, proxy advisory firms do not base their recommendations on empirical evidence of what is beneficial to the capital markets or industry.

VI. PROXY ADVISORY FIRMS HARM THE INTEGRITY OF PROXY VOTING BECAUSE THEIR REPORTS REGULARLY CONTAIN FACTUAL INACCURACIES AND GROSS ANALYTICAL ERRORS

One of the major factors undermining integrity in the proxy voting system is that the recommendations of proxy advisory firms are at times based on mistakes of fact or gross

[16] Chuck Nathan, James D.C. Barrall and Alice Chung, *Say on Pay 2011: Proxy Advisors On Course for Hegemony, New York Law Journal*, (Nov. 28, 2011)

analytical errors where the drafters of the reports "just don't get it."[17] Because the services do not release their proxy reports publicly except for high fees, even after the annual meeting is concluded, and because they place strict limits on sharing of reports, it is difficult to be precise on the quantity of misinformation and clearly poor analysis produced by the firms. The Society's survey results indicate that 65% of the respondents experienced--at least once--a vote recommendation based on materially inaccurate or incomplete information, or where the proxy advisory firm reported as fact information that was incorrect or incomplete. [Q 5] One quarter of those respondents experienced inaccurate or incomplete information on several occasions. For the respondents who found inaccurate information in a vote report, the proxy advisory firm did not correct the mistake 57% of the time. Furthermore, in 44% of the instances where issuers found mistakes the proxy advisory firm reviewed its recommendations but was unwilling to change the recommendation or factual assertion. In another 22% of the instances where issuers found mistakes, the proxy advisory firm was unwilling to reconsider the recommendation at all.

This lack of accuracy harms both issuers and investors. Several Society members have informed us that in several instances their institutional investors were unaware of a mistake in a proxy advisory firm report or recommendation and stated to the issuer in private that had they known otherwise, their own votes would have been different. Other Society members from small or mid cap companies do not receive proxy advisory firm reports at all, and cannot begin to assess the basis upon which votes may have been made by their institutional investors. Moreover, Glass Lewis does not make its vote recommendations available to issuers at all—so issuers have no idea when there are mistakes in a report unless their institutional shareholders or proxy solicitors inform them. *At the very least, proxy recommendation reports should be provided to all issuers in advance to enable the issuer to check the factual accuracy of the report. Votes that are not based on actual facts are not informed votes.*

The Society believes that mistakes are made because the procedures utilized by proxy advisory firms are inadequate and not subject to review. We believe this is largely a cost and resource issue. Issuers note that the staff at proxy advisory firms seem overwhelmed during proxy season and do not appear to spend the appropriate time reviewing the issues in the context of the specific company nor in engaging in substantive dialogue with the issuer to discuss concerns they may have regarding a proposal. Moreover, much of the staff at proxy advisory firms appears to be junior, poorly paid in comparison with their investment manager clients, and to have limited experience.

To illustrate the many concerns Society members have about the processes utilized by proxy advisory firms, we have collected a number of examples from our members, which are reflected (anonymously) in the Appendix hereto. The concerns fall into the following general categories:

[17] The best example this season was a Glass Lewis recommendation against a financial company's say on pay where it showed the company's 2012 earnings per share declining by 90% when in fact the opposite was true and the company had a very large increase in earnings per share.

Insufficient Time to Review and Comment

In the minority of situations in which a proxy advisory firm offers an issuer an opportunity to review its draft report, the review period is very short (sometimes less than 24 hours). For example, one Society member reported: "This year ISS gave us 17 hours to review and respond to their report on us this year, and 7 of those hours were between the hours of midnight on a Sunday and 7 am on a Monday." In several instances, ISS delivered the report immediately before Easter Sunday and required the issuer to respond that Monday.

No Possibility for Review at All

ISS does not permit most firms (any company not in the S&P 500 index) to review its reports before issuance.

Glass Lewis will not provide reports to any issuer **[or otherwise engage with them except in limited, typically off-season, situations.]** Companies that hire proxy solicitors usually get the report from their solicitor after Glass Lewis has distributed it to investors. Alternatively, companies can pay a fee of either $3,500 or $5,000 for its own report.

This year, the access to Glass Lewis reports has become even more difficult and costly. Proxy solicitors have been told that their under the revised terms of the subscription license they can read their clients the reports over the phone, but they can't share copies of the reports with their clients. Instead, Glass Lewis apparently expects issuers to either buy their own report, or use the Equilar "Governance Center" service that permits modeling and access to Glass Lewis reports at a cost of up to $30,000.

Infrequent Correction of Factual Errors by the Proxy Advisory Firm

Even when the issuer points out factual errors upon which the recommendation is based, proxy advisory firms do not always correct the errors – much less change the recommendation. Thus, one Society member reported in 2010 that its report from ISS calculated its CEO's compensation as cash plus a "Guaranteed Bonus" when the CEO did not receive any guaranteed bonus. When the issue was raised to ISS, the analyst said that this metric was "hard-coded" and could not be changed.

More recently, ISS and Glass Lewis have both been more receptive to change factual errors, but only when the companies know about the errors and have time to correct them. Many times it is very late in the voting process. And again, for the small and mid-cap companies that do not see reports in advance and may not use proxy solicitors, the time between discovery of error and the company meeting can be very short to nil, if at all.

Comparison to Irrelevant or Misleading Peer Groups

Inappropriate peer groups used by proxy advisory firms has been one of the most prevalent problems in recent years. Peer groups figure strongly in the two major proxy advisory firm's analysis of compensation issues, particularly say on pay. Both firms decline to use company peer groups, or to begin with those peer groups and subject them to critical analysis. Instead, they use less-costly approaches in assigning peer groups to all companies on a formulaic basis.

Both firms have changed their methodologies in the last year, at least in part in response to criticism. In both cases, there appears to be improvement, but in the case of ISS the improvement appears to be limited and its application remains unclear. For example, Apache Corp. in a supplemental filing states that ISS chose a peer group that included nine additional companies, none of which are in the oil and gas exploration and production business and are "essentially opposite parts of the energy sector, the majority of them are significantly smaller than" Apache. Even worse, one of the ISS peers had a CEO who worked only six months rather than a year, but ISS failed to annualize the compensation.

Failure to Change Recommendations after "corrections"

One company noted in a supplemental filing that one of their directors was a member of a law firm. Their initial proxy disclosed that the law firm had done business with the company, but did not disclose the amount of fees involved as it was a minimal amount ($9,000). ISS recommended investors withhold support for the director. The company called ISS and explained that $9,000 was an immaterial amount. ISS told them if the amount was not disclosed, they assumed it was a conflict. The company then filed an amendment to proxy disclosing the amount. Nevertheless, ISS did not change the withhold recommendation. All of this happened within a very short time frame since the company is not an S&P 500 company and does not get an advance copy of ISS report. While the director was ultimately elected, the company had to incur the expense to deal with ISS recommendation, which turned out to be wasted effort.

Misapplication of State law

ISS does not always apply a company's applicable state law to its voting recommendations or procedures. For example, when ISS counts votes on shareholder proposals, it does not count abstentions. Yet, state law governs how votes must be counted. Shareholders can vote for, against, or abstain, on shareholder proposals. Many investors "abstain" and this often means they do not support the proposal, yet the abstentions are not counted by ISS. The result is that a proposal will "pass" under ISS's standard but not under state law (e.g. Delaware). We think the "votes cast" threshold should include abstentions in the denominator, which would make it consistent with the Delaware standard. Even for proposals that are only advisory, the state law should trump an arbitrary standard set by a proxy advisory firm. ISS's policies should be consistent with the applicable law governing shareholder rights. Not counting abstentions tips the scale to more shareholder proposals "passing." This is important particularly because ISS has indicated that beginning next year it will take action against directors if a shareholder proposal "passes" and the company does not enact the proposal as ISS seems fit. In effect, they could be withholding support for a director even though a majority of the shareholders have not indicated their support for the prior year's proposal.

VII. PROXY ADVISORY FIRMS HAVE NO ECONOMIC INTEREST IN THE OUTCOME OF THE VOTES THAT THEY RECOMMEND

Proxy advisory firms do not have an economic interest in the companies in which they are making voting recommendations. The delegation by investment advisors of their vote to proxy advisory firms has resulted in a divorce between the persons who make the investment decision and the persons who exercise the vote. This gap makes clear that, as the proxy voting system currently operates, voting recommendations may bear no relation to the economic performance of the company—and therefore, such voting recommendations may not, in fact, improve the performance of a company.

Because proxy advisory firms do not need to take into consideration the economic consequences of their recommendations, they do not feel compelled to specifically tailor their recommendations to the particular facts and circumstances of each issuer—and this, in turn only encourages the "one size fits all" approach currently seen in proxy advisory firm recommendations.

Thus, the fact that investment managers (with fiduciary duties) can rely on proxy advisory firms (with no fiduciary duties) not only to make voting recommendations—but also to effect the vote itself—is a disconnect in the current system that must be remedied. As further discussed below, we believe persons with the economic and fiduciary responsibilities of share ownership need to exercise more responsibility in decision-making with respect to the voting process.

VIII. PROXY ADVISORY FIRMS SHOULD BE REQUIRED TO IMPROVE THEIR PROCEDURES

Proxy advisory firms should be required to change certain of their current procedures. The Society respectfully requests that proxy advisory firms be required to:

- Establish procedures to manage conflicts of interest, and specifically disclose in their reports any and all conflicts of interest with the subject of their recommendation (e.g., as discussed above, by noting their relationship with proponents of the proposal)

- Disclose the methodologies, guidelines, assumptions or rationales used in making their recommendations, including discussion as to whether the proxy advisory firm's methodology is a "generic methodology" applied to all issuers (i.e., is not specific to the facts and circumstance of a particular issuer)

- Disclose the processes used to gather their information, including how their reviewers are trained; the number of companies each analyst reviews within a given time frame; and whether or not the recommendations go through a "second review" process by a more senior manager

- Provide ALL companies the reports in advance with at least 3 business days to review draft reports prior to their release to investors

- Disclose the processes, if any, the proxy advisory firm has established to discuss their recommendations with an issuer prior to their release; and disclose whether the firm has an "appeals" process if the issuer disagrees with the recommendation

- Include in their reports any response by the issuer regarding any factual matters or items the issuer has contested (we note this recommendation is also endorsed by the NYSE Commission on Corporate Governance), and include whether the issuer invoked an "appeal" of the recommendation (if the proxy advisory firm has such a process) and whether the proxy advisory firm revised its recommendation as a result

- Report to the SEC at the end of each proxy season the number of incidents where issuers took exception to the factual statements contained in the proxy advisors' reports or appealed the recommendation of the proxy advisory firm

- Disclose their executive compensation models and standards so that issuers do not need to purchase consulting services from a proxy advisory firm in order to determine if it will get a favorable recommendation on a stock plan

The purpose of these disclosures and procedures is intended to make the processes and methodologies utilized by the proxy advisory firm more transparent, accountable and reliable. The goal is to ensure that proxy advisory firm recommendations are undertaken with more care, accuracy and fairness.

IX. INVESTMENT ADVISORS AND PROXY ADVISORY FIRMS SHOULD BE SUBJECT TO STRICTER REGULATION

Investment advisors and other fiduciaries, such as pension plans, have a fiduciary duty to vote the shares they hold on behalf of their beneficiaries. As noted above, because of the volume of proxies needed to be voted each season, most investment managers outsource their voting responsibilities to proxy advisory firms. However, these proxy advisory firms are generally not required to also be registered with the SEC and, as they have no fiduciary duties to the shareholders on whose behalf they are making voting decisions, they have no responsibility to take into consideration how their recommendation will affect the economic value of the company's shares they are voting.

The Society believes that both investment advisors and proxy advisory firms must have an affirmative obligation to ensure that vote recommendations are based on accurate facts, are given by providers free from conflicts of interest, and are in the best interests of shareholders. While conflicts of interest may be mitigated by "Chinese Wall" procedures and adequate disclosure by both the investment advisor and the proxy advisory firm, the Society notes that issues such as lack of accuracy and accountability, which are largely resource issues, are rooted in the economics of how proxy advisory firms are compensated for their services. The Society supports proxy advisory firms having adequate staffing to enable them to undertake a thorough review of the specific facts and circumstances of individual companies--rather than merely following formulas and general guidelines. The Society believes, however, that without adequate and appropriate SEC regulation of proxy advisory services, there is no incentive for proxy advisory firms or the investment managers that hire them to provide the necessary resources to the system to ensure that vote recommendations are accurate and responsible.

A. All Proxy Advisory Firms should be required to register as Investment Advisors

An initial recommendation to improving the quality of the proxy voting system would be to require proxy advisory firms to become registered investment advisors. In this way, the practices and procedures of such firms would be subject to SEC examination. These examinations, we believe, would provide additional discipline and accountability to the system. Once registered, proxy advisory firms would need to establish to an oversight authority that they are following their procedures and would need to provide factual support for the bases of their disclosures (enhanced, as suggested above).

However, the Society is not confident that registration of proxy advisory firms, in and of itself, will solve the issues noted above, particularly the "one-size-fits-all" approach now generally taken by proxy advisory firms with respect to their recommendations and votes. The Society notes, for example, that ISS is currently registered under the Investment Advisors Act of 1940, and it is not required to perform, as part of its services, an analysis of how each proposal for which it is giving a vote recommendation will or will not benefit the company's shareholders from an economic point of view. We therefore believe registration of proxy advisory firms is just the first step needed to correct the current system.

B. The Special Treatment under the Proxy Solicitation Rules that Proxy Advisory Firms Now Enjoy is Untenable

The SEC should consider whether proxy advisory firms should also be brought within the regulatory constraints of the proxy rules themselves, through a requirement to file their recommendations as soliciting material. Many members of the Society believe that the vote recommendation is tantamount to soliciting a proxy. And while the proxy advisory firms may characterize their reports as "opinions," the fact that they issue recommendations on how to vote a particular item is no different than if a retail shareholder's broker gave a similar recommendation on how to vote.

The exemption currently available to the proxy advisory firms under Rule 14a-2(b)(3) is therefore inappropriate as applied to their business model. They characterize themselves as being in the business of giving individualized advice to those investors who subscribe to their services; however this is not true in practice since the recommendations have broad influence. The proxy advisory firms are able to function like the do because the market listens to them; Proxy advisory firm recommendations can move markets, especially in hotly contested votes, like proxy fights and mergers/acquisitions. Therefore, having made themselves an integral part of the proxy voting process, they should be required to abide by the same rules as all the other participants.[18]

C. Investment Advisors Relying on Proxy Advisory Firms Should Oversee Their Recommendations and Analysis

In addition to the registration of proxy advisory firms, any investment advisor or other fiduciary that relies upon or uses a proxy advisory firm should be required to exercise appropriate oversight of the proxy advisory firm and its recommendations. The entity that has fiduciary duties to its clients (who are the beneficial owners of the issuer’s stock) should, at a minimum, ensure that the proxy advisory firm (who in fact is acting as the investment manager’s agent) has processes and procedures in place that are responsible, auditable, accountable and transparent with respect to its voting recommendations.

We therefore propose that the proxy advisory firm that is used by an investment manager be audited periodically by the investment manager to assess the quality of the votes cast on its behalf, including ensuring that the votes cast were consistent with the policies of the institutional advisor/fiduciary (if different from the proxy advisory firm).

In addition, each investment manager or other fiduciary that utilizes the services of a proxy advisory firm should be required to disclose to its clients: (i) the name(s) of the proxy advisory firm it has engaged, and (ii) the extent to which the investment advisor/fiduciary has followed or not followed the recommendations of the proxy advisory firm.

Most importantly, we would propose that each investment manager or other fiduciary that utilizes the services of a proxy advisory firm be required to establish procedures to ensure that by following the voting recommendation of the proxy advisory firm with respect to a particular company, the investment manager was acting in the best economic interests of the shareholders of such company. Only in this way will the total disconnect that currently exists between those who manage the economics of share ownership and those who determine the vote associated with share ownership be addressed and corrected.

[18] Wachtell Lipton Comment Letter to SEC RE: Concept Release on the US Proxy System (Release No. 34-62495: IA-3052; IC-29340) dated October 19, 2010 at 7.

The purpose of the procedures and disclosures suggested above is not intended to limit the ability of investment managers and other fiduciaries in retaining the services or proxy advisory firms. Rather, the additional procedures being proposed are intended to provide discipline, accountability and oversight for the process by which proxy advisory firms develop and vote their recommendations, and the additional disclosures being proposed are intended to provide appropriate and necessary information to the relevant stakeholders (issuers and their shareholders, fund participants of investment managers, and clients of proxy advisory firms) of these processes and of any conflicts of interest that may exist between participants in the process.

The processes and disclosures proposed above may become more applicable in light of regulations proposed on October 21, 2010 by the Department of Labor which, if adopted, would substantially broaden the definition of the term "fiduciary" under the Employee Retirement Income Security Act of 1974 ("ERISA"). One result of the broadened definition may be the inclusion within such term of proxy advisory firms, which firms would then become subject to the rigorous standards of conduct with which plan fiduciaries are charged under ERISA. Even if proxy advisory firms are not themselves brought within the definition of "fiduciary" under the proposed regulations, it is clear from the Preamble of the proposed rules that the DOL views investment advice as advice relating to "other property of the plan" including "advice and recommendations as to the exercise of rights appurtenant to shares of stock (e.g., voting proxies)."[19] We note that this rule proposal was withdrawn and is expected be re-proposed this year.

Consistent with the DOL's views as articulated in the proposed rules, the Society believes it is clear that investment managers need to be more responsible and take a more active role in supervising the voting recommendations of proxy advisory firms. Consistent with their fiduciary duties, investment managers need to be able to demonstrate that the vote cast in respect of a particular proposal for a particular company supports and helps maximize the economic value of the shares being voted. Only in this way will the disconnect between economic and voting power that currently exists in the proxy voting system be remedied.

Summary

As stated so aptly by Larcker, McCall and Ormazabal above: "The obvious question that remains to be answered is whether or not the confluence of government regulations, the outsourcing of recommendations the proxy advisory industry, and responses by boards of directors to these recommendations, produces an increase in shareholder value as anticipated by government regulators (SEC, 2003)."[20] We believe that the answer is no. But with appropriate oversight of proxy advisory firms, through additional regulation of both the firms and the investment managers that engage them, the system will be significantly improved, more transparent, and more accountable.

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[19] Federal Register, Vol. 75, No. 204, Oct. 22, 2010 at 65266.
[20] Larcker study at 4.

We appreciate the opportunity to have commented on this important proposal and would be happy to provide you with further information to the extent you would find it useful.

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And Then A Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?

By David F. Larcker, Allen L. McCall, and Brian Tayan
February 25, 2013

THE ROLE OF PROXY ADVISORY FIRMS

Proxy advisory firms are independent, for-profit consulting companies that provide research and voting recommendations on corporate governance matters brought before investors at shareholder meetings. These matters include the election of the board of directors, approval of equity-based compensation programs, advisory approval of management compensation, and other management- and shareholder-sponsored initiatives regarding board structure, compensation design, and other governance policies and procedures.

There are many reasons why investors might choose to consult with third-party advisors when voting their position on these matters. Institutional investors are generally required by the Securities and Exchange Commission to vote all matters on the corporate proxy and disclose their votes to beneficial owners of their funds. Given the size and diversity of their holdings, it might be impractical for professional investors to have a thorough understanding of all items brought before them. Small investors, in particular, might not employ sufficient analytical staff to review all proposals in detail. For these reasons, reliable and valid third-party recommendations can contribute to a well-functioning market by improving information flow between issuers and investors leading to better decisions on compensation and corporate governance.

The proxy advisory industry in the United States is currently dominated by two major firms: Institutional Shareholder Services (ISS) and Glass Lewis & Co., whose clients manage $25 trillion and $15 trillion in investment assets, respectively. The research literature demonstrates the influence that these firms have over voting outcomes. Bethel and Gillan (2002) find that a negative recommendation from ISS on a management proposal can sway between 13.6 percent and 20.6 percent of the vote.[1] Cai, Garner, and Walking (2009) find that a negative ISS recommendation can influence 19 percent of the vote.[2] Research evidence also demonstrates the influence that proxy advisory firms have over the design of corporate governance policies. In a recent survey conducted by the Conference Board, NASDAQ and the Stanford Rock Center for Corporate Governance, over 70 percent of directors and executive officers report that their compensation programs are influenced by the policies or guidelines of proxy advisory firms.[3]

For these reasons, the quality of proxy advisory recommendations is critical to ensuring that shareholders, corporate officials, and regulators make appropriate decisions regarding compensation and governance policies. The clients of proxy advisory firms need to be diligent in their evaluation of the policies of these firms to ensure that these policies are "accurate" and aligned with their interest to maximize long-term shareholder value.[4] Accurate recommendations are those that successfully differentiate between good and bad future outcomes. Negative recommendations from proxy advisory firms should be correlated with negative future outcomes (e.g., poor future stock performance, increased risk of accounting restatement, etc.) and positive recommendations correlated with positive future outcomes.

POLICY DEVELOPMENT PROCESS

To assess the accuracy of proxy advisory firm policies, we can evaluate both the process by which they are developed and their consistency with neutral, rigorous empirical research. Glass Lewis provides little information to the general public on the development of their voting policies. According to a Glass Lewis discussion paper:

> *Glass Lewis' policies, tailored for each market, are formulated via a bottoms-up approach that involves discussions with a wide range of market participants, including investor clients, corporate issuers, academics, corporate directors and other subject matter experts, among others. The process takes into consideration relevant corporate governance standards, company, local regulations and market trends. Policy changes and report enhancements are driven by such discussions, as well as through consultations with the Glass Lewis Research Advisory Council.*[5]

Moreover, Glass Lewis does not provide clarifying detail on how general corporate governance concepts and standards are translated into codified policy. Without this information, it is difficult for investors to assess whether the process used by Glass Lewis leads to accurate recommendations.

Institutional Shareholder Services discloses more extensive information than Glass Lewis does about the firm's policy development process. According to their website:

> *ISS is committed to openness and transparency in formulating its proxy voting policies and in applying these policies to more than 40,000 shareholder meetings each year…. Our bottom-up policy formulation process collects feedback from a diverse range of market participants through multiple channels: an annual Policy Survey of institutional investors and corporate issuers, roundtables with industry groups, and ongoing feedback during proxy season. The ISS Policy Board uses this input to develop its draft policy updates on emerging governance issues each year. Before finalizing these updates, we publish draft updates for an open review and comment period.*[6]

Patrick McGurn, executive director at ISS, contends that the firm's "multi-tiered process" helps to mitigate "unintended consequences" by incorporating "fact-specific feedback" to shape final policies.[7] Martha Carter, director of research at ISS, believes that "our commitment to this approach enhances the value of the research we deliver to clients."[8]

However, there are several issues in ISS' approach which raise questions about the accuracy of its recommendations. First, the ISS data collection process relies on a very small number of participants. For example, ISS' most recent policy survey received responses from only 97 institutional investors.[9] This figure is down 69 percent from just four years ago.[10] A sample of this small size is unlikely to identify compensation and governance policies that should be applied uniformly to all publicly traded corporations.[11] The decline in respondents is particularly troubling because it suggests that ISS is not successful in contacting participants or in convincing them of the value of their participation. It also raises the concern that more strident viewpoints might be over-weighted in the sample if strongly opinionated investors are more likely to participate.

Second, the composition of the respondent pool that ISS does reach is not well disclosed. Although ISS provides descriptive statistics of the types of institutions that participate in the survey, the investment objectives of these investors is not clear (see Exhibit 1). This matters because assessing policy outcomes will differ depending on whether they are tailored to *shareholder*-centric investors or *stakeholder*-centric investors. As it is, there is no way to determine whether ISS' response pool is representative of shareholder groups broadly or instead reflects the opinions of a narrower set of activists, hedge funds, passive investors, etc. (In the survey, ISS asks respondents whether their organizations are "mission-based" but does not disclose the resulting statistics. See the bottom of Exhibit 1)

Third, the survey suffers from design errors that are likely to confuse and/or bias respondents. For example, the ISS survey is flawed in how it frames certain questions and offers response choices (see Exhibit 2). These errors are important because they make survey results difficult to interpret and even more difficult to generalize into voting recommendations. Furthermore, the ISS survey does not seek to establish the precise thresholds or conditions under which a recommendation "for" or "against" will be triggered. Instead, the ISS survey uses vague qualifying words such as "excessive," "problematic," and "significant" whose exact meanings are open to interpretation by the respondents. As such, it is difficult to understand how responses to these questions ultimately lead to concrete voting policy decisions (e.g., a negative say-on-pay recommendation will be triggered if CEO compensation levels are above [*some specific threshold*]).

Fourth, it is unclear how ISS incorporates the feedback that it receives during the open comment period to finalize voting policies. For example, ISS recently proposed a draft rule that would recommend investors vote against directors of a company that failed to act on a shareholder proposal receiving majority support during the previous year. ISS justified the rule by citing its policy survey results which found that "86 percent of institutional investor respondents expect that the board should implement a shareholder proposal that receives support from a majority of shares cast." It claimed that the rule would "strengthen its policy to hold directors accountable for failure to respond."[12] In a comment letter, Pfizer opposed the change and pointed out that the rule can run counter to a board's fiduciary duties:

> *The Policy runs the risk that Boards would be coerced to abdicate their fiduciary duties, which do not disappear or become less significant when a majority of the votes cast at a meeting support a particular proposal. Boards should not feel compelled to act where they believe that such action is not in the best interests of the company. It certainly would make sense to disclose the Board's rationale, but an automatic vote against all directors is inappropriate and inadvisable.*[13]

Similar arguments were made by executives at Ball Corporation, Eli Lilly, FedEx, Honeywell, and Principal Financial Group and by the Business Roundtable and the National Association of Corporate Directors (NACD).[14] Still, ISS adopted the rule without specifying the conditions under which it would defer to a board's judgment of what constitutes a correct action given its fiduciary duties.[15]

Finally the linkage between the opinions proxy advisors collect through the solicitation process and the policies ultimately enacted is unclear. ISS solicits investor and issuer sentiment on general concepts relating to board structure, compensation, and governance matters and then somehow translates this into codified policies. For example, the firm's most recent policy survey asked institutional investors their view on the practice of allowing executives and directors to pledge company stock as collateral for a margin loan. Forty-nine percent responded that any pledging of shares is "significantly problematic;" 38 percent responded that pledging is concerning if it involves a "significant amount of shares;" and 13 percent responded that it is not a concern (see Exhibit 2 for the exact question and responses).[16] ISS cited these results in its 2013 policy document which was updated to recommend that investors vote against the election of directors of companies whose executives or directors have pledged shares, depending on the "magnitude of aggregate pledged shares in terms of total common shares outstanding or market value or trading volume."[17] Left unspecified is the threshold above which pledged shares will trigger an "against" or "withhold" vote. ISS did not solicit this information in the policy survey, nor did it publish the results of rigorous empirical testing to demonstrate the levels at which executive or director pledging of shares has been reliably shown to reduce shareholder returns or amplify enterprise risk. Without rigorous and transparent research, how can ISS ensure that its final policies are anything other than arbitrary?

More broadly, ISS and Glass Lewis should demonstrate that they engage in testing to ensure that their final policies are accurate—i.e., that they produce outcomes that are, on average, superior to the outcomes observable under alternative policies or no policy at all. Since proxy advisory firms have the data used to make their recommendations, it should be easy for them to back-test results to verify that their past voting recommendations were correct.

A review of the research literature uncovers numerous instances where proxy advisory policies are either in conflict with research results or not directly supported by them. For example, research suggests that proxy advisory firm voting recommendations for management "say on pay" are not value enhancing but instead value destroying.[18] Similarly, research suggests that proxy advisory firm voting recommendations for stock option exchanges also decrease shareholder value.[19] To our knowledge, there is no research evidence to support ISS criteria for equity compensation plans or the firm's calculation of proprietary metrics such as the "annual burn rate" and "shareholder value transfer" which are used to determine whether shareholder dilution is excessive. In contrast, proxy advisory firm guidelines on other matters, such as certain anti-takeover protections, do have empirical support.[20]

WHY THIS MATTERS

1. ISS claims that its process for developing proxy voting guidelines is "open and transparent." However, a careful examination does little to clarify the information they rely on in deciding to adopt a policy. How exactly do ISS and Glass Lewis determine that a policy is "correct?" How do they determine that a specific policy is in the best interest of shareholders?
2. Proxy advisory firms obtain feedback from a diverse set of market participants in the policy formulation process. However, the most recent ISS survey contained responses from only 97 institutional investors. Who participates in the policy development process with both ISS and Glass Lewis? How do we know that these participants validly represent the objectives and opinions of all market participants?
3. Investors and corporate issuers often have very different perspectives on corporate governance matters. How does ISS weigh these competing perspectives? Do they "favor" the investor perspective over the issuer perspective? If so, when is this approach justified and when is it not?
4. Ultimately, the accuracy of a recommendation can only be determined by rigorous statistical analysis showing positive impact of a governance choice on shareholder value. What rigorous empirical research supports each of the voting recommendations promulgated by proxy advisors? Why don't ISS and Glass Lewis disclose the specific research (either that they have conducted or conducted by third-parties) that justifies each of their recommendations? ■

[1] Jennifer E. Bethel and Stuart L. Gillan, "The Impact of Institutional and Regulatory Environment on Shareholder Voting," *Financial Management* (2002).

[2] Jie Cai, Jacqueline J. Garner, and Ralph A. Walking, "Electing Directors," *Journal of Finance* (2009).

[3] The Conference Board, NASDAQ, and Stanford Rock Center for Corporate Governance, "The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions," (2012). Available at: http://www.gsb.stanford.edu/cldr/research/surveys/proxy.html.

[4] In a recent speech, former SEC Commissioner Daniel M. Gallagher warns of the potential problems that can arise from overreliance on the advice of proxy advisory firms. In particular, he emphasizes the need to ensure that their policies are accurate and free from conflict of interest: "It is important to ensure that advisers to institutional investors… are not over-relying on analyses by proxy advisory firms. We learned a significant lesson about overreliance on the diligence of others in the run up to the financial crisis, as investors and regulators relied on credit rating agencies with disastrous results. As with credit rating agencies, it is important for policymakers to understand, evaluate, and if necessary address the practices and business models of proxy advisory firms. Of particular interest should be accountability for accuracy as well as potential conflicts of interest…." See: Daniel M. Gallagher, "Remarks before the Corporate Directors Forum," Jan. 29, 2013, Available at: http://www.sec.gov/news/speech/2013/spch012913dmg.htm.

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[8] ISS, "Institutional Shareholder Services Releases 2013 Proxy Voting Policies," (Nov. 16, 2012).

[9] ISS, 2012-2013 Policy Survey Summary of Results (September 2012).

[10] RiskMetrics Group, 2008-2009 RiskMetrics Group Policy Survey: Summary of Results (October 2008).

[11] ISS, Proxy Advisory Services (2013). Available at: http://www.issgovernance.com/proxy/advisory.

[12] ISS, "Board Response to Majority-Supported Shareholder Proposals (U.S.). Available at: http://www.issgovernance.com/BoardResponseMajorityShareholderProposals2013.

[13] Letter from Matthew Lepore, Vice President and Corporate Secretary, Chief Counsel, Pfizer Inc (November 7, 2012). Available at: http://www.issgovernance.com/files/PfizerInc..pdf.

[14] ISS, 2013 Draft Policies for Comment. Available at: http://www.issgovernance.com/policycomment2013.

[15] Following the open comment period, ISS amended the final rule to include the condition that "less than full implementation will be considered on a case-by-case basis;" however, this qualification raises more questions than it answers on how ISS will decide whether to defer to the board's judgment. See: ISS, U.S. Corporate Governance Policy: 2013 Updates (Nov. 16, 2012).

[16] ISS, 2012-2013 Policy Survey Summary of Results (September 2012), loc. cit.

[17] ISS, 2013 Updates, loc. cit.

[18] David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "The Economic Consequences of Proxy Advisory Say-on-Pay Voting Policies," Rock Center for Corporate Governance at Stanford University working paper (May 2012). Available at: http://ssrn.com/abstract=2101453.

[19] David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "Proxy Advisory Firms and Stock Option Exchanges: The Case of Institutional Shareholder Services," Stanford Rock Center for Corporate Governance at Stanford University working paper (Apr. 15, 2011). Available at: http://ssrn.com/abstract=1811130.

[20] Proxy advisory firm opposition to staggered boards is supported by John Pound, "The Effects of Antitakeover Amendments on Takeover Activity: Some Direct Evidence," *Journal of Law and Economics* (1987); Lucian Arye Bebchuk, John C. Coates IV, and Guhan Subramanian, "The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy," *Stanford Law Review* (2002); and other papers. Proxy advisory firm opposition to dual class shares is supported by Ronald W. Masulis, Cong Wang, and Fei Xie, "Agency Problems at Dual-Class Companies," *Journal of Finance* (2009).

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EXHIBIT 1 — ISS POLICY SURVEY: RESPONDENT PROFILE (2012-2013)

More than 370 total responses were received. A total of 97 institutional investors responded. Approximately 71 percent of investor respondents were located in the United States, with the remainder divided between U.K., Europe, Canada, and Asia-Pacific. 237 corporate issuers responded, with 79 percent of them located in the United States and the remainder divided between U.K., Europe, and Canada.

Institutional Investor	
Investment manager or asset manager	62%
Government or state sponsored pension fund	8%
Mutual fund or mutual fund company	8%
Commercial or investment bank	4%
Insurance company	3%
Foundation or endowment	2%
Labor union-sponsored pension fund	2%
Alternative asset management	1%
Investor industry group	1%
Private bank, wealth management, or broker	1%
Other	8%

Size of Organization	Institutional Investor	Corporate Issuer
Over $100 billion	32%	5%
$10 billion - $100 billion	22%	29%
$1 billion - $10 billion	30%	31%
$500 million - $1 billion	4%	7%
$100 million - $500 million	6%	7%
Under $100 million	5%	2%
Not applicable	2%	19%

Notes: Size of institutional investors measured by equity assets under management or assets owned; size of corporate issuers measured by market capitalization.

Results not reported to the question: “Is your organization a mission-based or socially-responsible investor?”

Results also not reported to the question: “Is your organization a UN Principles for Responsible Investing (PRI) investor signatory?”

Source: ISS, 2012-2013 Policy Survey Summary of Results (September 2012).

EXHIBIT 2 — EXAMPLES OF QUESTION DESIGN FLAWS

The ISS 2012-2013 Policy Survey contains three types of question design flaws:

1. The assumptions that frame some questions are not adequately defined.
2. Some questions contain leading or biasing comments.
3. Some questions contain response selections that bind respondents to multiple answers or to answers that might not match their opinion.

Consider the following questions.

Question 14. Currently, ISS has a policy on overboarded directors (directors serving on an excessive number of boards) which counts only public company boards. Should ISS include other significant directorships in its policy (e.g., private companies, national non-profit organizations, subsidiary company boards)?	Institutional Investors	Corporate Issuers
Yes	59.0%	17.8%
No	23.1%	71.3%
It depends (please specify)	17.9%	10.9%

Design flaws:
- The policy on "overboarded directors" is referred to but not provided.
- The term "excessive" is not quantified.
- The question binds respondents to multiple responses. E.g., an investor who believes that private company directorships should be included in the policy but not nonprofit directorships is not permitted to express this opinion.

Pay for Failure. Question 22. During the past decade, shareholder have witnessed a series of CEOs who have received sizable termination packages at a time of significantly lagging shareholder returns. Does your organization consider the following actions to be problematic in such a scenario?	Institutional Investors		Corporate Issuers	
	Yes	No	Yes	No
A severance settlement when the executive is stated to be retiring or resigning	81.3%	18.8%	40.3%	59.7%
Immediate acceleration of all unvested equity upon termination without cause	84.4%	15.6%	44.8%	55.2%
Cash severance exceeding 3x base salary and target bonus	93.8%	6.2%	81.1%	18.9%
Cash severance exceeding 1x base salary and target bonus	35.9%	64.1%	11.0%	89.0%
New severance agreement entered immediately prior to departure	89.6%	10.4%	61.7%	38.3%
Large pension / SERP payouts	80.6%	19.4%	32.5%	67.5%

Design flaws:
- The heading "pay for failure" biases respondents that the termination packages in question are not merited.
- The terms "sizable packages" and "significantly lagging returns" are not quantified.
- The term "problematic" is vague. It could be interpreted to mean anything from a minor annoyance to a critical issue.
- The question is not clearly tied to a policy decision.

EXHIBIT 2 — CONTINUED

Pledging of Shares. Question 24. Some shareholders have raised concerns about the practice of executives or directors pledging company stock (e.g., shares used as collateral for margin accounts or other loans). What is your organization's view of suck practice?	Institutional Investors	Corporate Issuers
Any pledging of shares by executives or directors is significantly problematic	49.2%	45.0%
Concerning if it involves a significant amount of shares (e.g., > 500,000 or a value exceeding 10% of the company's market value)	37.7%	34.9%
Not a concern	13.1%	20.1%

Design flaws:

- The first sentence of the question biases respondents that pledging is negative.
- The scale is not properly structured. It does not sufficiently allow for moderate opinions.
- The second response combines different conditions. 500,000 shares is very different from shares representing 10% of a company's market value.
- The question is not clearly tied to a policy decision.

Question 25. A number of issuers have adopted compensation metrics that are tied to non-financial performance such as environmental goals or regulatory compliance. Similarly, some shareholder proponents submit proposals requesting adoption of environmental or other sustainability-related metrics for executive compensation. Which of the following statements best represents your organization's view on this topic?	Institutional Investors	Corporate Issuers
The decision to use environmental or other sustainability-related metrics is best left to the members of a compensation committee. Calls for use of such metrics constitute undue micromanagement of the executive pay process	27.9%	72.5%
Calls for a board to adopt environmental or other sustainability-related metric may be appropriate at companies where there have been significant problems in the past. A case-by-case approach is best suited to determining if the use of such metrics would benefit shareholders.	35.3%	19.6%
Environmental or other-sustainability-related compensation metrics are appropriate tools for boards to use to focus executives on managing significant risks. Use of such relevant non-financial metrics in pay programs would benefit shareholders.	32.4%	5.8%
Other (please specify)	4.4%	2.1%

Design flaws:

- The question biases respondents that the adoption of these performance metrics is positive.
- The choices bind respondents to multiple answers. It is possible to agree with the first sentence of each but not the second.
- The question is not clearly tied to a policy decision.

Source: ISS, 2012-2013 Policy Survey Summary of Results (September 2012).

MERCATUS
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HOW TO FIX OUR BROKEN PROXY ADVISORY SYSTEM

James K. Glassman and J. W. Verret

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ABSTRACT

A RULE ENACTED by the Securities and Exchange Commission in 2003 required institutions to adopt and disclose policies for proxy voting that were intended to minimize conflicts between the institutions' interests and those of their shareholders. An SEC staff interpretation of that rule led to a result almost the opposite of the ruling's intent. Institutions could easily protect themselves from legal liability by shifting responsibility to proxy advisory firms, which acquired increasing power over corporate governance, to the detriment of shareholders. The rule resulted in outsourcing decision making to advisors with little particularized knowledge and no incentive to maximize value. The proxy advisory firms themselves face the same conflicts of interest that the rule was intended to minimize. The problem is compounded by a market for proxy advice that is dominated by two firms. To fix this broken system, it is necessary to return the responsibility to determine the need for a vote to shareholders and directors.

JEL codes: G1, G2, G3 K2, and L2

Keywords: proxy advisory firms, shareholders, hedge funds, mutual funds, Institutional Shareholder Services, Securities and Exchange Commission

I. BACKGROUND

A DECADE AGO, the Securities and Exchange Commission (SEC) voted to require that every mutual fund and its investment adviser disclose "the policies and procedures that [they use] to determine how to vote proxies"—matters put to a vote by the public companies whose stock the fund holds—and to disclose votes annually.[1]

The idea behind Rule 206(4)-6 and Rule 30b1-4, which were enacted on August 6, 2003,[2] was to "encourage funds to vote their proxies in the best interests of shareholders" and to avoid conflicts of interest between those shareholders and the fund's "investment adviser, principal underwriter, or certain of their affiliates."[3]

The SEC rule followed changes at the US Department of Labor (DOL) in the 1980s mandating that ERISA pension plan fiduciaries—such as union, corporate, and other officials who control or manage a plan's assets—vote the plan's shares on the basis of active analysis, regardless of whether or not the fiduciary was certain that expending time and effort to analyze how to vote would create value for a fund.[4]

The vast majority of shareholder elections are uncontested, and the vast majority of shareholder proposals are unsuccessful. As a result, it has been argued that actively participating in shareholder elections, shareholder proposal votes, or other proxy votes may not be worth the effort for pension or mutual funds in lieu of other strategies (such as abstaining or passively voting in favor of management

1. SEC, "Securities and Exchange Commission Requires Proxy Voting Policies, Disclosure by Investment Companies and Investment Advisers," press release, January 1, 2003, http://www.sec.gov/news/press/2003-12.htm.
2. "SEC Brings Second Case Alleging Improper Proxy Voting by an Adviser," Ropes & Gray, May 20, 2009, http://www.ropesgray.com/intech/.
3. SEC, "Proxy Voting Policies."
4. "ERISA 3(16) Fiduciary Plan Administrator Overview," ING Financial Services, accessed April 4, 2013, ing.us/file.../5399/fiduciary_erisa_3_16__plan_admin_overview.pdf.

recommendations unless specific circumstances require more scrutiny).[5] But the Department of Labor ruled otherwise. In a key 1988 document called the "Avon Letter," DOL stated that "the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock."[6] The SEC eventually followed suit.

A few months after the adoption of the SEC's rule, one of the SEC commissioners, Paul Atkins, expressed his relief that "the rule did not impose a 'one-size-fits-all' requirement for the written proxy voting procedures. Instead, we left advisers with the flexibility to craft suitable procedures."[7]

Unfortunately, the rule became a classic case of unintended consequences. Many institutional investors largely outsourced their shareholder voting policies to a proxy advisory industry that relies on precisely the type of "one-size-fits-all" policies that were intentionally excluded from the original regulation because of objections by commissioners. The SEC staff interpretation of the rules on proxy voting have led to the opposite result of what many of its supporters intended. Instead of eliminating conflicts of interest, the rule simply shifted their source. Instead of encouraging funds to assume more responsibility for their proxy votes, the rule pushes them to assume less. Instead of providing informed, sensitive voting on proxies, the incentive has been to outsource decision making to two small organizations that most investors have never heard of. These two firms have emerged as the most powerful force in corporate governance in America today, shaping the way that mutual funds and other institutions cast votes on proxy questions posed by about 5,000 US public companies.

The larger of the firms, Institutional Shareholder Services (ISS), was founded in 1985. When the Department of Labor issued its new mandate a few years later, ISS made a specialty of advising institutional investors on how to comply with it,[8] and the firm has since profited from the demand created for its services by the government's requirements.

5. David Yermack, "Shareholder Voting and Corporate Governance," *Annual Review of Financial Economics* 2 (December 2010): 30, doi:10.1146/annurev-financial-073009-104034. Passive voting strategies are distinguished from abstentions. Companies need to obtain a quorum of shareholder participation even in an uncontested vote to have a successful board election, merger approval, etc., and so passively voting shares can still be a valuable exercise.

6. Allan Liebowitz, letter to Helmuth Fandl, February 23, 1988, cited in "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 17, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

7. "Speech by SEC Commissioner: Remarks at the Investment Counsel Association of America," Commissioner Paul S. Atkins, SEC, April 11, 2003, http://www.sec.gov/news/speech/spch041103psa.htm.

8. "25for25: Observations on the Past, Present, and Future of Corporate Governance In Celebration of ISS' 25th Anniversary," ISS (2011): iv, http://www.rhsmith.umd.edu/cfp/pdfs_docs/commentary/ISS.pdf.

Proxy season is now underway. More than half of US annual meetings, where proxies are tallied, take place in April, May, or June.[9] In 2010 the SEC issued a "concept release" that called for an examination of the entire US proxy system, including "the role and legal status of proxy advisory firms."[10] No action has been taken on the release, but with a new SEC chair moving into office a reexamination of the issue could be imminent. This report lays the groundwork for that consideration. What remains to be seen is whether the SEC will address a system that is badly broken and, most of all, hurts the small shareholders it is supposed to help.

The authors do not hastily rush for a regulatory solution to all corporate governance challenges. We recognize that on most issues shareholders have a plethora of nonregulatory tools available, including self-funded proxy fights, taking short positions, pricing corporate governance quality at firms into trading activity, and suing a company in state court for breach of fiduciary duty by a director or officer.

We want to be clear. Good corporate governance is crucial to the long-run success of any publicly traded company, and even the most aggressive defenders of capitalism agree that the participation of shareholders in proxy voting on governance issues can be an appropriate practice. In a recent report, the US Chamber of Commerce lauded "policies that promote effective shareholder participation in the corporate governance process. Strong governance is a critical cornerstone for the healthy long-term performance of public companies and their positive promotion of long-term shareholder value."[11]

But for the problem created by government rules that have enshrined two small proxy advisory firms, shareholders do not have a nonregulatory solution. We argue that as long as proxy advisors hold regulatory preferences and a regulatory mandate that funds purchase their services, more regulatory attention to the conflicts posed by these proxy advisors is wise. The remainder of this paper will sketch the specific problems that should be addressed and our approach to resolving them.

9. "A dialogue with Institutional Shareholder Services," Audit Committee Leadership Network in North America, ViewPoints, no. 139 (November 7, 2012): 3, https://webforms.ey.com/Publication/vwLUAssets/Proxy_advisory_firms/$FILE/ViewPoints_39_November_2012_Dialogue_with_ISS.pdf.
10. Concept Release on the U.S. Proxy System, SEC, 75 Fed. Reg. 42,981, 43,009 (July 22, 2010). Comments on the concept release can be found at http://www.sec.gov/comments/s7-14-10/s71410.shtml.
11. US Chamber's Center for Capital Markets Competitiveness, "Best Practices and Core Principles for the Development, Dispensation, and Receipt of Proxy Advice," March 2013, http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Best-Practices-and-Core-Principles-for-Proxy-Advisors.pdf.

II. THE SOURCES OF ADVISORS' POWER

OF THE TWO firms that dominate the proxy-advisory business, the larger by far is ISS with a 61 percent market share.[12] The second is Glass, Lewis & Co., LLC, with a market share of about 36 percent.[13] ISS is owned by MSCI Inc., a New York Stock Exchange–listed company that maintains dozens of stock and bond indices and provides portfolio management analytics for investment firms. Glass Lewis is owned by the Ontario Teachers' Pension Plan Board, which manages a fund with more than $100 billion in assets. These two principal proxy advisors have inherent conflicts not simply in their ownership but also in the services they provide to clients. Proxy advisors also have shown a tendency toward ideological bias in their recommendations, especially in areas that involve labor union power, executive compensation, and the environment.

The power of the two firms has increased in recent years for several reasons. First, mutual funds have become a larger force in investing, especially with the rise of defined-contribution pension plans. Institutional stock ownership has risen from 47 percent of assets of the 1,000 largest public corporations in 1987 to 76 percent just 20 years later.[14] Overall, mutual fund assets have risen nearly 30-fold since 1987, and total shareholder accounts have quintupled.[15]

Second, shareholder activism by well-connected groups—particularly unions and environmental organizations—has sharply increased. In addition, the Supreme Court's recent decision in *Citizens United v. FEC*[16] opened up new avenues for corporate spending in elections, spurring current debates about whether shareholders should be able to approve such expenditures and whether corporations should be

12. A study by the US Government Accountability Office in 2007, "Corporate Shareholder Meetings: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting," found that between them, ISS and Glass Lewis had more than 2,000 institutions (mutual funds and other financial firms) as clients, with $40.5 trillion in equity assets. Institutions served by the next three largest proxy-advisory firms had just $1.1 trillion in assets. See Government Accountability Office, *Corporate Shareholder Meetings: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting, a Report to Congressional Requesters*, GAO-07-765 (Washington, June 2007): 13, http://www.gao.gov/new.items/d07765.pdf.

13. Tamara C. Belinfanti, "The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight," *Stanford Journal of Law, Business & Finance* 14 (Spring 2009): 395. The author, an associate professor at New York Law School, attached the comment to a letter filed with the SEC on October 20, 2010. See http://www.sec.gov/comments/s7-14-10/s71410-183.pdf.

14. "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 15-16, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

15. "2012 Investment Company Fact Book: A Review of Trends and Activity in the U.S. Investment Company Industry," Investment Company Institute (2012): 134, http://www.ici.org/pdf/2012_factbook.pdf.

16. 558 U.S. 310 (2010).

17. James R. Copland, Yevgeniy Feyman, and Margaret O'Keefe, "Proxy Monitor 2012: A Report on Corporate Governance and Shareholder Activism" (Fall 2012): 19, http://proxymonitor.org/pdf/pmr_04.pdf.

required to disclose them.[17] New rules either proposed or approved by the SEC are making it even easier for such measures to be added to proxy ballots by shareholders.[18]

As a result, proxy proposals by shareholders are on the rise, according to a November 2012 "Shareholder Activism Insight Report" from the law firm Schulte, Roth & Zabel, polling corporate executives and shareholder activists:

> Corporate executives should expect to see increasing opposition from shareholders during next spring's proxy season, according to the 78% majority of overall respondents. Using poor financial performance and the need for management or operational change as motivation, hedge funds, pensions and unions will continue the growth of shareholder activism. A significant increase in shareholder proposals will result, according to 84% of respondents.[19]

The principal legislation that resulted from the 2008–09 crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act,[20] adds to the importance of proxy voting by mandating that companies with a public float greater than $75 million conduct periodic (in most cases, annual) "Say-on-Pay" (SoP) votes.[21] While those votes are nonbinding, they are taken seriously by corporate directors, not least because lawsuits could ensue if shareholder preferences are ignored. The SoP mandate was expanded this year to include 1,500 smaller reporting companies.[22]

More institutional ownership, a trend toward activism, and the Dodd-Frank legislation have all enhanced the power of proxy advisors. But an even more important factor was how the original 2003 SEC rule was interpreted by SEC staff. In a staff letter responding to a request from Egan-Jones, a small proxy firm, the SEC advised on May 24, 2004:

> An investment adviser that votes client proxies in accordance with a pre-determined policy based on the recommendations of an

18. See Stephen Choi, Jill Fisch, and Marcel Kahan, "The Power of Proxy Advisors: Myth or Reality?," *Emory Law Journal* 59 (2010): 872–77, listing reasons for the increased in shareholder power, including the elimination of broker discretionary voting and the movement from plurality to majority and non-staggered boards; "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 5–6, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

19. Marc Weingarten, "2012 Shareholder Activism Insight Report," The Harvard Law School Forum on Corporate Governance and Financial Regulation (blog), November 26, 2012, https://blogs.law.harvard.edu/corpgov/2012/11/26/2012-shareholder-activism-insight-report/.

20. "Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act," SEC, last modified February 14, 2013, http://www.sec.gov/spotlight/dodd-frank.shtml.

21. SEC, "SEC Adopts Rules for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act," press release, January 25, 2011, http://www.sec.gov/news/press/2011/2011-25.htm.

22. "Proxy Advisory Business: Apotheosis or Apogee?," Corporate Governance Commentary, Latham & Watkins LLP (March 2011): 2–3, http://www.lw.com/upload/pubContent/_pdf/pub4042_1.pdf.

> independent third party will not necessarily breach its fiduciary duty of loyalty to its clients even though the recommendations may be consistent with the adviser's own interests. In essence, the recommendations of a third party that is in fact independent of an investment adviser may cleanse the vote of the adviser's conflict.[23]

In other words, if an independent proxy advisory firm recommends a proxy vote, then the mutual fund and its adviser can follow that recommendation and avoid a claim that it has a conflict of interest. A second important interpretation was that mutual funds and their advisers had to vote all their shares on all proxy issues on the basis of actively developed policies.[24] Overall, US issuers pose more than 250,000 proxy questions a year, and it is not unusual for large mutual funds and their advisers to be required to cast votes on more than 100,000 of them on the basis of actively developed voting policies.

By paying fees to proxy advisors, funds and their investment advisers could avoid being sanctioned by the SEC or being sued successfully by lawyers representing shareholders unhappy with particular proxy votes.[25] A 2011 study by the Center for Executive Compensation quotes Leo E. Strine Jr., vice chancellor of the Delaware Court of Chancery, saying, "Following ISS constitutes a form of insurance against regulatory criticism, and results in ISS have a large sway in the affairs of American corporations."[26] For the proxy advisors, the SEC's actions produced a bonanza of revenues—and of political power. Suddenly ISS became, as one recent report put it, "the de facto pay and governance police."[27]

The Egan-Jones letter helped ISS in another way. Part of ISS's business was advising listed firms ("issuers," in the parlance of regulators) on corporate governance, including recommendations on how to win proxy votes. While, on the face of it, this may seem to be a conflict, the SEC letter explicitly said that it was not.

23. "Investment Advisers Act of 1940—Rule 206(4)-6: Egan-Jones Proxy Services," SEC letter to Kent S. Hughes, May 27, 2004, http://www.sec.gov/divisions/investment/noaction/egan052704.htm.

24. The SEC's proxy policy rules have been interpreted to include a mandate to vote shares on the basis of actively developed policies. See Concept Release on the U.S. Proxy System, SEC, 75 Fed. Reg. 42,981, 43,009 (July 22, 2010).

25. There are exceptions. In 2009, the SEC brought a complaint against INTECH Investment Management, LLC, alleging that the firm tried to curry favor with the AFL-CIO by adopting an ISS proxy-voting platform that followed the voting recommendations of the union. INTECH's aim, according to the SEC, was to improve its score on an annual AFL-CIO survey ranking investment advisers. A total of $350,000 in fines was assessed. See Order Instituting Administrative Cease-and-Desist Proceedings Pursuant to Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order, File No. 3-13463 (May 7, 2009), available at http://www.sec.gov/litigation/admin/2009/ia-2872.pdf.

26. Leo E. Strine, Jr., "The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (And Europe) Face," *Delaware Journal of Corporate Law* 30 (2005): 688.

27. "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 15–16, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

> In your letter, you ask whether a proxy voting firm would be considered to be an independent third party if the firm receives compensation from an issuer ('Issuer') for providing advice on corporate governance issues. We believe that the mere fact that the proxy voting firm provides advice on corporate governance issues and receives compensation from the Issuer for these services generally would not affect the firm's independence from an investment adviser.[28]

III. THE DEPTH AND BREADTH OF ADVISORS' INFLUENCE

IN 2003, W. James McNerney Jr., then chairman of 3M Corporation, stated in a letter to the SEC that ISS controlled the proxy votes of half of his company's shares and that "many of the top 30 institutional shareholders we contacted in each of the past two years to discuss our position would not engage in any meaningful discussions, often citing adherence to ISS proxy voting guidelines."[29]

The McNerney letter was referenced in a study of proxy advisors published in the *Stanford Journal of Law, Business, and Finance*.[30] The study also cited Lynn Stout of Cornell, who wrote, "When institutional investors follow ISS [proxy recommendations] en masse, directors of public corporations can expect to see 20%, 30% even 50% of their company's shares being voted not as the directors recommend, but as ISS recommends."[31]

Of course, no single institution determines the outcome of every proxy vote, but, according to a study by David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, opposition by a proxy advisor results in a "20% increase in negative votes cast."[32] That figure underestimates the power of ISS and Glass Lewis since corporations trying to avoid a negative recommendation from a proxy advisory firm will shape their policies accordingly. Another study, published by researchers Jennifer E. Bethel and Stuart L. Gillan in the journal *Financial Management*, found that when ISS

28. "Investment Advisers Act of 1940—Rule 206(4)-6: Egan-Jones Proxy Services," SEC letter to Kent S. Hughes, May 27, 2004, http://www.sec.gov/divisions/investment/noaction/egan052704.htm.
29. "Comment from W. James McNery, Jr. on SEC Proposed Rule," SEC, December 5, 2003, http://www.sec.gov/rules/proposed/s71903/3m120503.htm.
30. Tamara C. Belinfanti, "The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight," *Stanford Journal of Law, Business, and Finance* 14 (Spring 2009): 386–87n14.
31. Ibid.
32. David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policy" (Rock Center for Corporate Governance at Stanford University Working Paper No. 119, Stanford, CA, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2101453.

recommends a "no" vote on a management proposal, affirmative votes decline by 13.6 percent to 20.6 percent.[33]

Between them, ISS and Glass Lewis clients control 25 percent to 50 percent of the typical mid-cap or large-cap company's shares, according to a study by a proxy solicitation firm.[34] Members of the Society of Corporate Secretaries and Governance Professionals "think that ISS alone controls one-third or more of their shareholders' votes."[35]

Last year a survey conducted by the Conference Board, NASDAQ, and the Stanford University Rock Center for Corporate Governance reported research demonstrating the influence that proxy advisory firms have over the design of corporate governance policies. Over 70 percent of directors and executive officers reported that their compensation programs were influenced by the policies or guidelines of proxy advisory firms.[36]

To a large degree, corporate directors and executives are now subject to decision making on critical issues by organizations that have no direct stake in corporate performance and make poor decisions as a result. Conscientious shareholders, who do have such a stake, also suffer because their votes are usurped or overwhelmed by these same organizations. The SEC's proxy policy rules have led to results unimagined by their original advocates.

Instead of mutual funds assuming more responsibility for their proxy votes, they have assumed less. Instead of providing more incentive for informed, sensitive voting on proxies, the incentive has been to outsource decision making to firms that, for understandable business reasons, make their recommendations using one-size-fits-all standards.

The problem is compounded because, as a result of the financial crisis, Congress and the president have decided to give shareholders more authority over directors—and that means more authority for proxy advisors, who play a key role in determining how shareholders vote. As Strine wrote, "The influence of ISS and its competitors over institutional investor behavior is so considerable that traditionalists will be

33. Stuart Gillan and Jennifer E. Bethel, "The Impact of the Institutional and Regulatory Environment on Shareholder Voting," University of Delaware Working Paper No. 2002-002, Newark, DE, 2002. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=354820.

34. Yin Wilczek, "Bounty Program to Cramp Corporate Boards: ABA Speakers Discuss Governance Provisions," Daily Report for Executives, *Bloomberg BNA*, Aug. 10, 2010, cited in "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 20, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

35. Quote from Susan E. Wolf, former chair of the Society, cited in "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 20, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

36. The Conference Board, NASDAQ, and Stanford Rock Center for Corporate Governance, "The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions," (March 2012), http://www.gsb.stanford.edu/cldr/research/surveys/proxy.html.

concerned that any initiative to increase stockholder power will simply shift more clout to firms of this kind."[37]

The victims of the unintended consequences are America's investors. As we shall see, research shows that rather than being enhanced, shareholder value is being depleted by the recommendations of proxy advisors because of inadequate professional standards, conflicts of interest, a lack of properly aligned incentives, ideological bias, or some combination of factors.

IV. SUSPECT ADVICE AND SHAREHOLDER VALUE

REGULATORS HAVE HANDED a valuable franchise, a franchise that lets them determine the shape of corporate governance in America, to two proxy advisory firms. If the decisions these firms make are good ones—that is, if they promote good governance and thus enhance shareholder value—the concentration of power might not be so troublesome. In that case, even in the absence of a regulatory mandate, institutions might want to make use of proxy firms. The key question is, How good is the firms' advice?

The objective of strong corporate governance is to enhance shareholder value, but it is by no means clear that ISS and Glass Lewis have achieved this objective with their recommendations. In fact, two serious studies found the contrary.

A July 2012 Stanford study titled "The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policies" looked at ISS and Glass Lewis recommendations on compensation policies and issued these stark conclusions:

> First, proxy advisory firm recommendations have a substantive impact on say-on-pay voting outcomes. Second, a significant number of firms change their compensation programs in the time period before the formal shareholder vote in a manner consistent with the features known to be favored by proxy advisory firms apparently in an effort to avoid a negative recommendation. Third, the stock market reaction to these compensation program changes is statistically negative. Thus, the proprietary models used by proxy advisory firms for say-on-pay recommendations appear to induce boards of directors to make choices that decrease shareholder value.[38]

37. Leo E. Strine Jr., "Toward a True Corporate Republic: A Traditional Response to Lucian's Solutions for Improving Corporate America," (John M. Olin Center for Law, Economics and Business Discussion Paper Series, Paper 541, Harvard Law School, Cambridge, MA, 2006), http://lsr.nellco.org/harvard_olin/541.

38. David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policy" (working paper, Rock Center for Corporate Governance at Stanford University Working Paper No. 119, Stanford, CA, 2012): Abstract, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2101453.

Specifically, the researchers found that, in their study of a total of more than 2000 firms, the "average risk-adjusted return" on the implementation of the recommendations "is a statistically significant −0.42%."[39]

In another Stanford study, in 2011, researchers looked at exchange offers—that is, transactions in which executives holding stock options are allowed to trade them in for new options. These offers (also called "re-pricing") typically occur when the original options the executives were granted are trading far out of the money and are unlikely to be worth much, if anything, in the future, thus destroying the incentive that options are supposed to produce.

Certainly, exchange offers can be abused, but whether to issue them is a subtle question that has no simple, uniform solution. Still, ISS has taken a strong stand on limiting exchanges. For example, it issues negative recommendations on exchanges in which executive officers or directors can participate or when new options vest in six months or less.

The study looked at 272 exchange offers and found that only 23 percent were compliant with ISS guidelines. This was a rare instance in which ISS's policies were not particularly influential, but it turned out better for shareholders that ISS was ignored. The researchers observed "a positive price reaction to [all] exchange offers, suggesting that shareholders view these proposals as value-increasing." In addition, "the stock price reaction is significantly less positive when the exchange offer is constrained to meet ISS guidelines." The authors also found that "future operating performance is lower and executive turnover is higher when the exchange program is constrained in the manner recommended by ISS."[40] Thus, the authors found that shareholders experienced better returns if they ignored ISS.

Shareholders do not always ignore ISS's policies in instances where they harm companies. An example is ISS's policies concerning the new Say-on-Pay voting mandate. SoP was immensely popular among state pension and union pension funds. Notably, no representatives from the mutual fund or hedge fund community were active in the debate over SoP, which one would expect if the practice created value for shareholders.[41] The focus that proxy advisors place on SoP votes may stem

39. Ibid, 4.

40. David Larcker, "Do ISS Voting Recommendations Create Shareholder Value?" (Rock Center for Corporate Governance at Stanford University, Closer Look Series: Topics, Issues and Controversies in Corporate Governance and Leadership No. CGRP-13, Stanford, CA, April 19, 2011): 2, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1816543##.

41. At a Senate hearing at which one of the authors testified on this issue, the five-person panel included a representative from the American Federation of State, County and Municipal Employees, a powerful union, and one from the Council of Institutional Investors, a pension fund group controlled by state and union pension funds. Notably, no representatives from the hedge fund or mutual fund lobby were present or particularly supportive of pushing the rule forward at the SEC. The absence of hedge fund or mutual fund support indicates that SoP may be about political issues rather than a focus on shareholder returns. See *Hearing on Protecting Shareholders and Enhancing Public Confidence by Improving Corporate Governance Before the Senate Committee on Banking, Housing, & Urban Affairs*, 111th Cong. (July 29, 2009), http://www.banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Hearing&Hearing_ID=c754606c-0b95-4139-a38a-63e63b4b3fa9.

more from conflicted interests in pleasing particular types of clients than in recommending value-enhancing voting policies.

ISS requires that the board obtain the votes of at least 70 percent of shareholders for its compensation plan, but the proxy advisor provides no evidence to support that arbitrary requirement. Nor does ISS show how SoP votes themselves encourage more efficient compensation policies. ISS also universally recommends annual say-on-pay votes—again, with no empirical support. What SoP votes do encourage (despite the fact that they are not technically binding) are lawsuits.[42]

ISS also backs other corporate governance policies for which the empirical evidence is mixed, at best, but which nevertheless enjoy support among politically motivated institutional investors. Current ISS policies indicate support for independent directors,[43] and the firm indicates it will support, on a case-by-case basis, proposals to give shareholders the right to nominate director candidates to the corporate proxy, despite evidence suggesting that proxy access generally fails to add value.[44] ISS guidelines also indicate opposition to options repricing, as we noted.[45] The evidence on all of these issues is mixed, at best.

ISS supports independent chairs,[46] but the literature is unclear on whether having a chairperson separate from the CEO correlates with increased returns.[47] Golden parachute agreements, which ISS opposes, are actually associated with increases in stock prices.[48] Similar critiques have been raised with respect to independent

42. Sarah A. Good, Cindy V. Schlaefer, and Ana N. Damonte, "Proxy Season Brings Third Wave of 'Gotcha' Shareholder Litigation," PillsburyLaw.com, February 21, 2013, http://www.pillsburylaw.com/publications/proxy-season-brings-a-third-wave-of-gotcha-shareholder-litigation.

43. This paragraph describes policies contained in ISS's most recent policy statement for the 2013 proxy season. See "2013 U.S. Proxy Voting Concise Guidelines," ISS (December 19, 2012), http://www.issgovernance.com/files/ISS2013USConciseGuidelines.pdf.

44. See Thomas Stratmann and J.W. Verret, "Does Shareholder Proxy Access Damage Share Value in Small Publicly Traded Companies?," *Stanford Law Review* 64 (2011): 1431–68.

45. The debate over whether options repricing is material to executive compensation packages is explored in Brian J. Hall and Thomas A. Knox, "Underwater Options and the Dynamics of Executive Pay-to-Performance Sensitivities," *Journal of Accounting Research* 42, no. 2 (May 2004): 365–412.

46. See generally Roberta Romano, *Foundations of Corporate Law*, 2nd ed. (New York: Thomson Reuters/Foundation Press, 2010) 410–25.

47. See, e.g., Paula L. Rechner and Dan R. Dalton, "CEO Duality and Organizational Performance: A Longitudinal Analysis," *Strategic Management Journal* 12, no. 2 (February 1991): 157. See also Audra L. Boone et al., "The Determinants of Corporate Board Size and Composition: An Empirical Analysis," AFA 2005 Philadelphia Meetings, Philadelphia, PA, March 2006. http://dx.doi.org/10.2139/ssrn.605762. See also "Comment from Fidelity Investments on SEC Proposed Rule," SEC, March 18, 2004, http://www.sec.gov/rules/proposed/s70304/fidelity031804.htm.

48. See generally Richard A. Lambert and David F. Larcker, "Golden Parachutes, Executive Decision Making and Shareholder Wealth," *Journal of Accounting and Economics* 7 (1985).

directors.[49] The jury is also still out on takeover protections that have been consistently opposed by ISS and Glass Lewis.[50]

More research is needed to establish with a strong degree of certainty whether proxy advisory recommendations consistently increase shareholder value. A problem with conducting such research is the lack of transparency on the part of the proxy advisors. A Conference Board survey related to advisory firm SoP recommendations concluded:

> While the evidence suggests that companies are aware of and react to proxy advisory policies as they relate to SOP, the evidence does not speak to whether these changes are positive or negative for shareholders. Until proxy advisory firm methodologies are vetted by third-party examiners, it cannot be determined whether these changes are beneficial to companies and their shareholders.[51]

Such third-party examinations will be difficult, if not impossible. As a Rock Center commentary stated:

> Ultimately, the accuracy of a recommendation can only be determined by rigorous statistical analysis showing positive impact of a governance choice on shareholder value. What rigorous empirical research supports each of the voting recommendations promulgated by proxy advisers? Why don't ISS and Glass Lewis disclose the specific research (either that they have conducted or conducted by third parties) that justifies each of their recommendations?[52]

49. Sanjai Bhagat and Bernard S. Black, "The Uncertain Relationship Between Board Composition and Firm Performance," *Business Law* 54, no. 3 (May 1999): 932.
50. Barry Baysinger and Henry Butler, "Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation," *Virginia Law Review* 71 (1985): 1302–3. See also Marcel Kahan and Edward Rock, "Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment," *Pennsylvania Law Review* 152 (2003): 516.
51. The Conference Board, NASDAQ, and Stanford Rock Center for Corporate Governance, "The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions" (March 2012): 6, http://www.gsb.stanford.edu/cldr/research/surveys/proxy.html.
52. David F. Larcker, Allan L. McCall, and Brian Tayan, "And Then a Miracle Happens! How Do Proxy Advisory Firms Develop Their Voting Recommendations?" (Rock Center for Corporate Governance at Stanford University Closer Look Series: Topics, Issues and Controversies in Corporate Governance and Leadership No. CGRP-31, Stanford, CA, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2224329.

V. TWO SOURCES OF LOW-QUALITY ADVICE

THE EVIDENCE STRONGLY suggests that proxy advisors do not enhance shareholder value with their recommendations. It is time to examine why. The problem begins with a simple fact: proxy advisors lack the resources to make adequate judgments. Currently, ISS has 1,300 clients and covers more than 40,000 meetings and every holding within client portfolios in more than 100 developed and emerging markets worldwide.[53] ISS does all this with a research staff of fewer than 200 persons.[54] The other major advisor, Glass Lewis, says that it "empower[s] institutional investors to make sound decisions by uncovering and assessing governance, business, legal, political and accounting risks at more than 23,000 companies in 100+ countries" with a total of just 300 employees, only 200 of whom are involved in research.[55] In addition, more than half of company shareholder meetings occur in a three-month span (April to June),[56] and this concentration makes thoughtful evaluations even more difficult.

A perverse outcome of the current system is that regulators are effectively separating the evaluation of corporate governance from investment analysis by driving funds to use crude alternatives to assess proxies, rather than the analytic expertise that they tout as their comparative advantage. A 2010 report published on the Harvard Law School forum found that

> at best, they may rely on statistical modeling in an effort to sort portfolio companies by performance, such as grading a company against a peer group determined by SIC codes or the like. . . . Voting decision makers do not and cannot utilize the tools of investment decision makers because it is simply not feasible to do so in the cost environment in which proxy advisors and internal corporate governance staffs are required to operate.[57]

53. "Proxy Advisory Services," ISS, accessed April 4, 2013, http://www.issgovernance.com/proxy/advisory.
54. "A dialogue with Institutional Shareholder Services," Audit Committee Leadership Network in North America, ViewPoints, no. 139 (November 7, 2012): 6, https://webforms.ey.com/Publication/vwLUAssets/Proxy_advisory_firms/$FILE/ViewPoints_39_November_2012_Dialogue_with_ISS.pdf.
55. "About Glass Lewis," GlassLewis.com, accessed April 4, 2013, http://www.glasslewis.com/about-glass-lewis/.
56. "A dialogue with Institutional Shareholder Services," Audit Committee Leadership Network in North America, ViewPoints, no. 139 (November 7, 2012): 6, https://webforms.ey.com/Publication/vwLUAssets/Proxy_advisory_firms/$FILE/ViewPoints_39_November_2012_Dialogue_with_ISS.pdf.
57. Charles Nathan, "The Parallel Universes of Institutional Investing and Institutional Voting," *The Harvard Law School Forum on Corporate Governance and Financial Regulation,* April 6, 2010, http://blogs.law.harvard.edu/corpgov/2010/04/06/the-parallel-universes-of-institutional-investing-and-institutional-voting/.

On February 19 of this year, the Norges Bank Investment Fund (NBIF), the world's largest sovereign wealth fund ($650 billion), released a report questioning the application of one-size-fits-all universal codes for evaluating corporate governance.[58] The NBIF report concluded that "principles should be seen as best practices and that considered deviation must be expected and welcomed." The implication is that the models used by proxy advisors are no substitute for informed analysis that considers the mission and background of each individual fund and looks carefully not just at rules and guidelines but also at the real-life nature of each proxy question.

An especially egregious example of the current reliance on guidelines and models involves Warren Buffett, perhaps the most respected investor and corporate leader of the past 40 years, a man brimming with experience and integrity. His company, Berkshire Hathaway, first bought Coca-Cola shares in 1988 and had amassed $10 billion worth of stock, making Coke at the time its largest single investment. Buffett had long served on the audit committee of the board.

But in April 2004, ISS opposed Buffett's reelection because some of Berkshire's companies, like Dairy Queen, sell Coke products, thus creating what ISS saw as a conflict. According to an ISS press release, "The recommendation is based on ISS's best practice corporate governance guidelines that call for completely independent audit committees."[59]

Buffett was reelected to the board anyway, and he commented, "I think it's absolutely silly. . . . Checklists are no substitute for thinking."[60] We do not suggest that it is necessarily wrong to focus on conflicts of interest on audit committees or otherwise; however, we do suggest that ISS's failure to consider Buffett's history with the company, his stature, and the firm's own compliance with rigid New York Stock Exchange listing rules for audit committee membership indicate a recommendation process that is unsophisticated and "one size fits all."

Checklists are precisely what the regulators have encouraged. For example, ISS guidelines state that the firm will recommend voting against directors of a company that does not act on a shareholder proposal that received a majority of votes in the previous year.[61] This sort of checklist item, of course, means that SoP "precatory," or advisory, votes actually carry the authority of being nearly mandatory. More importantly, the checklist item fails to take into account the possibility that directors may

58. Norges Bank Investment Management, NBIM Discussion Note: Corporate governance, November 19, 2012, http://www.nbim.no/Global/Documents/Dicussion%20Paper/2012/DiscussionNote_14.pdf.

59. ISS, "Institutional Shareholder Services' Response to Coca-Cola Director: Herbert Allen's April 15 Wall Street Journal Op-Ed Misses Point on Audit Panel Independence at Coke," PR Newswire, April 15, 2004, http://www.prnewswire.com/news-releases/institutional-shareholder-services-response-to-coca-cola-director-72496527.html.

60. David Larcker and Brian Tayan, *Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences* (New Jersey: FT Press, 2011), 403.

61. See ISS guidelines referenced in note 43 on page 15.

have more information or wisdom than shareholders, or that events have occurred in the intervening year that supersede the original vote. It is telling that ISS is willing to make that generalized recommendation in the absence of clear evidence whether the underlying successful shareholder proposal will add value at the company.

In addition, ISS toughened some of its standards in 2013, giving shareholder votes even more weight. According to an article in a trade publication, "The firm will now consider a proposal to have gained majority support if it wins a majority of shares cast, not just a majority of shares outstanding. That's a significant change, since many shareholders never cast their votes."[62]

The problem with checklists is that they simplify the complexities of business reality. Consider the matter of ISS's reliance on determining appropriate compensation by linking it to what a company's peer group members are paying. Company A may be on the ropes because a CEO just died or the company is simply performing poorly. The pool of top CEOs in the industry may be tiny, and competitors may be grabbing market share. Company A's directors may believe that hiring away Company B's CEO will both hurt a competitor and help Company A in a time of dire need, and to get B's CEO to move may require doubling his or her salary and offering substantial stock options. Such nuances occur in real life but not on the checklists of ISS and Glass Lewis.

Besides a lack of resources, proxy advisory firms lack the right incentives to make decisions that meet the interests of shareholders. As a working paper from the University of Pennsylvania School of Law states,

> Proxy advisors do not have a financial stake in the companies about which they provide voting advice; they owe no fiduciary duties to the shareholders of these companies; and they are not subject to any meaningful regulation. Moreover, it is not clear that the proxy advisory industry is sufficiently competitive and transparent to subject advisory firms—ISS in particular—to substantial market discipline.[63]

By contrast, the same paper points out that directors have powerful incentives to make the right decisions. They own shares in their companies, they are subject to lawsuits, and they risk their personal reputations. The danger is that "boards may do what they believe ISS wants them to in order to keep their seats, whether or not their belief is justified."[64]

62. Joseph McCafferty, "Proxy Advisers Make Changes to Voting Guidelines for 2013," *Compliance Week*, December 7, 2012, http://www.complianceweek.com/proxy-advisers-make-changes-to-voting-guidelines-for-2013/article/271784/.
63. See Stephen Choi, Jill Fisch, and Marcel Kahan, "The Power of Proxy Advisors: Myth or Reality?," *Emory Law Journal* 59 (2010): 872.
64. Ibid.

VI. THE ADDITIONAL PROBLEM OF CONFLICTS OF INTEREST

WHEN THE SEC adopted its rule requiring mutual funds to disclose their proxy voting policies, Chairman Harvey Pitt emphasized that the principal motivation for the new rule was his concern about potential conflicts of interest that mutual fund advisors face in voting their shares. He noted: "Because the securities are held for the benefit of the investors, they deserve to know the fund's proxy voting policies and whether they were in fact followed. Many wield voting power in the face of conflicts; they may cast votes furthering their own interests rather than those for whom they vote."[65]

Conflicts of interest deserve considerable discussion. Let's begin by looking at the results of poor advice under similar circumstances at credit-rating agencies.[66]

Federal regulators have designated nine firms as "nationally recognized statistical rating organizations."[67] One of the key functions of these NRSROs is to determine the creditworthiness of corporate and government borrowers and of specific bond issues. Two private firms dominate the market, though not quite as thoroughly as ISS and Glass Lewis dominate proxy advice. The two are Standard & Poor's, which according to the most recent SEC survey accounted for 44,500 of the 99,286 ratings of corporate issuers in 2010, and Moody's, which accounted for 30,285. Between them, the two firms accounted for 75 percent of the market for corporate bonds; a third firm, Fitch, added another 14 percent. S&P and Moody's had an even larger share—83 percent—of the market for rating government securities, with Fitch accounting for nearly all the rest.[68]

An array of financial regulations requires banks, insurance companies, and other institutions "to use credit ratings to establish investment risk standards for their portfolio holdings,"[69] for example, to meet capital requirements. After the financial crisis of 2008–09, credit-rating agencies, with conflicts of interest similar to proxy advisory firms, came under criticism for underestimating the risk involved in asset-backed securities, which they also rate (S&P and Moody's controlled 73 percent of that market in 2010; Fitch, another 21 percent). On February 5 of this year, the

65. "Speech by SEC Chairman: Remarks at the Commission Open Meeting," Chairman Harvey L. Pitt, SEC, January 23, 2003, http://www.sec.gov/news/speech/spch012303hlp.htm.
66. Editorial, "Standard & Poor's Stands Accused," *New York Times*, February 5, 2013, http://www.nytimes.com/2013/02/06/opinion/standard-poors-stands-accused.html.
67. "Annual Report on Nationally Recognized Statistical Rating Organizations," SEC (March 2012): 6–7, https://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0312.pdf.
68. Ibid., 9–10
69. Ibid., 15.

Department of Justice brought suit against S&P, charging that severe harm was inflicted on investors.[70]

The problem was not simply that credit-rating firms misjudged risk (either innocently or because of conflicts of interest) but that—just as with proxy advisory firms—regulators conferred substantial evaluative powers on a few firms, thus enabling institutions that engaged those firms to pass off responsibility for exercising their own fiduciary duty to conduct an informed analysis of the suitability of securities held in client accounts.

Proxy advisors don't literally or legally have the same license as credit-rating agencies, but their oligopoly is eerily similar. The fear now is that the regulations that have empowered a few proxy advisers are leading to the same adverse results as the rules that have empowered a few rating agencies.[71]

Remember that the main purpose of the 2003 SEC rule on proxies was to address problems caused by conflicts of interest between institutions and the shareholders whose assets they manage. In fact, the conflicts have merely been shifted to different firms. The conflicts have actually been exacerbated by the rule, since their regulatory mandate gives proxy advisors substantial market power. Before the 2003 rule, competitive pressures were already encouraging some mutual funds to disclose information about their proxy voting policies to customers.[72] Now those competitive pressures are less effective.

There are two major kinds of conflicts of interest that afflict proxy advisors. The first is that advisors may beinfluenced by some of their largest clients to make recommendations that serve those clients' social and political interests. As James R. Copland of the Manhattan Institute wrote in a *Wall Street Journal* op-ed: "ISS receives a substantial amount of income from labor-union pension funds and 'socially responsible' investing funds, which gives the company an incentive to favor proposals that are backed by these clients."[73] As a result, the behaviors of proxy advisors "deviate from concern over share value, [suggesting] that this process may be oriented toward influencing corporate behavior in a manner that generates private

70. "Department of Justice Sues Standard & Poor's for Fraud in Rating Mortgage-Backed Securities in the Years Leading Up to the Financial Crisis," United States Department of Justice (February 5, 2013), http://www.justice.gov/opa/pr/2013/February/13-ag-156.html. To be clear, the authors doubt that this particular lawsuit has merit. See "Payback for a Downgrade? The Feds Sue S&P but not Moody's for Pre-crisis Credit Ratings," *Wall Street Journal*, February 5, 2013, http://online.wsj.com/article/SB100014240 53111903596904576518460162935404.html.

71. Charles M. Nathan and Parul Mehta, *The Parallel Universes of Institutional Investing and Institutional Voting* (Rochester, NY: Social Science Research Network, 2010), 3.

72. See "Comment from Franklin Tempelton Fund on SEC Proposed Rule," SEC, December 9, 2002, http://www.sec.gov/rules/proposed/s73602/mlsimpson1.htm.

73. Opinion, "Politicized Proxy Advisers vs. Individual Investors," *Wall Street Journal*, October 7, 2012, http://online.wsj.com/article/SB10000872396390444620104578012252125632908.html.

returns to a subset of investors while harming the average diversified investor."[74] The legacy of the SEC's proxy policy rules appears to have encouraged a focus, in the words of SEC Commissioner Daniel Gallagher, on "social and political issues rather than issues that would be material to investors."[75]

The second variety of conflict that taints advisors is that they provide consulting services to the issuers about whom they make voting recommendations to mutual funds. These consulting services are designed precisely to facilitate managers' obtaining favorable recommendations. Copland writes about ISS:

> About 20% of its revenues also come from consulting contracts with companies about corporate governance issues and executive compensation, according to MSCI's 2011 annual report. Shareholder proposals that increase corporate sensitivity to ISS preferences would have the effect of increasing the incentive for public companies to enter into such consulting contracts with ISS. . . . From 2006 to 2012, ISS supported 35% of shareholder proposals related to environmental issues such as global warming or natural-gas hydraulic fracturing, and 70% of proposals seeking to increase disclosure of or to limit corporate political spending. Only one such proposal has received the support of a majority of shareholders.[76]

The SEC's Egan-Jones Letter, issued by the SEC shortly after its proxy advisor rule was enacted, addressed this potential conflict:

> An investment adviser could breach its fiduciary duty of care to its clients by voting its clients' proxies based upon the proxy voting firm's recommendations with respect to an Issuer because the proxy voting firm could recommend that the adviser vote the proxies in the firm's own interests, to further its relationship with the Issuer and its business of providing corporate governance advice,

74. James R. Copland, Yevgeniy Feyman, and Margaret O'Keefe, "Proxy Monitor 2012: A Report on Corporate Governance and Shareholder Activism" (Fall 2012): 3, http://proxymonitor.org/pdf/pmr_04.pdf.

75. Ning Chiu, "SEC Commissioners take divergent views on corporate governance and related disclosure regulations," *Lexology*, February 26, 2013, http://www.lexology.com/library/detail.aspx?g=d121d7fb-a090-4338-aff7-55d8b5fe13c1.

76. Opinion, "Politicized Proxy Advisers vs. Individual Investors," *Wall Street Journal*, October 7, 2012, http://online.wsj.com/article/SB10000872396390444620104578012252125632908.html.

> rather than in the interests of the adviser's clients. The proxy voting firm's relationship with an Issuer thus may present a conflict of interest that is in addition to any conflict of interest that the investment adviser may have.[77]

While the SEC staff clearly recognized the potential for conflict, the letter then took a turn that was surprisingly deferential to the proxy advisory firms by suggesting that disclosure would be sufficient to relieve the problem:

> Accordingly, an investment adviser should obtain information from any prospective independent third party to enable the adviser to determine that the third party is in fact independent, and can make recommendations for voting proxies in an impartial manner and in the best interests of the adviser's clients. . . . For instance, under the circumstances that you describe in your letter, the procedures should require a proxy voting firm that is called upon to make a recommendation to an investment adviser regarding the voting of an Issuer's proxies to disclose to the adviser any relevant facts concerning the firm's relationship with an Issuer, such as the amount of the compensation that the firm has received or will receive from an Issuer.[78]

This approach stands in stark contrast to other situations in which the SEC has issued regulations motivated by conflict-of-interest concerns in the arena of corporate governance. In cases involving investment analysts, for instance, the SEC has been quite aggressive. In its regulation of some non-audit advisory services offered by firms that conduct financial audits, the SEC was similarly dismissive of arguments that conflicts of interest could be managed merely through disclosure.[79] (Debates over the advisability of the SEC's approach to potential conflicts of interest involving investment advisers or auditors are beyond the scope of this paper. The examples suggest that the SEC's soft approach to proxy advisory firm conflicts of interest has been uncharacteristic.)

The Department of Labor, which regulates pension plans under ERISA (Employee Retirement Income Security Act of 1974, the main law regulating pension plans), has taken a more forceful stand against conflicts of interest in voting proxies. DOL's Advisory Opinion 2007-07A expressed "strong concern about the

77. SEC to Hughes, May 27, 2004.

78. Ibid.

79. See, e.g., Strengthening the Commission's Requirements Regarding Author Independence, 68 Fed. Reg. 6006 (February 5, 2003) (to be codified at 17 C.F.R. pts. 210, 240, 249, and 274).

use of plan assets to promote particular legislative, regulatory or public policy positions that have no connection to the payment of benefits or plan administrative expenses."[80] The letter used this example:

> The likelihood that the adoption of a proxy resolution or proposal requiring corporate directors and officers to disclose their personal political contributions would enhance the value of a plan's investment in the corporation appears sufficiently remote that the expenditure of plan assets to further such a resolution or proposal clearly raises compliance issues under [ERISA].[81]

In March 2011, the DOL's inspector general issued a report warning that unions may be using "plan assets to support or pursue proxy proposals for personal, social, legislative, regulatory, or public policy agendas."[82] The inspector general noted that the Employee Benefits Security Administration (ESBA), the division of DOL that enforces ERISA, often lacked adequate assurances that plan fiduciaries or third parties like proxy advisory firms base their votes or recommendations for votes on actual economic benefit.[83] It appears that the Labor Department's Inspector General shares our concern that corporate voting policies by some politically active funds may be conflicted.

It is possible that conflicts of interest posed by proxy advisory firms accepting consulting fees from issuers may already be prohibited under ERISA—or expose plan fiduciaries or proxy advisors to liability under the law. DOL has contemplated designating proxy advisors as fiduciaries under ERISA, a question beyond the scope of our analysis.[84] Even in the absence of such a rule, reliance on proxy advisors who provide consulting services may be prohibited.

When an ERISA fiduciary (that is, an official or firm with influence over pension plan investments) appoints others to fulfill its obligations—such as when it gives voting power to a proxy advisor—the ERISA fiduciary also has an obligation to monitor those appointees.[85] If relying on an expert that also receives fees from those whom the expert is assessing—fees that relate to the very matters in question—is deemed unreasonable, then ERISA fiduciaries may not meet their obligations for prudence.

Also, under ERISA, when a fiduciary acts to the benefit of a third party, even if

80. See 29 C.F.R. § 2509.94-2 (2008).

81. Ibid.

82. "Proxy-voting May Not be Solely for the Economic Benefit of Retirement Plans," Department of Labor, Office of Inspector General—Office of Audit, Employee Benefits Security Administration, Report No. 09-11-001-12-121 (March 31, 2011): 4–8, http://www.oig.dol.gov/public/reports/oa/2011/09-11-001-12-121.pdf.

83. Ibid.

84. Definition of the Term "Fiduciary," SEC, 75 Fed. Reg. 65,263, (October 22, 2010).

85. See Shirk v. Fifth Third Bancorp, No. 05-cv-49, 2007 WL 1100429, at *16 (S.D. Ohio April 10, 2007).

the fiduciary's own interest is not implicated, the fiduciary may violate its duty.[86] In addition, the lack of company-specific recommendations by proxy advisors and the limited empirical evidence supporting those recommendations call into question whether ERISA fiduciaries are fulfilling their obligations.

While the SEC's fiduciary rules for investment advisers are less developed than the Department of Labor's, many of the same principles could also inform interpretive guidance from the SEC to regulate the role of conflicts of interest faced by proxy advisors in corporate governance.

Some proxy advisors or ERISA fiduciaries might provide boilerplate disclosure about the possibility of conflicts stemming from consulting fees, yet in analogous contexts, like those involving auditors whose firms offer consulting services, institutional investor groups have been highly suspicious and have found disclosure or firewalls to be insufficient remedies.

For instance, the California Public Employees' Retirement System (CalPERS) advocates the following clear principle on auditor independence: "The external auditor should not provide internal audit services to the company."[87] Consulting services provided by the same entity that provides the external assessment represent an unavoidable conflict of interest in the view of CalPERS, which, with $254 billion in assets, serves 1.6 million members. It would seem that a similar problem is present when the same proxy advisory firm may be called upon to provide an external rating of a corporate governance proposal or mechanism it helped design.

In addition, the Council of Institutional Investors advocates that "a company's external auditor should not perform any non-audit services for the company, except those, such as attest services, that are required by statute or regulation to be performed by the company's external auditor."[88] Some proxy advisors have attempted to keep their work in proxy recommendations separate from their consulting work for issuers.[89] Still, it would seem inconsistent to argue that auditors providing tax structuring advice or internal audit consulting to the issuers they audit represent such an obtrusive conflict of interest that the practice must be banned outright, and at the same time argue that proxy advisors can successfully avoid the conflicts posed by providing consulting services to the issuers about whom they make voting recommendations.[90]

Indeed, the analogy to auditing fees actually *understates* the conflict involved. To be fully analogous, we would have to consider a situation where auditors provided issuers with consulting services about how to navigate successfully an outside audit (and by the same firm).

86. See Bevel v. Higgonbotham, Civ.-98-474-X, 2001 WL 1352896, at *14 (E.D. Okla. Oct. 4, 2001).
87. See Global Principles of Accountable Corporate Governance, CalPERS, November 14, 2011 at 27.
88. See Global Principles of Accountable Corporate Governance, CalPERS, November 14, 2011.
89. See Concept Release on the U.S. Proxy System, SEC, 75 Fed. Reg. 42,981, 43,009 (July 22, 2010).
90. See "Comment from Council of Institutional Investors on SEC Proposed Rule," SEC, January 10, 2003, http://www.sec.gov/rules/proposed/s74902/sabteslik1.htm.

Courts have held that obligations imposed by ERISA should be construed consistently with those of the federal securities laws.[91] Thus, to the extent that these principles cross over to the fiduciary obligations owed by proxy advisors and the investment advisers who rely on them, similar restrictions and liability risks from proxy advisor consulting fees may be present.

We have now examined three sources of low-quality advice: lack of resources, misaligned incentives, and conflicts of interest. Conflicts may already violate DOL regulations, which in turn provide guidelines for the SEC to follow. We have other recommendations as well to fix the current broken system.

VII. RECOMMENDATIONS

THE PROXY ADVISORY industry was principally created by regulation. Without regulatory mandates requiring active participation in proxy votes, and without interpretative releases giving preferential treatment to investment managers who use proxy advisors, a profitable proxy advisory industry might not exist.

There are legitimate concerns about merely adding more regulations, such as requirements that proxy advisors further "professionalize" their staffs or that a mandatory disclosure regime be created to solve a problem caused by regulation. The result of additional rules, as with credit-rating agencies, is often to make the regulated institutions less open to competition and closer to their regulators, a phenomenon known as "regulatory capture." Also, as we have seen, regulations often produce unintended consequences. It was no surprise that the US Chamber of Commerce, in a set of proposals in March for repairing the proxy advisory system, rejected the regulatory approach.[92]

On the other hand, replacing poor regulations with well-designed regulations can render businesses more exposed to the normal market forces that produce good outcomes.

The Egan-Jones letter shifted fiduciary responsibility for proxy decisions from mutual funds to third parties while simultaneously limiting the fiduciary exposure of those third parties. In the end, except in extraordinary cases, no one is responsible for representing the interests of shareholders. As a remedy, the law firm Wachtell, Lipton, Rosen & Katz argued, according to a piece in the *New York Times*, "that proxy advisory services should be subject to the proxy solicitation rules. If these rules applied, shareholders and public companies could sue the advisory services over disclosure lapses in their recommendation reports."[93] It is possible, of course,

91. *Shirk*, 2007 WL 1100429, at *15.

92. Ross Kerber, "Chamber of Commerce wants more proxy advisor disclosures," Reuters, March 20, 2013, http://www.reuters.com/article/2013/03/20/us-proxy-advisors-chamber-idUSBRE92J0S120130320.

93. Steven M. Davidoff, "Proxy Firms Need More Rules, Companies Say," DealBook, November 30, 2010, http://dealbook.nytimes.com/2010/11/30/in-one-area-companies-want-more-regulation/.

that "by imposing this liability, the ability of proxy advisors to make recommendations would be chilled, if not killed."[94] This paper does not suggest either a mandatory disclosure regime or the Lipton proposal, though both are valid options that deserve a place in the debate.

At a bare minimum, regulators must act to end to proxy advisor services' conflicts of interest, actual and potential. The firms must choose their clients: either corporate share issuers or investment institutions such as mutual funds—but not both. Even if this conflict were eliminated, the change would not remove that possibility that ISS would favor the ideological and political views of large proxy-advisory clients. That bias can't be removed through oversight, only through competition. In other words, if it were more broadly known that ISS recommendations diminished shareholder value, both kinds of potential clients might look elsewhere for advisory services.

Knowledge about shareholder value depends on research, and this sort of research is difficult to design because the advisory firms lack transparency. If regulators eliminate rules that offer preferential treatment to proxy advisors and the firms that use them, and eliminate the regulatory mandate for active voting policies, disclosure will occur voluntarily through market forces. This voluntary disclosure can occur along the lines recently suggested by the US Chamber, asking that proxy advisors

> review the effects of their recommendations six months, or as practicable, after relevant proxy votes, and publish those results (with other necessary data) to permit interested persons to assess the accuracy, validity, and appropriateness of the PA Firm's recommendations. . . . These reviews should permit regularly revisiting and, if appropriate, modifying, proxy voting policies to ensure that they have a positive—or at a minimum no negative—effect on shareholder value.[95]

Unfortunately, ISS issued a response to the Chamber's suggestion that illustrates the extensive buffer it enjoys from market competition:

> We take exception with the Chamber's misinformed characterization of the proxy advisory industry and with their disrespect for the financial institutions that are our clients and, ironically, some of the Chamber's own members. . . . We are accountable to our

94. Ibid.

95. "Best Practices and Core Principles for the Development, Dispensation, and Receipt of Proxy Advice," Center for Capital Markets Competitiveness, Chamber of Commerce (March 2013): 7, http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Best-Practices-and-Core-Principles-for-Proxy-Advisors.pdf.

> clients who place their confidence in our service, to the companies we analyze and to the regulators that set the real guidelines for fiduciary responsibility. The Chamber should take its own advice by grounding its "Principles" in actual facts rather than its own self-serving interests.[96]

Fixing the current system also requires that we acknowledge that mutual funds can't possibly make considered judgments about tens of thousands of proxies, and that it is not in their best interest to do so. "Institutional investors like mutual funds and pension funds do not have the resources to analyze and consider all these proposals," as Steven Davidoff, a law school professor, wrote in the *New York Times*.[97] TIAA-CREF, for instance, holds stock in 7,000 companies and must cast more than 100,000 votes a year. Instead of requiring mutual funds to engage in active analysis of tens of thousands of votes, the SEC could allow funds and their advisers to determine when such analysis would be in their fund's best interest. This approach recognizes that the ultimate source of the problem is not the way ISS conducts its business but the burden the SEC has imposed on mutual funds that made them turn to ISS in the first place.

That burden is compounded by Dodd-Frank's insistence that shareholders cast certain votes, such as Say-on-Pay. We believe such proxy requirements are unnecessary. If issuers ignore the wishes of shareholders, then shareholders will take appropriate action through self-funded proxy fights, filing civil lawsuits, taking short positions, or simply voting with their feet by selling shares, thereby sending the powerful signal of a falling stock price.

In the absence of such a policy shift, many institutional investors cannot or will not dedicate sufficient resources to develop individual assessments of all proxies. And, since the SEC has provided them with what appears to be a legal "safe haven," these mutual funds will continue to turn to firms like ISS, firms that cannot adequately evaluate all the companies in the investment universe.

On the other hand, if the SEC recognized the limitations of the current policy, investors would benefit from lower costs and a decrease in the risk associated with centralized decision making. This change would not necessarily eliminate the role of proxy advisors but would reduce it to its proper weight in the scheme of corporate governance. Holly Gregory of the law firm Weill, Gotshal & Manges recently wrote on the blog of the Harvard Law School Forum on Corporate Governance

96. "ISS Response to the U.S. Chamber of Commerce's Guidelines for Proxy Advisory Firms," ISS, accessed April 4, 2013, http://www.issgovernance.com/press/issreponsechamberofcommerce.
97. Davidoff, "Proxy Firms Need More Rules, Companies Say."

and Financial Regulation, "Decisions to utilize the services that proxy advisors offer should be made on an informed basis after appropriate due diligence, especially if the shareholder is an institutional investor that owes fiduciary duties to beneficiaries."[98]

Those fiduciary duties include serious considerations of costs versus benefits. A perverse result of mandating that institutions vote all matters on a company proxy is that the SEC is essentially saying all issues are important to all shareholders. In fact, the potential benefits realized by voting on certain items, as required by SEC regulations, are outweighed by the cost to the fund of conducting a proper evaluation—a cost ultimately absorbed by the shareholders. In other words, the cost of, say, deciding how to vote proxies on 1,000 shares of a stock owned by a mutual fund with high turnover *subtracts* from shareholder value.

A report by the law firm Latham & Watkins, LLP, cites a 2008 interpretation by the Department of Labor, which found

> that an investment adviser's fiduciary duty requires it first affirmatively to conclude that the potential economic benefits to share value arising from the act of voting outweighs [*sic*] the costs of voting (including the risk that the vote could decrease share value), with voting being appropriate only for those matters at a particular company that are determined to have greater benefit than cost.[99]

So far, neither the Department of Labor nor the SEC has reconciled this need for benefit-cost analysis with universal active proxy voting policy requirements. While the 2008 DOL interpretation tried to address the universal active voting mandate, a shift in priorities and a lack of enforcement at the DOL has since undercut the 2008 interpretive letter.

The SEC also has yet to address the responses to its 2010 concept release on proxy voting. When it does, it must recognize that its own interpretation of the original 2003 rule is at the root of the trouble—and the trouble is that two small firms, and one in particular, have become the central arbiters of corporate governance in America, and those firms are not equipped or incentivized to make value-enhancing decisions.

98. Holly Gregory, "Preserving Balance in Corporate Governance," *The Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), February 1, 2013, http://blogs.law.harvard.edu/corpgov/2013/02/01/preserving-balance-in-corporate-governance/.

99. "Proxy Advisory Business: Apotheosis or Apogee?," *Corporate Governance Commentary*, Latham & Watkins LLP (March 2011): 2, citing 29 C.F.R. § 2509 (2008).

Three steps are needed to fix the problem:

1. Limit proxy voting requirements of mutual funds and pension funds so that those institutions will be the sole arbiters of when it makes sense to vote using active analysis of the question at hand. The test should be whether the vote enhances the value of an investment to a significant degree and whether the benefits of the voting process exceed the costs.
2. End the preferential regulatory treatment that proxy advisors currently enjoy in the law. That process must start by rescinding the Egan-Jones letter issued by the SEC staff. Institutional investors would remain free to purchase proxy advisory services if those services are valued for their own merit. Continued resistance by proxy advisors to sharing the empirical foundation for their recommendations suggests demand for their services may decline in the absence of their regulatory advantages.
3. End extraneous proxy requirements, such as Say-on-Pay votes. Let shareholders and directors decide the matters that should be put to votes, if any, beyond those already required under state corporate law.

All three steps are reasonable, nonideological, and address a pressing problem. They should be relatively easy to accomplish. However, if step 2 is not enacted, we would advocate as an alternative limiting proxy advisors to a single business in order to mitigate conflicts of interest. They can advise issuers on corporate governance and getting proxy proposals passed, or they can advise mutual funds and other financial institutions on how to vote—but not both. As we noted in the previous section, such a conflict may already subject ERISA plans relying on proxy advisors to potential liability. The SEC's rules for mutual funds and their advisers recognize this conflict.

The time for reform is now. The regulatory advantages proxy advisory firms enjoy should be curtailed in the interest of America's shareholders.

Outsourcing Shareholder Voting to Proxy Advisory Firms

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Outsourcing Shareholder Voting to Proxy Advisory Firms

Abstract: This paper examines the economic consequences of institutional investors outsourcing research and voting decisions on matters submitted to a vote of public company shareholders to proxy advisory firms. These outsourcing decisions appear to be the result of the regulatory requirement that institutional investors vote their shares combined with incentives for these investors to minimize their cost of voting activity. We investigate the implications of these decisions in the context of shareholder say-on-pay voting required in 2011 under the Dodd-Frank Act. Analyzing a large sample of firms from the *Russell 3000* that are subject to the initial say-on-pay vote mandated by the Dodd-Frank Act, we find three primary results. First, consistent with prior research, proxy advisory firm recommendations have a substantive impact on say-on-pay voting outcomes. Second, a significant number of firms change their compensation programs in the time period *before* the formal shareholder vote in a manner consistent with the features known to be favored by proxy advisory firms in an effort to avoid a negative voting recommendation. Third, the stock market reaction to these compensation program changes is statistically *negative*. These results suggest that the outsourcing of voting to proxy advisory firms appears to have the unintended economic consequence that boards of directors are induced to make choices that *decrease* shareholder value. While this evidence does not speak to the optimality of outsourcing all voting decisions compared to alternative regulatory constructs (e.g. prohibiting proxy advisors or reducing the number of items to be voted on), it does inform this debate by providing evidence on the potential negative economic consequences of outsourcing shareholder voting to proxy advisors.

Keywords: proxy advisory firms; say-on-pay; institutional shareholder voting

JEL Classification: G1; G3; K2; L5

1. Introduction

Significant regulatory, financial press and academic research attention has been paid in recent years to mechanisms that will give shareholders of public companies more control over firms' corporate governance. While most of the focus has been on actual or perceived failings of corporate governance within firms, relatively little attention has been paid to how large institutional shareholders actually utilize their increased influence to affect the governance choices of individual firms.[1] This is an especially important issue because the number of opportunities for shareholders to cast votes on various corporate governance items has increased in recent years (e.g. through shareholder proposals and mandated votes such as say-on-pay) and firms are increasingly responsive to voting results.[2]

Like many instances of voting by a dispersed base, shareholder voting is subject to free rider problems because any individual shareholder's vote likely matters very little, but they bear the full cost of researching matters subject to vote. While retail investors can choose to not vote, institutional investors have a fiduciary obligation to cast votes on virtually all shareholder ballots, and therefore they represent the preponderance of votes cast. If the free rider problems sufficiently dilute the benefits of engaging in costly research to identify the optimal voting choice, institutional investors may choose to engage in a low cost voting strategy that meets their regulatory requirements but might not result in optimal feedback to the firms. In this paper, we examine the characteristics and the economic consequences of institutional investor voting, and in particular the outsourcing of voting to cost-effective third parties such as proxy advisory firms.[3]

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[1] Our focus is on governance choices influenced through the regular corporate vote channels. This is different from research on shareholder activism (e.g. Gillan and Starks, 2007, and Barber, 2007) which has been largely inconclusive on the value implications to shareholders.

[2] Among firms covered by ISS Voting Analytics the average number of ballot items per firm increased from 6.48 in 2003 to 9.46 in 2011.

[3] A recent (somewhat extreme) example of outsourcing is the decision of BlackRock to outsource voting on the question of whether to split the chairman and CEO for JPMorgan Chase to Governance for Owners. Since

Institutional investors generally have a fiduciary responsibility to vote shares in their portfolios in a manner that is beneficial to their shareholders.[4] In 2003, the SEC further increased the requirements for mutual funds by requiring them to disclose their voting policies as well as disclose how they actually voted on every ballot item. A key objective of this regulation was to motivate institutional investors to monitor firms in a manner that benefits all shareholders (SEC, 2003). However, institutional investors tend to have relatively small holdings in a large number of stocks making the cost of researching every ballot item at each annual meeting for all stocks in their portfolio costly.[5] Moreover, the economic benefits to an institutional investor conducting this research (presumably by forcing appropriate governance changes and reducing agency problems) are likely to be quite small because an individual fund only recognizes the partial benefit associated with its small ownership stake in firms where the investor is the pivotal voter, while incurring all the costs of this research activity (i.e., traditional free-rider problems confront each institutional investor). One consequence of this is that shareholder voting processes have taken on characteristics of compliance function (i.e., making sure that the votes are cast according to a specific policy), as opposed to an activity involving the portfolio managers who are engaged in research resulting in buy or sell decisions for shareholders in the funds.[6]

BlackRock owned approximately 6.5% of the shares of JPMorgan Chase, they were required to outsource to an independent third party under the Bank Holding Company Act (see Craig and Silver-Greenberg, 2013).

[4] Throughout the paper, we use the term "institutional investors" to include all non-individual investors such as mutual funds, pension funds, endowments, insurance companies, and other similar entities. These investors usually have a fiduciary responsibility to vote their shares, but the relevant controlling regulations vary across investor types. Mutual funds are a subset of the larger group that are specifically subject to the changes in voting requirements and disclosure of actual votes implemented in by the SEC in 2003

[5] Glass Lewis & Co. notes, "Most institutions do not have adequate in-house resources to ensure that the right decisions are being made on the hundreds or thousands of proxies they vote each year". Source: www.glasslewis.com/solutions/proxypaper.php (accessed April 22, 2011)

[6] For instance, at Fidelity Investments, according to their proxy voting policy, proxy voting is conducted by a separate internal group and does not explicitly provide for input or recommendations from portfolio managers or research analysts covering the firm on many common proxy items. Fidelity's policy provides for consulting portfolio managers on items for which no guidelines have been established. However guidelines have been established for many common circumstances, including director elections, equity compensation plans, stock option exchanges and "say-on-pay" advisory votes, implying that portfolio managers would not ordinarily participate in the

In this market setting, we would expect “corporate governance research entities” such as proxy advisory firms to form and invest in costly data collection and research where this cost is ultimately shared across many institutional investor clients.[7] That is, institutional investors will tend to outsource their voting decisions to these proxy advisory firms as long as their net benefits will exceed those from doing all the necessary research in-house.[8] This is even a more likely outcome after the SEC (2003) issued an interpretation that the use of proxy voting policies developed by an independent third party (i.e., proxy advisors) would be deemed free of a conflict of interest and would meet mutual funds’ proxy voting obligations. Thus, the least costly way to satisfy an investors’ regulatory responsibility to cast shareholder votes can easily be to outsource voting to Institutional Shareholder Services (ISS) or Glass Lewis (GL).

The important public policy issue in this setting is whether the payments made by institutional investors are sufficient for the proxy advisory firms to engage in costly research to develop “correct” governance recommendations from the perspective of firm shareholders. If the institutional investors are only using the proxy advisor voting recommendations to meet their compliance requirement with the lowest cost, these payments will not compensate proxy advisors for conducting research that is necessary to determine appropriate corporate governance structures for individual firms. Under this scenario, the resulting recommendations will tend to be based on simple, low cost approaches that ignore the complex contextual aspects that are almost certainly instrumental in selecting the corporate governance structure for individual firms. Given the

review of those items (Fidelity Funds’ Proxy Voting Guidelines, November 2010). Other firms completely outsource the voting process to third-party proxy advisors, bypassing input from portfolio managers.

[7] Since institutional investors hold shares in many thousands of individual domestic and international companies, a proxy advisory firm must have sufficient scale to provide voting recommendations for many proposals for this large number of firms. Thus, there are substantial fixed costs to start a competitor firm and the prospects of success are likely to be low given the “first mover” advantages of the two largest firms (ISS and Glass Lewis). Over the past decade, new entrants have failed to generate any meaningful market share (e.g., Egan Jones). The proxy advisory industry has the classic oligopoly structure.

[8] An additional alternative available to institutional investors would be to make no investment in research of proxy items and simply make an arbitrary voting decision, such as always following management’s recommendation. This strategy would carry significant legal/regulatory risk because, if discovered, the institution may have violated its fiduciary duty to its shareholders.

theoretical and practical difficulty of selecting corporate governance, there is no reason to assume that a simple approach to voting recommendations is optimal for the affected firms. However, if proxy advisors can influence enough shareholder votes, boards of directors will be forced or induced to respond by changing executive compensation programs and governance structure in a manner consistent with the recommendations of proxy advisor firms. The obvious question that remains to be answered is whether or not the confluence of government regulations, the outsourcing of recommendations the proxy advisory industry, and responses by boards of directors to these recommendations, produces an increase in shareholder value as anticipated by government regulators (SEC, 2003).

In this paper, we examine impact of institutional shareholder voting, particularly the outsourcing of research and recommendations to proxy advisory firms, in the setting of shareholder say-on-pay voting. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) imposed a requirement that public companies allow shareholders the opportunity to cast an advisory vote on executive compensation (typically annually) beginning in 2011. This requirement is commonly referred to as say-on-pay (SOP).[9] Shareholders that disagree with a firm's executive compensation program can cast a non-binding (or precatory) vote "against" the management compensation program disclosed in the proxy statement for the annual shareholder meeting. The primary regulatory assumption with SOP is that firms will make changes to their compensation program when a substantial proportion of negative (against) votes are cast by shareholders.

The implementation of SOP voting provides several advantages to other shareholder vote issues for purposes of evaluating the economic impact of vote outsourcing to proxy advisors.

[9] Prior to the Dodd-Frank Act, firms receiving aid under the Troubled Asset Relief Program (TARP) were required to conduct SOP votes beginning in 2009, and a small number of non-TARP firms voluntarily adopted SOP votes prior to Dodd-Frank.

First, the regulation is broad, effecting most of the U.S. equity market. Second, because this is a new proxy ballot item, inferences are less confounded by questions of timing (e.g., whether actions might be in response to a past vote or in anticipation of a future vote). Finally, we exploit the fact that while SOP voting was new for most public companies, the policies used by proxy advisors to develop their recommendations were well publicized and known to boards of directors in advance the first SOP votes required by Dodd-Frank Act. This enables us to examine changes that boards of directors make to compensation programs *in anticipation of* the initial SOP votes and the shareholder reaction to those changes. If a board anticipates opposition to its executive compensation program and believes that this opposition is costly to shareholders (e.g., because it invites derivative lawsuits, negative press, regulatory scrutiny, or distracts executives and employees) or is personally costly to them (e.g., through litigation or reputation risk), it might rationally take preemptive actions to decrease the probability of receiving negative votes. In such a setting, the board of directors will be interested in anticipating whether institutional investors (who generally hold the majority of outstanding shares) will vote for or against a SOP proposal.

We document that many institutional investors rely on proxy advisory firms, primarily ISS and GL, for data and analysis to guide their voting choices. Although each institutional investor ultimately controls the votes cast for its own shares, it is common for funds to rely in whole or in part on the policies and guidelines of proxy advisory firms to inform their SOP voting decisions (Belinfanti, 2010). For example, SEI Investment Management, Grantham, Mayo, and Van Otterloo, Evergreen Investment Management, Dimensional Fund Advisors, Wells Fargo Funds Management, and Nuveen Asset Management voted more than 99% of the time with the ISS recommendation. Similarly Charles Schwab, Neuberger Berman, Loomis

Sayles, and Invesco disclose that they follow GL SOP recommendations.[10] As a result, depending on their shareholder base, it is possible for firms to substantially decrease votes against SOP by obtaining a positive recommendation from proxy advisory firms.

This shift in expected voting outcomes can be accomplished by making changes to the compensation program so that its features more closely align with the voting policies of the proxy advisory firms before the proxy statement is released and these firms issue their SOP voting recommendation. For example, in a recent survey conducted by The Conference Board, NASDAQ, and the Stanford Rock Center for Corporate Governance (2012), over 70% of the director and executive officer respondents indicated that their compensation programs were influenced by the policies of and/or guidance received from proxy advisory firms during their evaluation of SOP. If the policies and guidelines of proxy advisors effectively identify poor pay practices, changes made by boards of directors to align their executive compensation programs more closely with these policies will decrease executive rent extraction and increase shareholder value. However, if proxy advisor voting policies do not identify suboptimal corporate governance, changes made to align executive compensation programs with these policies could move compensation contracts away from the optimal structure and reduce the value of the firm. We provide insight into these potential shareholder value implications by examining the determinants of the SOP voting outcomes (including proxy advisor recommendations), assessing whether boards of directors make compensation plan changes that are favored by proxy advisors in anticipation of the first SOP vote, and estimating the economic consequences of these decisions for shareholders.

[10] While GL does not publish their recommendations to non-subscribers, we confirm that these institutions make the same vote in more than 99% of cases, which is consistent with use of the same recommendations.

Our tests are based on 2,008 firms from the *Russell 3000* index that held their shareholder meeting in 2011 and were required to have a SOP vote under the Dodd-Frank Act. Consistent with prior research (e.g., Bethel and Gillan, 2002, Cai, Garner, and Walking, 2009, and others), we first show that the proxy advisory firm recommendations substantially influence the voting tally. For example, a simple univariate analysis reveals that firms that received a negative recommendation by ISS (GL) obtained an average 68.68% (76.18%) voting support in SOP proposals.[11] In contrast, firms that did not receive a negative recommendation from ISS (GL) obtained an average of 93.4% (93.7%) support in those proposals. This differential voting effect is even more pronounced when the specific institutions owning shares in the firm historically rely more heavily on ISS recommendations (i.e., institutions are more likely to vote in line with ISS recommendations when there is a disagreement between the voting recommendation of ISS and management). Specifically, for negative SOP recommendations, we find that firms with investors that have an above-median likelihood of voting with ISS exhibit 63.5% support for the proposal, whereas firms where that likelihood is below median exhibit 73.5% support for the proposal.

As a result of their ability to influence SOP votes, proxy advisory firms can induce firms to adopt compensation plan features that they are known to favor (e.g., performance-based equity and elimination of tax gross-ups in change of control plans).[12] While firms rarely discuss the specific role of proxy advisors in making changes to executive compensation in their public

[11] In the first year of SOP, firms in our sample received, on average, 90.27% approval from shareholders. However, 13.24% of companies received at least 20% votes against their plan and 32 of the sample companies actually failed their vote (less than 50% of vote cast in favor of management's proposal).

[12] For example, General Electric stated that changes were made to stock options previously granted to the CEO after "a number of constructive conversations with shareowners" (General Electric SEC Form DEFA14A filed April 18, 2011). Disney initially tried to argue that shareholders should ignore a negative vote recommendation from ISS (The Walt Disney Company SEC Form DEFA14A filed March 2, 2011), but later removed the key feature causing the negative ISS recommendation without discussion of the reason (The Walt Disney Company SEC Form DEFA14A filed March 18, 2011). ISS changed their SOP recommendation for Disney on the same date (ISS Proxy Voting Report dated March 18, 2011).

filings, reports by business media indicate that these changes were made in response to proxy advisor policies.[13]

Our primary tests examine compensation changes made in the time period *preceding* the SOP vote that better align the compensation program with known proxy advisor policies. We find that these changes are more likely to be observed among firms that expect to receive a negative SOP recommendation in the absence of a compensation plan change and where ISS can influence a substantial number of shareholder votes. Since most executive compensation changes must be publicly disclosed on Securities and Exchange Commission (SEC) Form 8-K, it is possible to precisely estimate the stock market assessment of these decisions by the board of directors. We find that the average risk-adjusted return on the 8-K filing date is a statistically significant -0.44% lower among compensation changes aligned with proxy advisor policies than among compensation changes unrelated to proxy advisor policies. Moreover, this effect is unique to 8-K changes in the time period before SOP and similar results are not observed for earlier time periods.

As with all observational studies, there are a variety of alternative interpretations of this result. However, we believe that the most plausible conclusion is that the confluence of the regulatory environment and free ridership problems inherent in shareholder voting leads institutional investors to outsource the proxy voting decision to proxy advisory firms, but that they are not willing to pay for research sufficient to induce optimal governance choices in firms.

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[13] For example, see Joann S. Lublin, "Firms Feel 'Say on Pay' Effect," *The Wall Street Journal*, May 2, 2011; and Andrew Dowell, and Joann S. Lublin, "Strings Attached to Options Grant for GE's Immelt," *The Wall Street Journal*, April 20, 2011. Twelve firms made changes to (or commitments to change) compensation programs after filing their proxy statement containing the SOP proposal, and subsequently received a positive recommendation from ISS. Ten of these firms received a positive ISS recommendation on the same date as the public announcement of their revised compensation programs, one received positive recommendation two days later, and the last firm received a positive recommendation three weeks later. Nine of the 12 firms had received an initial negative recommendation from ISS that was reversed to a positive recommendation when the firm disclosed its changes. The other three firms received their initial (positive) recommendation from ISS immediately after filing amendments to their proxy statements.

As a result, the proprietary SOP policies of proxy advisory firms induce the boards of directors to make compensation decisions that *decrease* shareholder value. While we cannot assess the overall social welfare effect related to the outsourcing of proxy voting to the proxy advisory industry, this paper informs this debate by providing evidence on the potential negative economic consequences of outsourcing shareholder voting to proxy advisors.

The remainder of the paper consists of six Sections. Section 2 discusses the institutional background for proxy advisory firms, SOP and prior research on these topics. Section 3 describes our sample selection. Section 4 presents our analysis of the determinants of proxy advisors' SOP recommendations. Section 5 assesses the influence of proxy advisors on shareholder voting. Section 6 examines the responses by boards of directors to proxy advisors' policies, the economic consequences of these responses, and an assessment of alternative interpretations of our results. Summary and concluding remarks are provided in Section 7.

2. Institutional Background and Literature Review

2.1 Proxy Voting Requirements for Institutional Investors

Institutional investors are generally fiduciaries for the ultimate economic owners of the assets they are investing, which obligates them to a duty of care and loyalty that includes exercising the voting rights on shares in their portfolios. Prior to 2003, there was little insight into how individual institutional investors were actually using their voting power. In response to concerns that institutional investors were conflicted in their voting by other business dealings with issuers, as well as significant pressure from organized labor groups, the SEC adopted new voting requirements in 2003 (Cremers and Romano, 2009). The key requirements of the 2003 regulations were for mutual funds to disclose their votes on all shareholder ballot items, as well as the policies and procedures used to determine their vote (SEC, 2003). The SEC summarized the objectives of requirements in the final rule:

> Proxy voting decisions by funds can play an important role in maximizing the value of the funds' investments, thereby having an enormous impact on the financial livelihood of millions of Americans. Further, shedding light on mutual fund proxy voting could illuminate potential conflicts of interest and discourage voting that is inconsistent with fund shareholders' best interests. *Finally, requiring greater transparency of proxy voting by funds may encourage funds to become more engaged in corporate governance of issuers held in their portfolios, which may benefit all investors and not just fund shareholders* (SEC, 2003, emphasis added).

The objectives stated by the SEC clearly assume that institutional investors will conduct the research necessary to cast votes that will lead to “optimal” corporate governance choices. However, each institutional investor also faces a classic free rider problem. Most institutional investor holdings are relatively small portions of each firm’s total securities [in our sample, the mean (median) holding is 0.3% (0.03%)]. This makes it unlikely that a given institution is a pivotal voter on any ballot item. Most of these institutions also hold a large number of securities, making the cost of engaging in research necessary to determine the correct vote on every proxy item very high. These free rider problems make it clear that there are economic incentives for institutional investors to not invest in costly research on proxy votes.

Determining how to vote on complex issues of corporate governance typically involves evaluating a wide range of idiosyncratic firm issues, such as each director’s experience and their cumulative skills, appropriateness of firm oversight and strategy, firm compensation relative to firm strategy, personal characteristics of executives, practices of other industry and labor market competitors, and many others features of the economic setting. This type of research is not the primary business of most institutional investors. As a result, outsourcing this research (and in many cases the voting decision) may be the most cost efficient means of meeting their obligation to vote their owned shares.[14] At the same time the new proxy voting rules were finalized, an interpretative letter from the SEC provided that the use of proxy voting policies and recommendations developed by an independent third party such as proxy advisors would be deemed free of a conflict of interest and would meet mutual fund proxy voting obligations. From a compliance perspective, this ruling provided considerable incentives for mutual funds to rely on the recommendations of third-party proxy advisory firms, particularly when they might be perceived to have conflicts of interest arising from other business dealings (Belinfanti, 2010). If the free rider problems are substantial and portfolio managers do not use the proxy advisory firm recommendations in stock selection, institutional investors will not pay higher fees for better research beyond that necessary to meet the simple compliance requirements. If the resulting ISS and GL SOP recommendations are inappropriate, corporate governance changes induced by these votes are unlikely to increase shareholder value. These concerns have not gone unnoticed by the SEC, as (former) Commission Chairwoman Mary Shapiro noted, the SEC will:

> "…be examining the role of proxy advisory firms. Both companies and investors have raised concerns that proxy advisory firms may be subject to undisclosed conflicts of interest. *In addition, they may fail to conduct adequate research, or may base recommendations on erroneous or incomplete facts*" (emphasis added).[15]

2.2 Proxy Advisory Firms

Past research has documented that proxy advisor recommendations have a significant impact on the voting outcomes on various types of shareholder ballot items. For example, Morgan, Poulsen, and Wolf (2006) investigate trends in shareholder voting on management

[14] For instance, passive index funds typically do not conduct firm-specific corporate governance research for their trading activities. Although actively managed funds may trade on selected governance characteristics, this does not appear to be a key part of their typical fundamental investment strategies based on our interviews with portfolio managers at six large mutual funds. Moreover, the recent Tapestry Networks and IRRC Institute (2012) study of how mutual funds vote finds that many funds outsourced their voting on say-on pay to proxy advisory firms.
[15] Speech by Mary Schapiro, from *NACD Directorship Magazine*, Dec. 2010/Jan. 2011, p. 48

sponsored compensation programs. Over the time period from 1992 to 2003, affirmative voting for these management sponsored proposals declined, and in particular, negative vote recommendations of a proxy advisory firm resulted in a 20% increase in negative votes cast. Similarly, Bethel and Gillan (2002) and Cai, Garner, and Walking (2009) find that a negative ISS recommendation on a management proposal can sway between 13.6% to 20.6% and 19% of votes, respectively. Prior research clearly establishes a strong association between negative recommendations by proxy advisory firms and subsequent voting outcomes for management proposals. However the precise nature of the role of proxy advisors remains unclear.

Thomas, Palmiter and Cotter (2012) point out that proxy advisors may represent an aggregation of institutional investor perspectives that allow the industry to effect corporate governance changes in a coordinated way. From this perspective, proxy advisory firms may simply be an informative conduit between institutional investors and firms. However, Larcker, McCall and Tayan (2013) evaluate the public disclosures of the processes by which proxy advisors develop their voting guidelines and show that there is considerable discretion applied in translating the diverse feedback (using questionnaires and informal discussions) from investors and corporate issuers into specific voting recommendations. That is, the voting recommendations are not a simple tabulation of views expressed by institutional investors. Regardless of whether proxy advisors provide independent assessments and/or simply aggregate the views of institutional investors, it is important for researchers, shareholders, and regulators to understand whether ultimate policies that are adopted are value enhancing for firm shareholders.

The economic implications of outsourcing voting decisions to proxy advisors are unclear in prior literature. Larcker, McCall and Ormazabal (2012) examine the consequences of designing stock option repricing programs according to proxy advisor policies and find that programs that are constrained to meet proxy advisor criteria are less valuable to shareholders. Alexander, Chen, Seppi, and Spatt (2010) provide insight into the role of proxy advisors in the context of contested director elections. They conclude that an ISS recommendation in favor of the dissident slate can serve as both an indicator for the likelihood that the dissident slate is elected and as a certification of the value of the dissidents to shareholders. However, the setting of contested elections is quite different from typical proxy ballot items. In particular, the decision to propose opposing director slates is a relatively rare occurrence that comes from dissident shareholders rather than management, and proxy advisors have different processes and (more seasoned) research teams for evaluating contested elections and merger and acquisition transactions (Winter, 2010).

2.3 Regulation of Executive Compensation and Shareholder Say-On-Pay

Concerns and criticisms over the reasonableness of compensation levels for managers of publicly traded companies has been a topic of interest for journalists, politicians, and researchers for at least a century. Efforts to restrict executive compensation have typically utilized either taxes (e.g., Internal Revenue Code Regulations 162m and 280G)[16] to make certain arrangements prohibitively expensive or increased disclosure (e.g., the 1992 and 2006 revisions for reporting executive compensation in the annual proxy statement or SEC Filing DEF 14A) in an effort to motivate boards and executives to make changes in response to pressure from shareholders or the public.[17] Research examining the effects of IRC 162m has shown modest effect on the form but not the level or performance sensitivity of executive compensation (e.g., Hall and Liebman,

[16] IRC 162m limits the deductibility of executive compensation to $1 million per year for each named executive officer unless the compensation qualifies as "performance-based" under the code. 280G imposes a 20% excise tax on "golden parachute" payments following the acquisition of the company if they exceed certain thresholds. The 1992 and 2006 revisions to proxy reporting regulations represented substantial revisions of the disclosure regime, significantly increasing the tabular and narrative disclosure of compensation to named executive officers (e.g., see Freher, 1992, and Buck Consultants, 2006 for discussion of changes).

[17] Core, Guay, and Larcker (2008) also find little evidence that negative discussion in the press causes firms to reduce the level or change the mix in executive compensation.

2000, Rose and Wolfram, 2002). In fact, some research suggests that pay levels actually rose in the wake of increased disclosure requirements (Murphy 1998).

"Say-on-pay" provides shareholders with a new mechanism to influence executive pay. Instead of legislating particular practices, shareholders are given the opportunity to evaluate a firm's publicly disclosed compensation practices and provide direct feedback to boards of directors through a non-binding shareholder vote. With the passage of the Dodd-Frank Act, nearly all U.S. public companies are required to provide shareholders with a non-binding advisory vote on executive compensation beginning with annual shareholder meetings occurring on or after January 21, 2011.[18] Shareholders are asked whether they approve of the executive compensation programs as disclosed in the Compensation Discussion and Analysis (CDA) of the annual proxy statement. Prior to the Dodd-Frank Act, U.S. firms that received federal assistance under the Troubled Asset Relief Program (TARP) were required to provide SOP proposals to shareholders. However, for other firms, providing shareholder SOP voting was voluntary.[19]

Cai and Walkling (2011) examined the market reaction to the passage of a say-on-pay bill in the House of Representatives and found that firms with excess compensation saw a positive market adjusted return, suggesting that shareholders believe this monitoring mechanism would be effective. However, Cai, and Walkling (2011) also find that firms that are targeted by labor unions with shareholder proposals on executive compensation experienced a negative reaction to

[18] In its final rule on SOP, the SEC provided a temporary exemption to the SOP requirement for companies with a public float less than $75 million. These firms will be required to implement SOP votes in annual meetings on or after January 21, 2013 (see: http://www.sec.gov/news/press/2011/2011-25.htm).

[19] SOP related activity has been increasing in recent years, beginning with shareholder pressure on firms to implement SOP votes through the shareholder proposal process, voluntary adoptions and requirements for TARP participants. In 2007 (2008) there were approximately 50 (90) shareholder proposals calling for SOP votes which garnered average support of 40.8% (41.7%) in favor. In 2008, Aflac, Inc. and RiskMetrics Group, Inc. (then the parent company of ISS) submitted SOP votes to shareholders. In 2009, TARP participants were required by the American Recovery and Reinvestment Act to provide a SOP vote, and other companies, notably Verizon Communications Inc. and Motorola, Inc. voluntarily introduced SOP votes after shareholder proposals received majority support (Hodgson 2009).

the proposal disclosures. This result may indicate a potential cost if certain shareholders and activists are able to use the mechanism to possibly pursue an agenda different from making decisions to increase shareholder value. In contrast, Larcker, Ormazabal, and Taylor (2011) find that stock market reactions to the SOP provision in Dodd-Frank Act are decreasing in CEO pay levels. This suggests that observed compensation choices are the result of value-maximizing contracts between shareholders and management, and broad government actions that regulate such governance and compensation choices are value destroying.

While the Dodd-Frank Act represents the first time that U.S. companies have been required to provide a SOP vote, a similar non-binding vote structure has been in place since 2002 in the United Kingdom.[20] Carter and Zamora (2009) and Alissa (2009) find that negative votes are associated with measures of excess compensation, and that boards respond to negative votes by reducing excess salary levels and by forcing out highly paid CEOs. Ferri and Maber (2013) find that firms adjust contractual features and increase the sensitivity of pay to performance in response to negative voting outcomes. However Conyon and Sadler (2010) did not find any change in the overall level of executive pay or its rate of growth subsequent to SOP votes.[21] Thus, whether SOP produces compensation contracts that are more desirable from the perspective of shareholders remains an important and unresolved question.

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[20] In 2003, Netherlands required companies to submit compensation policy changes to a binding vote. In 2005, Sweden and Australia both adopted requirements for non-binding shareholder votes on remuneration reports. It is noteworthy that each of these countries has significant requirements for pay disclosure. Norway, Spain, Portugal, Denmark and, most recently, France, have followed suit. In Canada, as of the end of April 2009, 12 of the country's largest companies have agreed to give their shareholders a non-binding vote on executive compensation. In 2013, voters in Switzerland passed a referendum requiring a *binding* SOP vote and German legislators have promised legislation giving investors more control of executive pay.

[21] U.S. shareholders have also historically had the ability to influence corporate governance outcomes, including executive compensation, outside of SOP votes. For example, Del Guercio, Seery, and Woidtke (2008) examine boards' response to shareholders withholding votes for director candidates and find evidence that they are associated with subsequent governance improvements. Ertimur, Ferri, and Muslu (2011) also examine director voting and non-binding shareholder proposals and find that targeted firms with high excess CEO pay see greater shareholder support for the proposals and subsequently reduce CEO pay.

2.4 Institutional Shareholder Services Say-on-Pay Voting Policies

In order to understand the ISS process for determining SOP voting recommendations, we reviewed the ISS 2011 U.S. Proxy Guidelines (ISS, 2011a) and a sample of other research reports purchased directly from ISS. ISS notes three primary considerations that can result in a negative SOP recommendation: misalignment between CEO pay and performance, problematic pay practices, and poor communication and responsiveness to shareholders. In addition, ISS evaluates five components of executive pay and assigns each either a high, medium or low level of concern. The five categories are (1) Pay for Performance Evaluation, (2) Non-Performance-Based Pay Elements, (3) Peer Group Benchmarking, (4) Severance/CIC Arrangements, and (5) Compensation Committee Communication and Effectiveness (ISS, 2011b).

The ISS "Pay for Performance Evaluation" conducts an initial screen based on recent total shareholder return (TSR). The screen first considers whether the one-year and three-year TSR are below the median of all the firms in the same four-digit Global Industry Classification Standard (GICS) code. If both the one and three year TSRs are below the corresponding medians of the GICS group, ISS examines whether the total compensation of a CEO who has served for at least two full fiscal years is aligned with total shareholder return over time (ISS, 2011a). The primary measure for evaluating alignment of CEO compensation highlighted in ISS reports is the one-year change in total compensation.[22] ISS also considers other elements of CEO pay alignment, including a graphical presentation of total CEO compensation and TSR over the previous five years and the percentage of equity compensation that is "performance-based"

[22] In defining "total compensation", ISS closely follows the presentation of the summary compensation table, and includes a combination of realized pay (e.g., salary, bonus payments, cash long-term incentives) and the expected value of awards that will be earned in the future (e.g., stock options, restricted stock).

(i.e., where the vesting of awards is contingent on meeting performance targets). [23] In the "Non-Performance-Based Pay Elements" analysis, ISS evaluates the reasonableness of elements they consider not performance based, including the value of perquisites, existence and cost of tax gross-ups on perquisites and non-qualified pension plans, and accumulated present value of pension obligations to the CEO. In their policy document (ISS, 2011a) ISS also notes that they consider repricing underwater stock options without shareholder approval a problematic pay practice that could result in a negative recommendation.

In their "Peer Group Benchmarking" analysis, ISS considers whether the firm's choice of peer companies and the target pay positioning against those peer companies are appropriate. The "Severance/CIC Arrangements" analysis identifies problematic features in severance and change-in-control (CIC) contracts for executives. In its policy document (ISS, 2011a) ISS identifies three features of new or extended CIC arrangements that they view as problematic: (1) payments exceeding three times the sum of salary and bonus; (2) payments made in the absence of involuntary job loss (i.e., single-trigger contracts); and (3) the provision of gross-up payments to offset golden-parachute excise taxes. The "Compensation Committee Communication and Effectiveness" analysis evaluates the disclosure of executive compensation in the proxy statement (which includes the role of the CEO in setting pay, disclosure of performance targets and compensation benchmarking practices) and the Board's responsiveness to investor input on compensation issues (which includes responses to majority-supported shareholder proposals and significant opposition to SOP votes) (ISS, 2011a).

2.5 Glass, Lewis & Co. Say-on-Pay Voting Policies

[23] It is interesting to point out that ISS and GL do *not* consider stock options or restricted stock with time-based vesting (which is the most common vesting criteria) to be performance-based pay elements.

Glass Lewis provides significantly less information on their policies in public documents.[24] Based on the available information, GL appears to use metrics that are similar to ISS in their SOP recommendation. However their approaches for determining an ultimate vote recommendation generate different results in many cases.[25] Specifically, GL organizes their analysis of executive compensation into three sections, "Pay-for-Performance", "Structure", and "Disclosure". Their proprietary “Pay-for-Performance” model results in a letter grade (A, B, C, D, or F) for each firm. The analyses of compensation “Structure” and “Disclosure” result in ratings of “Poor”, “Fair” or “Good” (GL, 2012)

To determine their “Pay-for-Performance” rating, GL compares a firm’s compensation to a peer group of firms developed using a proprietary computation. They then compare the percentile ranking of the firm against the peer group companies in two compensation metrics (CEO total compensation and total compensation of the top five executives) and seven performance metrics (stock price change, change in book value per share, change in operating cash flow, EPS growth, total shareholder return, return on equity and return on assets) over the prior one-, two- and three-year periods. Their model generates a weighted average compensation percentile and a weighted average performance percentile, and the difference between those values is referred to as the “pay-for-performance gap”. The firm is then given a grade based on a forced grading curve (e.g., with the 10% of firms with the highest gap receiving an “F” and the

[24] Unlike ISS, GL does not generally provide researchers with a means of accessing their proxy reports. We requested access to GL proxy reports for this study, but GL responded that they had provided their reports to other academics on an exclusive basis. GL’s proxy recommendation policy document (GL 2011a) also does not provide a detailed description of their process for determining recommendations. Therefore, we rely on GL reports obtained from web-based searches and the discussion of GL policies in Ertimur, Ferri, and Oesch (2013) which is based on the actual GL proxy reports.

[25] Ertimur, Ferri, and Oesch (2013) report that ISS and GL make the same recommendation 77.0% of the time. However, conditional on at least one of the firms making a negative recommendation, they agree only 17.9% of the time. This is consistent with our findings. We find that the unconditional agreement is 78.6% and conditional on at least one negative recommendation it is 22.5%. This is in part due to GL issuing almost twice as many negative recommendations as ISS, but even within the subset of firms receiving a negative recommendation from ISS, we (Ertimur, Ferri, and Oesch, 2013) find that the rate of agreement is only 48.1% (44.4%), indicating that although the model inputs are similar, the algorithms do have distinct features.

10% with the lowest gap receiving an "A" (GL, 2011b)). GL does not provide details of its analysis of the "Structure" category in its public policy documents. Ertimur, Ferri, and Oesch (2013) report that more than fifty different features of compensation programs are cited, and that the five most common items are (respectively) a lack of clawback provisions, limited performance-based nature of incentive plans, various types of tax gross-ups, controversial features in CIC plans, and lack of ownership requirements.

Similar to the "Structure" analysis, GL does not provide details of how it determines its "Disclosure" rating in its public policy documents. However, the two primary concerns driving Poor ratings for "Disclosure" appear to be lack of disclosure of performance metrics or goals and lack of disclosure of how equity awards are determined.[26]

3. Sample

Our initial sample consists of all firms included in the *Russell 3000* index during 2010. Since the composition of this index varies slightly across calendar quarters, our initial sample is composed of firms that appear in at least one quarter (n = 3,062). We focus on companies that held their shareholder meeting in 2011, have data available in Compustat, CRSP, Equilar (the source of our compensation data), and Voting Analytics. We also exclude firms that held their shareholder meeting before January 21, 2011 and smaller reporting entities (public float of less than $75 million) because those firms were not required to conduct a SOP vote in this period. We focus on companies that filed their proxy statement in the first half of 2011 because actions preceding later shareholder meetings might be confounded by the actions taken by competitors in

[26] Similar to the findings in the ISS evaluation, Ertimu, Ferri, and Oesch (2013) find that a poor score in the pay-for-performance model ("D" or "F") was associated with the most negative recommendations (89.2%). Other features that they document leading to negative recommendations include lack of performance-based equity plans, various types of tax gross-ups, controversial features in change of control plans, discretionary elements of pay, and lack of clawback provisions.

response to SOP and because during those months ISS announced changes in its voting policies for the 2012 proxy season. Finally, we require the firms to have an available ISS SOP recommendation and a CEO with tenure of at least two years in order to allow for a comparison of changes in CEO pay and firm performance. Our selection process produces a final sample of 2,008 firms.

Table 1 presents descriptive statistics of the sample firms and the 4,513 firms in the CRSP-Compustat universe with fiscal-year end dates from 6/30/2010 to 3/31/2011. The 2,008 sample firms capture approximately 71% of the market capitalization of this benchmark group. The mean (median) market capitalization of the sample firms is 5,982 (1,173) million dollars compared to the mean (median) market capitalization of the firms in the CRSP-Compustat universe of 3,750 (499) million dollars. We find that our sample firms also have a lower book-to-market ratio, lower return volatility, and higher percentage of shares owned by institutions than the benchmark group. In terms of industrial sectors as defined by Fama and French groups, we find that the industry affiliation of the sample firms is similar to that of the benchmark group (Table 1, Panel B).

4. Determinants of Proxy Advisory Firm Say-on-Pay Recommendations

4.1 Proxy advisory firm Say-on-Pay recommendations

We collect the ISS SOP voting recommendations from the ISS Voting Analytics database. We construct *ISS_against* as equal to one if the ISS recommendation was against SOP and zero otherwise. ISS recommended against 13% of the firms in our sample (Table 2, Panel A). Glass Lewis' recommendations are not publicly available. However, it is straightforward to infer GL recommendations from the voting behavior of four funds that publicly disclose that their SOP vote follows GL policies: Charles Schwab, Neuberger Berman, Loomis Sayles, and

Invesco (confirmed by each fund's proxy voting policies included in their 2011 Statement of Additional Information). We collect the SOP voting decisions of these four funds from SEC Form NPX disclosures and find that they vote in the same way in the vast majority of cases.[27] We construct *GL_against* as equal to one if those funds vote against the SOP proposal and zero otherwise. We find that GL recommended against 21% of our sample (Table 2, Panel A), which is considerably more aggressive than ISS, and consistent with the level of opposition reported by GL (Glass Lewis, 2012). [28] As might be expected, ISS and GL recommendations are highly correlated. ISS and GL recommendations coincide in approximately 79% of the cases, but they differ in 395 cases out of 1849 observations for which we have both ISS and GL recommendations (Table 2, Panel B). It is also interesting to note that no firm that received a positive ISS recommendation failed to pass the SOP proposal, whereas for GL one firm that received a positive GL recommendation did not obtain a majority support from shareholders.

4.2 Proxy advisory firm SOP policies

As discussed in Section 2, ISS and GL provide public information about their SOP voting policies. This information enables firms to make an "informed guess" about the likelihood of receiving a negative voting recommendation before their proxy statement is drafted, and possibly before the fiscal year end. However, an interesting question is whether proxy advisory firms actually make recommendations in a manner consistent with their public disclosures.[29]

[27] The voting decisions of Charles Schwab, Neuberger, Loomis, and Invesco only differed in six cases. In these few cases of disagreement, we code the Glass Lewis SOP voting recommendation using the majority vote across these four funds. As a robustness check, we also coded these differences as missing and obtained virtually identical results.

[28] We were not able to construct the GL_against variable for 159 companies as the result of missing data in the N-PX filings of the target funds.

[29] Larcker, McCall, and Ormazabal (2012) find that the ISS public description regarding the metrics used to develop voting recommendations on stock option exchanges is highly consistent with their actual recommendations. Although this might be expected for a relatively simple compensation program, it is not clear whether similar consistency should be expected for the more complicated SOP recommendation.

Based on a reading of ISS and GL material in the public domain, the primary explanatory variable used in the SOP recommendation models is whether a compensation plan exhibits an appropriate relationship of pay-for-performance (*P4P*). Consistent with these disclosures, we construct *P4P* as an indicator variable that equals one (and zero otherwise) if (i) the CEO's compensation increases from 2009 to 2010, (ii) total shareholders' returns in the last year (*TSR1Y*) is lower than the median *TSR1Y* for companies in the same GICS code, (iii) total shareholders' returns in the last three years (*TSR3Y*) is lower than the median *TSR3Y* among the companies in the same GICS code, and (iv) the CEO's total compensation is above the median compensation of the peer companies (the peer group is defined following ISS's criteria).[30] We compute CEO compensation in a manner similar to the ISS and GL guidelines. Specifically, CEO compensation is the sum of salary, bonus, all other compensation, change in the pension value and earnings from non-qualified deferred compensation, non-equity incentive plan payouts, and the grant date value of restricted stock and the Black-Scholes value of stock option grants. For our sample, 13% of the firms fail this pay-for-performance assessment (Table 2, Panel A).[31]

In addition to pay-for-performance (*P4P*), proxy advisors' voting policies include a variety of other criteria. While these additional inputs (e.g., tax gross ups) are very difficult to collect for a large sample, we develop five additional measures that are noted as part of the

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[30] While both firms (and GL in particular) describe more complicated evaluation algorithms, they do not provide sufficient detail in their public disclosures for us to precisely replicate their approach. While a simplification, our *P4P* variable captures the essential features of the CEO's relative pay and performance described in the proxy advisor policies. As we show in this Section, *P4P* is significantly associated with the voting recommendations of both firms. However, the explanatory power is lower than would be expected if we were able to closely replicate their models.

[31] As a robustness check, we also construct variants of the pay-for-performance assessment. First, we exclude the condition that *TSR3Y* is lower than the median *TSR3Y* among the companies in the same GICS code. Second, we add the condition that total shareholders' returns in the last five years (*TSR5Y*) is lower than the median *TSR5Y* among the companies in the same GICS code. The results are similar, but weaker, partly because the latter condition induces some sample attrition (200 observations). We use the metric in the text because it is closest to the approach used by ISS and GL.

overall evaluation process by proxy advisory firms. *PayDisparity* is the ratio between CEO compensation and the average compensation of the other named executive officers (NEOs). As presented in Table 2 (Panel A), the mean (median) ratio of CEO pay to average NEO pay is 2.76 (2.51). *PctLTincentives* is the present value of long-term incentives divided by the sum of the present value of both long term and short term incentives. We define long-term incentives as restricted stock, stock options, and incentive plan awards with a performance period greater than one year. Short-term incentives are incentive plan awards with a performance period of one year or less. The mean (median) percentage of total incentives that is long-term in nature is 62% (73%). *PctPBincentives* is the present value of performance-based equity incentives divided by the sum of the present value of both performance-based and non-performance-based equity incentives. Performance-based equity incentives are performance-contingent stock options, restricted stock and stock unit awards, in which the number of shares and/or the vesting event is contingent upon the firms' performance. Consistent with proxy advisory assumptions, non-performance based equity incentives include restricted stock and stock options that are not contingent on company performance. The mean (median) ratio of performance-based to non-performance-based equity incentives is 32% (0%). *nPM* is the number of performance measures used in performance-based long-term incentives awarded to the CEO. The mean (median) number of measures is 2.39 (2.00). Based on the public disclosures and commentaries by proxy advisory firms, we expect *P4P*, *PayDisparity* to have a positive association with the probability of receiving a negative SOP recommendation, and *PctLTincentives*, *PctPBincentives* and *nPM* to have a negative association with the probability of receiving a negative SOP recommendation.

Proxy advisors can also include other factors into their recommendations that are not publicly disclosed or difficult to quantify (e.g., "analyst expertise"). In an attempt to partially address this measurement or model specification problem, we include two additional variables in our analysis. We measure ISS degree of concern about the firm's compensation practices using their compensation GRId score.[32] Specifically, *GRId_comp* equals one, two, or three if the compensation GRId score computed by ISS is labeled as "high risk", "medium risk", and "low risk", respectively. ISS considers 21% of our sample companies to be "high risk." We also measure an assessment of general governance practices using *WithholdRec* which is computed as the number of "withhold" or negative recommendations issued by ISS on directors of the company in the *previous* proxy vote. The mean (median) number of withhold recommendations is 0.13 (0.00).

4.3. Results

To test whether the SOP policies disclosed by proxy advisors are associated with their recommendations we estimate the following probit regressions:[33]

$$Against = \delta_0 + \delta_1\, P4P + \varepsilon, \tag{1a}$$

$$Against = \delta_0 + \delta_1\, P4P + \theta\, OtherCriteria + \varepsilon, \tag{1b}$$

where *Against* is either *ISS_against* or *GL_against* and *OtherCriteria* include *PayDisparity*, *PctLTincentives*, *PctPBincentives*, *nPM*, *GRID_comp*, and *WithholdRec.*

The estimation results for equations (1a) and (1b) are presented in Table 3 (Panel A and B show results of ISS and GL recommendations, respectively). The statistically positive coefficients of *P4P* in both panels indicate that proxy advisory firms rely on their stated pay-for-

[32] GRId (which stands for "Governance Risk Indicator") was the ISS rating system to assess governance risk in 2011. The GRId score provided one of three ratings ("Low Risk", "Medium Risk", and "High Risk") in four governance categories (Audit, Board, Compensation and Shareholder Rights). ISS stated that they measured "long-term governance risk," but did not provide further detail on exactly what governance risk is or what outcomes would be associated with that risk. We collect GRId scores from publicly available sources (e.g., http://finance.yahoo.com/) in June of 2011.

[33] Firm level subscripts have been suppressed throughout the text. Unless noted otherwise, all regressions are cross-sectional analyses. We also estimate equations (1a) and (1b) using logistic regressions and OLS and obtain very similar results.

performance criterion to issue SOP voting recommendations. However, the explanatory power for this *P4P* model is relatively modest (approximately 14% and 3% for ISS and GL, respectively). The marginal effects of *P4P* on *ISS_against* and *GL_against* are, respectively, 24% and 20%, which means that, on average, meeting the *P4P* criteria is associated with roughly a 20% increase in the probability of obtaining a favorable recommendation.

When other potential criteria for the voting recommendation are included in the specification, the explanatory power improves to approximately 21% and 9% for ISS and GL, respectively. As expected, we also find that *PayDisparity* and *WithholdRec* have positive coefficients for both the ISS and GL models. *GRID_comp* exhibits a negative coefficient, suggesting that the higher ISS rates the firm's compensation practices, the more favorable the SOP voting recommendation. As expected, the coefficient on *PctPBincentives* is negative, although not statistically significant. Thus, consistent with their public disclosures, pay-for performance and selected other criteria are statistically important determinants of the proxy advisory SOP recommendations. The results in Table 3 are important because they provide insight about what changes firms can make to reduce the probability of obtaining a negative recommendation.

5. Vote Outsourcing to Proxy Advisors

5.1 Shareholder voting outcomes

We compute the voting support of the SOP proposals (*PctSupport)* as the percentage of votes *in favor* of the SOP proposal based on each firm's reported voting outcomes. For example, some firms report percentage of votes in favor with respect to the sum of votes in favor and against, while other firms also include abstentions (exchange rules prevent broker non-votes from being counted as votes in favor of SOP, and they are typically excluded from the SOP voting results altogether).[34] We also identify firms that failed to obtain a majority support for their SOP proposals using an indicator variable (*Fail*), that takes the value of one if *PctSupport* < 50% and zero otherwise. Most companies obtained a very high percentage of favorable votes for their initial SOP vote. Specifically, the mean (median) SOP proposal was backed by 90.6% (95.3%) of the votes. Only a small percentage (1.6%) failed to obtain majority support from shareholders (Table 2, panel A).

5.2 Proxy advisory firm influence

Boards of directors are likely to respond to proxy advisory firms only when they can actually influence substantial numbers of shareholder votes. If the firm has very limited institutional ownership, ISS and GL recommendations might be largely irrelevant to the board of directors.[35] Similarly, if institutional investors do not follow proxy advisory firm recommendations, these firms will have limited influence on the company. In order to incorporate these features into our analysis, it is necessary to develop a measure for the likely influence of proxy advisors on the voting by institutional shareholders for each firm confronting a SOP vote.

Using voting data from the ISS Voting Analytics database, we compute for each firm the expected percentage of institutional votes that will follow ISS voting recommendations (*ISS_influence*). We first calculate the proportion of times that each institution holding shares in a given firm votes with ISS when there is *disagreement* with management on any proposal from

[34] To compute the percentage support to shareholder proposals, 50.79% of our sample companies divide the number of votes in favor of the proposal by the sum of the votes in favor and against the proposal, 48.71% include the abstentions in the denominator, and 0.51% uses the total number of shares outstanding in the denominator. To ensure that our results are not sensitive to this cross-sectional variation in reporting voting results, we re-estimate equation (2) applying each one of these three ways of measuring voting support to all sample firms. Our inferences do not change.

[35] This statement may not be true if individuals comprise a large percentage of shareholders and they are influenced by proxy advisory firms. However, individuals do not generally have easy access to the ISS and GL SOP recommendations because they are not typically publicly disclosed and subscriptions to the reports may be expensive to individual who do not realize the compliance benefits of the proxy advisors.

2003 to 2010 in the ISS Voting Analytics database. We then collect the percentage ownership of the firm for each institution from the Thomson-Reuters Mutual Fund Holdings database of N30-D filings.[36] Finally, we multiply each institution's percentage ownership in the firm at the end of fiscal year 2010 by that institution's implied probability of voting with ISS if there is disagreement between the management and ISS. *ISS_influence* for a specific firm is the sum of the resulting measures across all institutions holding shares in that firm.

The mean (median) value of our measure of ISS influence is 8.84% (8.40%). This influence level is lower than the observed influence on the average vote outcome because not all users of proxy advisor services are captured in the cross section of the Voting Analytics and Thompson-Reuters databases. For example, pension funds or university endowments may subscribe to proxy advisors' services, but because they are not mutual funds, they are not required to report their voting record on Form NPX. Nonetheless, these values confirm that a sizable percentage of institutional votes follow ISS recommendations in cases of disagreement with management recommendations. In principle, it is possible to construct a similar influence measure for GL. However, since historical GL recommendations on all proposals are not available, we are not able to compute a similar GL influence measure.

We also use the percentage of firm shares owned by institutions (*PctInstit*) as alternative proxy for the influence of proxy advisors in the firm. We compute this variable collecting data from the Thomson-Reuters database of 13-F filings. Although this variable does not capture the propensity of institutional shareholders to follow proxy advisors' recommendations (because voting data is not publicly available for all institutions), it includes holdings by institutions other than mutual funds that could also be subject to proxy advisory influence.

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[36] This database is also referred to as CDA/Spectrum S12 mutual fund holding database. The Spectrum data file contains information on quarterly equity holdings for mutual funds registered with the SEC.

5.3 Results

To assess the impact of ISS and GL on SOP votes, we estimate (using double-censored regression and the variables previously defined) various forms of the following general model:

$$PctSupport = \delta_0 + \delta_1\, ISS\_against + \delta_2\, ISS\_influence + \delta_3\, ISS\_influence \times ISS\_against + \varepsilon. \quad (2)$$

The estimated intercepts in Table 4 (Panel A) show that firms with a positive recommendation from ISS and low ISS influence on institutional shareholders receive well in excess of 90% favorable votes. In column (1), the coefficient on *ISS_against* is −0.25 (t-stat. = −25.68) which suggests that a negative ISS recommendation decreases the percentage of favorable votes by about 25%. This estimate, along with the high explanatory power of this model (Pseudo R^2 = 49.21%) is consistent with the interpretation that ISS recommendations exert a substantial influence on SOP shareholder voting. However, the results in column (3) reveal that the effect of a negative recommendation significantly depends on the proxy advisor's influence on the company. Specifically, the interaction between *ISS_influence* and *ISS_against* is −0.01 (t-stat. = −6.67). This estimate suggests that, conditional on receiving a negative ISS SOP recommendation, two firms in the 25th and 75th percentile of *ISS_influence* (5.18 and 11.84, respectively) will exhibit a difference of 6.66% in voting support for their SOP proposals. Table 4 also shows that the results are similar when *PctInstit* is used as alternative proxy for proxy advisory influence, which suggests that it is unlikely that our inferences are confounded by measurement error in our measure of proxy advisory influence.

For reasons discussed above, we cannot estimate equation (2) using a direct measure of GL influence. However, we find that a negative GL recommendation is statistically associated with an 18% decrease in favorable SOP votes (Table 4, Panel B). When both ISS and GL recommendations are included in the model, both coefficients are negative and statistically significant. The estimated coefficients suggest that when both ISS and GL have negative SOP recommendations, the favorable votes for SOP decrease by approximately 34%. Finally, when we use *PctInstit* as an indirect measure of GL influence, we find in column (3) that voting outcomes are increasingly negative when institutional ownership is higher. Overall, the results in Table 4 provide evidence that proxy advisory firm recommendations can substantially shift SOP votes.[37]

6. Board of Director Responses to Proxy Advisors Policies

6.1 Compensation changes before ISS recommendations

Using the discussion in Sections 2 and 4, we first identify compensation plan changes that are unambiguously viewed as positive practices in the context of the proxy advisory firm SOP voting policies. We exploit the fact that any new or substantially changed executive compensation plan must be publicly disclosed on SEC Form 8-K. This regulatory requirement provides an explicit announcement date for estimating excess returns associated with compensation plan changes.[38] An important advantage of this date is that 8-K filings only include the items or transactions being reported and the associated announcement date is less confounded with other information than periodic reports such as 10-Ks and proxy statements. However, since executive compensation changes are likely to be an outcome of board meetings, it is possible that the 8-Ks are confounded by other decisions being reported from the same meeting. For this reason, we limit our sample to 8-Ks that do not contain other non-

[37] In untabulated results, we also find that ISS influence increases the probability of failing to obtain majority support given a negative recommendation. Specifically, in a probit regression of *Fail* on *ISS_influence* for the firms that receive a negative ISS recommendation, we find that the coefficient on *ISS_influence* is 0.07 (t-stat. = 3.72). The marginal effect and the effect at the mean for *ISS_influence* are, respectively, 1.37% and 1.52%. Using the same subsample of firms, we also regress *Fail* on *GL_against*. The coefficient on *GL_against* is 1.74 (t-stat. = 4.51). The marginal effect and the effect at the mean for *GL_against* are, respectively, 28.6% and 24.41%. These results confirm that GL recommendations also determine the probability of failing the SOP proposal.

[38] Pursuant to the Form 8-K General Instructions (http://www.sec.gov/about/forms/form8-k.pdf), if an 8-K is required, it must be filed or furnished within four business days after the occurrence of the event.

compensation related information (discussed below). If these changes are induced by proxy advisors, the observed excess return can be interpreted as the impact of proxy advisory firm SOP policies and voting recommendations on shareholder value.

We collect compensation changes reported on form 8-K during the eight months prior to the 2011 proxy statement release date for our sample. This window was chosen for two reasons. First, changes in months closely following the prior year's annual meeting could be a response to the previous year´s annual meeting and thus unrelated to future SOP considerations. Second, as most of our sample is comprised of firms with calendar fiscal year ends, the eight month window starts approximately at the same time as Dodd-Frank was signed into law (July, 2010).

Since we are interested in the market's reaction to compensation disclosures, we also exclude 8-Ks that include other important events such as executive hires or terminations and/or announcements related to other governance mechanisms (e.g. auditor changes or removal of a poison pill), which might confound our results.[39] To execute this data collection, we utilize a comprehensive database of 8-K filings from Equilar, Inc., which includes a categorization of the contents of each 8-K, allowing us to identify the subset of 8-K filings that meet our criteria. This selection procedure produces a sample of 733 8-Ks for our 2,008 firms, with 606 firms having at least one 8-K (the maximum number of 8-Ks for a single firm is three).

Each 8-K filing was read and compensation features that are unambiguously aligned with proxy advisor policies were identified. Specifically, we determine whether each 8-K discloses any of the following (see Appendix A for examples and the rationale for these choices): additional restrictions to equity plan(s) (10 observations), amendments to outstanding equity

[39] Because firms often aggregate compensation decisions (for instance, base salary, bonus and performance-based equity awards may be determined at the same time) it is not possible for us to confine the sample to only changes that are favored by proxy advisors. We utilize a sample of out-of-period filings to mitigate the concern that such decisions are confounding our results.

awards to add performance-based vesting or other holding requirements (1), new cash long-term incentive award(s) (21), reduction in CEO cash compensation (5), implementation of a clawback policy (6), amendments to change of control plan(s) (117), new performance-based equity award(s) (157), and reductions in executive perquisites and benefits (12). We construct the variable *PA_Aligned* ("PA" is shorthand for proxy advisor) as the number of these compensation changes announced in each 8-K. We set *PA_Aligned* equal to zero if either there are no 8-Ks in our sample or the compensation changes are not those we have identified as being unambiguously aligned with proxy advisor SOP policies. For our sample of 8-Ks, *PA_Aligned* equals three in 2 cases (0.27%), two in 28 (3.82%) cases, one in 267 (36.43%) cases and zero in 436 (54.48%) cases. It is important to note that the absence of a proxy advisor aligned feature does not necessarily imply that the compensation announcement in the 8-K would be viewed negatively in the proxy advisor models. Many common items, such as awarding of salary increases, determination of bonus payouts and determination of bonus performance objectives could be either good or bad in the context of the compensation and performance outcomes. Other items, such as minor amendments to plans or contracts to reflect tax or other legal changes may not enter into the evaluation.

Although the compensation changes used to construct *PA_Aligned* are considered desirable by proxy advisory firms, this does not necessarily imply that these changes are actually induced by ISS and GL. However, if these compensation changes are correlated with the likelihood that a firm will receive a negative SOP recommendation, this will provide some evidence that the changes are actually influenced by proxy advisors. The crucial assumptions for this interpretation are that the board of directors has a reasonable idea about the likely forthcoming SOP recommendation and that they believe that these changes during the time period prior to the proxy statement release in order to improve the ultimate SOP recommendation produce a net economic benefit for shareholders. That is, the cost of changing the compensation plan is less than the cost of receiving substantial negative SOP votes. This assumed behavior is consistent with the results of the recent survey conducted by The Conference Board, the Stanford Rock Center, and NASDAQ (2012) which finds that most firms reviewed proxy advisor policies and that those policies influenced their ultimate compensation programs presented to shareholders for the SOP vote.

To explore this possibility we compare key characteristics for firms that make proxy advisor aligned compensation changes previous to the 2011 annual meeting to the remainder of the sample firms. Specifically, we focus on *P4P* because it is a primary determinant of the SOP recommendation (see Table 3) and *ISS_influence* because it (along with the SOP recommendation) has a substantial impact on shareholder voting (see Table 4). We also include *PctInstit* as alternative proxy for proxy advisory influence.

Table 5 (panel A) compares descriptive statistics of these variables for the 275 firms that filed 8-Ks disclosing proxy advisor aligned compensation changes in the 8 months before the proxy filing to the remaining 1,733 sample firms. We observe that there is a significantly higher proportion of firms that did not meet the *P4P* criterion among the firms that disclosed proxy advisor aligned compensation changes compared to the rest of sample firms. Table 5 also shows that, compared to the remainder of the sample, firms that disclosed proxy advisor aligned compensation changes exhibit higher levels of proxy advisory influence (measured by *ISSinfluence* and *PctInstit*). These results suggest that compensation changes desired by proxy advisors are more frequent in firms that are otherwise more likely to receive a negative SOP recommendation and where proxy advisors have substantial influence on shareholders.

Table 5 (panel A) also compares descriptive statistics of the previous variables between firms filing proxy advisor aligned 8-Ks and firms that filed compensation 8-Ks that did not contain any of the proxy advisor aligned characteristics. This analysis provides insight into the specific subsample of firms that we know have made changes that align their compensation with proxy advisor policies. Table 5 shows that the differences between these two groups are very similar to those described previously. These results reinforce the idea that not meeting proxy advisor´s criteria leads to specific changes that are aligned with proxy advisor criteria, as opposed to a general set of compensation changes.

One important concern about the results in Table 5 (panel A) is that the identified pattern for compensation changes might be a usual phenomenon that occurs before every shareholder meeting, and thus not necessarily related to the SOP vote. To assess this concern, we take a random sample of 773 8-Ks from previous fiscal years (from 2006 to 2010) and examine whether this pattern of compensation-related 8-Ks is also found in previous years.[40] We then read and manually code each 8-K with the same criteria used for the 2011 sample of 8-Ks: additional restrictions to equity plan (7 observations), amend outstanding awards (0), new cash long-term incentive plans (29), reduction in cash compensation (22), clawback (6), changes/amendments to change of control plans (23), new performance-based equity plans (124), and reduce benefits (22). The most substantive difference between the two samples is the larger number of adjustments to change of control plans in the more recent time period. The most frequent change is the adoption of new performance-based equity plans in both time periods. For this random sample, *PA_Aligned* is greater than zero in 201 (27%) cases and zero in 532 (73%) cases. Thus, in the random sample from the 2006-2010 proxy seasons, there are substantially

[40] We code the randomization algorithm in a way that the random sample has the same number of 8-Ks every year and the same number of firms as the 2011 sample of 8-Ks.

fewer proxy advisor aligned 8-Ks than in the sample of 8-Ks from the 2011 proxy season (27.28% between 2006 and 2010 versus 40.51% in 2011).

In contrast to the results for the 2011 proxy season, *P4P* and *ISS_influence* are not significantly different between 8-Ks announcing proxy advisor friendly compensation changes and 8-Ks announcing other types of compensation changes. The results in Table 5 (Panel B) provide support for the interpretation that the time period prior to the first SOP vote exhibits unique compensation plan changes that are related to concerns about receiving a negative SOP recommendation from proxy advisors.

6.2 Compensation changes and subsequent ISS recommendations

Another crucial assumption for our claim that companies are making compensation plan changes in response to proxy advisors is that these changes should improve the chances of obtaining a more favorable recommendation. To provide some evidence on this issue, we examine whether making compensation changes that conform to proxy advisors' criteria decreases the probability of obtaining a subsequent negative SOP recommendation. We do this by estimating the following probit regression:

$$ISS\_Against = \delta_0 + \delta_1 Sum\_PA\_Aligned + \delta_2 P4P + \varepsilon, \qquad (3)$$

where *Sum_PA_Aligned* is the sum of *PA_Aligned* (i.e., the total number compensation changes disclosed on 8-K during the eight months previous to the 2011 proxy statement that are aligned with proxy advisors' policies).[41] We include *P4P* as a control for the likely proxy advisory firm recommendation if there were no compensation changes by the firm (i.e., if a firm fails *P4P*, they are likely to obtain a negative SOP recommendation). We find that the coefficient on

[41] For the sample of firms, *Sum_PA_Aligned* equals three in five cases (0.25%), two in 44 (2.19%) cases, one in 226 (36.43%) cases and zero in 1733 (86.30%) cases. Note that *Sum_PA_Aligned* is measured at firm level, whereas *PA_Aligned* is measured at 8-K level. Thus, the distribution of *Sum_PA_Aligned* differs slightly from the distribution of *PA_Aligned* compensation because for some firms changes are announced in more than one 8-K.

Sum_PA_Aligned is statistically negative which suggesting that making compensation changes to align compensation programs with proxy advisors' policies reduces the probability of obtaining a negative SOP recommendation (Table 6).

The second set of columns in Table 6 presents results restricting the analysis to firms that actually made some type of compensation change. Specifically, we include the compensation-related 733 8-Ks and test whether the number of changes aligned with proxy advisory policies in each 8-K is associated with a subsequent favorable recommendation from proxy advisors. The results in Table 6 confirm that compensation changes conforming to ISS criteria lead to more favorable SOP recommendations.

6.3 Market reaction to compensation plan changes

To estimate the shareholder value implications of changes in compensation contracts made to comply with proxy advisor SOP voting policies, we examine the stock market reaction at the relevant 8-K filing date. If the threat of receiving a negative SOP recommendation from proxy advisors motivates the board of directors to remove features of compensation contracts that allow executives to extract rents, the market reaction to the announcement should be positive. Alternatively, if the influence of proxy advisor SOP policies motivates firms to deviate from existing optimal compensation contracts, we should observe a negative market reaction.

We examine the market reaction to compensation changes prior the proxy statement release on the day when the company files the 8-K announcing the change.[42] Our dependent variable, *AdjRet*, is the daily risk-adjusted return on the filing day for each firm computed using

[42] We analyze 8-Ks that contain only information on compensation changes in order to minimize the chances that the market reaction on that day is confounded by other information. We also examine the twenty 8-Ks with the largest negative reaction and search in Factiva for other potentially confounding information about the firm. We do not identify any informational events that are likely to confound our interpretation of the adjusted returns.

the standard daily Fama-French model plus momentum to compute daily risk-adjusted returns.[43] The coefficients of the risk factors are estimated using daily data over a period of -6 to +6 months around the filing date, and the incremental intercept on the 8-K announcement date is used as an estimate of *AdjRet*.

To test whether the stock market reaction to the introduction of compensation changes is associated with the desired criteria of proxy advisory firms, we regress risk-adjusted returns on *PA_Aligned:*

$$AdjRet = \delta_0 + \delta_1 \, PA\_Aligned + \varepsilon \tag{4}$$

In Table 7 (panel A, column 1), we find that the estimated coefficient for *PA_Aligned* is −0.444 (t-stat. = −2.91), whereas the intercept is not statistically different from zero (t-stat. = 0.86). This result is consistent with the conclusion that compensation changes desired by proxy advisory firms produce a net cost to shareholders, while compensation changes not related to proxy advisors' criteria are value-neutral.[44] The coefficient on *PA_Aligned* also suggests that the cost to shareholders of these changes is economically significant (the estimated average decrease in shareholder wealth is 44 basis points per induced change).[45] When we repeat this analysis using the random sample of 8-Ks from prior proxy seasons, we find (Table 7, panel A, column 2) that the adjusted returns for compensation changes aligned with proxy advisor policies are not statistically different from zero. (t-stat. = 0.21). Thus, the negative stock market reaction to proxy advisor aligned compensation changes is only observed in the time period just prior to the initial SOP vote. As shown in Table 7 (panel A, column 3), the estimated difference in adjusted returns is −0.488 (t-stat. = −1.91). These results suggest that the observed negative adjusted

[43] We obtain similar inferences calculating average risk-adjusted returns within a (0,+1) window around the filing.
[44] We also estimate the average adjusted return partitioning by *PA_Aligned.* The average adjusted return of 8-Ks where *PA_Aligned* is non-zero (zero) is negative and significant (.positive and not significantly different from zero).
[45] In untabulated results, we find similar results when value-weight the excess returns.

returns are not some type of general "8-K effect", but rather are associated with compensation changes made to obtain a favorable SOP recommendation from proxy advisory firms.[46]

A potential concern about these results is that, even in the absence of compensation changes, *PA_Aligned* could be related to daily returns if this variable captures an omitted risk factor or other determinants for cross-sectional returns. To address this concern, we examine whether the negative adjusted returns of firms that make compensation changes related to proxy advisors' criteria are unique to the 8-K filing date. Specifically, we compute the average daily adjusted return for the 30 days before and the 30 days after the 8-K filing date and partition the 8-K sample into those 8-Ks where *PA_Aligned* equals zero and those where *PA_Aligned* is non-zero.[47] We find that the average adjusted returns of firms that make proxy advisor aligned compensation changes are not systematically lower than those of firms that make compensation changes unrelated to those criteria before (Table 7, panel B, column 1) or after (Table 7, panel B, column 3) the 8-K filing date. Columns 4 and 5 of Table 7, panel B show that the negative return associated with proxy advisor aligned 8-Ks are unique to the 8-K filing date.[48]

6.4 Moving shareholder meeting dates in anticipation of SOP

[46] Another way to assess the impact of proxy advisor SOP recommendations is to examine the market reaction to contractual changes disclosed *after* receiving a negative SOP recommendation. We have identified a small sample of 12 cases where firms either made changes to their compensation programs or commitments to change future programs after filing their proxy statement in order to garner a positive ISS recommendation and avoid failing the SOP vote. The 12 companies are: Assured Guaranty Ltd., The Walt Disney Company, General Electric, Gannett Co., Lockheed Martin, Alcoa, Collective Brands, The Providence Service Corp, Intermec, Inc., Brandywine Realty Trust, MeadWestVaco, and Interline Brands, Inc. In untabulated results, we find that the average adjusted return within the (−1,+1) window around the day the changes were announced for these observations is −0.30% (t-statistic = −1.01). Although this sample size is small (and the power of the test is limited), this evidence is consistent with our prior results that compensation changes induced by proxy advisory firms have an adverse impact on shareholder value.

[47] We also repeat the test using shorter- and longer-windows around the 8-K dates and find consistent results.

[48] We also assess which individual compensation changes induce the most negative adjusted returns. The most common compensation changes are new performance-based equity awards (157 observations) and changes/amendments to change of control plans (117 observations). These two types of changes are associated with negative returns −0.551 and −0.103, respectively. New cash long-term incentive plans exhibit the largest adjusted return (−2.15), but there are only twenty one observations for this category. All types of compensation changes except for reductions in benefits are associated with negative risk-adjusted returns on the day of the announcement.

As discussed in Section 2, a formal SOP vote is required for most companies with shareholder meetings occurring on or after January 21, 2011. If revisions to compensation plans induced by SOP is costly to firms (or, alternatively, personally costly to executives), we should see companies with shareholder meetings in the first calendar quarter that appear likely to receive a negative SOP recommendation moving their annual meeting to before January 21st. We find that the number of firms having their meeting in the few days before January 21st increased dramatically from 2010 to 2011 (see Figure 1). In 2011, 37 companies decided to have their shareholder meeting on one of the four days before January 21st. In contrast, only 7 firms had their shareholder meeting on those days in 2010. Figure 1 also shows that the number of firms having their shareholder meeting on or shortly after January 21st is significantly lower in 2011 than in 2010. This concentration of shareholder meetings immediately before January 21st 2011 suggests that some firms advanced their meetings to avoid being subject to a SOP vote in 2011.

There are 194 firms in the Russell 3000 that had their meeting in the first calendar quarter of 2010. Interestingly, 32 of these firms had the 2010 shareholder meeting *after* January 21st 2010, but their 2011 shareholder meeting *before* January 21st 2011. In contrast, only 4 firms had their 2010 shareholder meeting *before* January 21st 2010, but their 2011 shareholder meeting *after* January 21st 2011. Moreover, we find evidence that the firms most likely to move their annual meeting date are those that are more likely to fail the *P4P* criterion. While 28.12% of the 32 firms that moved their meeting forward did not meet the *P4P* criterion, only 10.30% of the remaining 162 did not meet this criterion. This difference is statistically significant (t-stat. = 2.73), and is further evidence consistent with the idea firms view SOP legislation as costly.[49]

[49] One of the potential costs of failing to obtain the required support for SOP proposals is that the firms and board members can be sued on grounds of alleged breach of fiduciary duty. After the 2011 proxy season, seven companies

6.5 Alternative interpretations of the results

Performance Signaling

One alternative interpretation of our results is that the market reacts negatively to the announcement of these compensation changes not because the recontracting is suboptimal, but because the change signals poor future performance or is indicative of other governance problems that the market was unaware of. For example, boards might introduce contractual changes because they possess inside information that firm performance will be worse than expected and as a result they impose compensation risk (e.g., performance-based equity) on managers in an attempt to change incentives and future performance. In this setting, the market would interpret the observed recontracting as a negative signal, and this has the potential to confound our conclusion that compensation changes induced by proxy advisors are value decreasing for shareholders.

Although signaling is a plausible alternative interpretation, the available empirical evidence does not support this conclusion. Specifically, prior literature has shown that firms adopting performance-based equity programs have historically realized positive future performance. For example Larcker (1983) finds a positive market reaction to the introduction of performance-based plans and Bettis, Bizjak, Coles, and Kalpathy (2010) find that companies that introduce performance-based features in compensation contracts have lower past stock price performance and significantly better subsequent operating performance than control firms. This

which experienced a SOP voting failure were sued shortly after the shareholder meeting. To the extent that the voting outcome and the subsequent lawsuits were (at least partially) unexpected by the market and the lawsuits are viewed as costly (e.g., either through direct costs related to the suit or the costs associated with management distraction), the market reaction to these events can also provide some insight into the cost implications of the SOP voting recommendations. In untabulated results, we find that the stock market reaction for firms involved in a SOP lawsuit is −0.50% (t-stat. = −1.58). Although this result should be interpreted cautiously because of the small number of observations (and reduced statistical power), it suggest that a negative SOP recommendation and a subsequent voting failure can impose substantial costs on affected.

evidence suggests that the adoption of performance-based equity plans (if anything) should be a signal of future good performance, as opposed to bad performance.

To provide further evidence on this point, we estimate a regression of future firm performance (calculated as the average of quarterly earnings deflated by total assets over the four quarters ending after the filing date of the 8-K) on the explanatory variables in equation (4). In untabulated results, we find that the coefficient on *PA_Aligned* is *positive* and not statistically significant (t-stat. = 0.59). This result is not consistent with the negative signaling explanation.

Another related way to provide insight into the signaling story is to examine the timing of the 8-K filings. As discussed in Section 2, shareholder return, measured at the end of the firms' fiscal year, is the primary measure of firm performance used by proxy advisory firms. Our analysis, on the other hand, considers 8-Ks filed in the 8 months prior to the proxy statement filing date, which is typically three to four months after the fiscal year end. As a result, 84.5% of our proxy advisor aligned 8-K observations occur *after* the fiscal year end when the relevant market returns are already known. If our findings were driven by a negative signaling effect, the negative reaction should be concentrated in the observations *prior* to the fiscal year end. However, out of the 297 filings with a potential SOP recommendation problem (i.e., where the variable *PA_aligned* = 1), only 46 are filed *before* the fiscal year end date, and the average risk-adjusted return for these 8-Ks is a statistically insignificant −0.27% (t-stat. = −1.17). In contrast, the average risk-adjusted return of the 251 changes announced *after* the fiscal year end is a statistically significant −0.35% (t-stat = −1.90).[50] These results suggest that the negative reaction is concentrated in 8-Ks filed *after* the fiscal year end, and thus the contractual change does not appear to be signaling negative performance for this fiscal year.

[50] In contrast, for the subset of 8-Ks with *PA_aligned* = 0 only 73 are filed *after* the fiscal year end date. The average risk-adjusted returns of 8-Ks filed both before and after the fiscal year end are positive, but not statistically significant.

Market Expectations of Compensation Changes

Our interpretation of the negative risk-adjusted return associated with compensation changes induced by proxy advisors is that unexpected and unfavorable information is released to the market at the 8-K announcement date. However, a concern with this explanation is that investor expectations about proxy advisor and board behavior are unknown. Conceptually, the observed risk-adjusted return should be the difference between the value of the observed change and the value of the compensation change (if any) expected by the market. This means that the market must have an expectation about the value of a future compensation change and the probability that this change will occur. Moreover, both of these variables are likely to be influenced by the probability that the proxy advisory firm will make a negative recommendation, expected costs of having a substantial number of against votes, and expected cost of changing the compensation program. There are several reasons to believe that this is an especially difficult inference problem for the market.

One complicating factor is that the market must develop an accurate expectation about proxy advisor recommendations *prior* to the 8-K filing event, which is (by construction) prior to the proxy statement. As we show in Table 3, it is very difficult to infer the proxy advisor recommendations even after considering a substantial portion of information that is available in the proxy statement. At the time of the 8-K, there is considerably less information available for investors to make an inference (for instance, proxy advisors evaluate the quality of proxy statement disclosures, which is not known until the proxy statement is actually filed). This raises serious questions about the market's ability to reasonably forecast proxy advisory firm SOP recommendations.

Even if the market can develop an accurate forecast for the recommendation, it is still necessary to estimate the expected costs of negative votes and the valuation of changes in the compensation plan which would lead to positive vote. It may be reasonable to assume that litigation costs or management distraction can be assessed by the market. However, private costs such as reputational concerns associated with a negative voting outcome and the expected costs (or benefits) resulting from a compensation change are likely to be very difficult for the market to assess. Thus, although not completely satisfactory from a pure theoretical perspective, we believe that as a practical matter the market's expectation for changes at the 8-K announcement date are likely to be quite diffuse.

Holding aside this conjecture about market expectations, it is possible that the market correctly anticipates that the firm will be exposed to the influence of the proxy advisors. Moreover, proxy advisor policies may be value increasing to shareholders, but the market is disappointed by the changes observed at the 8-K announcement (i.e., the changes do not "go far enough" to address compensation problems at a firm). In this scenario, we should observe a negative market reaction even though this outcome has nothing to do with suboptimal compensation changes being induced by proxy advisory firms.

The difficulty with this alternative interpretation is that it is based on a market that has biased expectations for SOP responses by firms. As discussed above, we expect the market to be faced with considerable difficulty in estimating the influence of proxy advisors, but there is no obvious reason for the market to make systematically biased estimates of expected compensation changes by firms. Moreover, under this interpretation the most negative market response should be observed for firms that exhibit pay-for-performance concerns (*P4P* = 1) and have 8-K announcements with compensation changes that are *not aligned* with proxy advisor policies. In untabulated results, we find a statistically insignificant positive mean risk-adjusted return for this subset of firms (t-stat. = 0.07). Thus, we do not believe that the interpretation of our results is completely confounded by economic issues related to market expectations.

Rent-Extracting Compensation Changes

It is also possible that the compensation changes are being made by rent extracting managers seeking to avoid market discipline that may be imposed on them after the SOP vote. For example, as illustrated in Table 6, the proxy advisor aligned changes reduce the likelihood of a negative recommendation and receiving a positive recommendation ensured a passing SOP vote. If boards and managers making compensation changes are actually engaging in rent extraction and the market correctly anticipates that they have reduced the likelihood of facing market discipline by conforming to proxy advisor policies, the market would be expected to reduce the value of the firm. Although the mechanism by which the shareholders are harmed is different than our interpretation, we reach the same conclusion that the proxy advisor policies are not value increasing for shareholders.

7. Summary and Concluding Remarks

Institutional investor voting on corporate proxies has the potential to influence a wide range of firm corporate governance choices. Over the past decade, the SEC and Congress have increased regulation focused on institutional investors voting. An explicit assumption in this regulation was that institutional investors would conduct the research necessary to vote in a manner that would maximize value for all firm shareholders. Unfortunately institutional investors face a classic free rider problem in conducting this research and may not have economic incentives to make such an investment. A significant proportion of institutional investors rely on proxy advisory firms to conduct research and determine votes on their behalf.

This outsourcing of voting responsibilities can be an efficient means of sharing the costs of research across investors. However, if the free rider problems sufficiently dilute the benefits to individual institutions, it is also plausible that the outsourcing of voting responsibilities to institutional investors represents the lowest cost voting compliance mechanism. In such a setting investors are unwilling to pay more for better research into optimal vote decisions because their vote is not expected to have an impact on the voting outcome and there is no additional benefit such as using the research to impact the stock selections made by portfolio managers.

The fundamental question is whether outsourcing votes to proxy advisors creates or destroys value for firm shareholders. This is important in the current environment because, unlike the individual institution which may only control a small block of shares, proxy advisors aggregate a large block of votes which will follow their recommendations (34% on average for our sample). As such, proxy advisors can be pivotal in the outcome of a given ballot item and induce firms to make governance changes in response. If these voting recommendations are optimal, changes in firms induced by these policies will improve firm governance and benefit shareholders. However, if the policies are arbitrary and/or not optimal, they may induce boards of directors to change to less appropriate governance structures.

We examine the shareholder value implications of outsourcing to proxy advisory firms on the recent requirement to implement Say-on-Pay. Using a large cross-section of firms, we confirm that proxy advisory firm recommendations have a substantive impact on SOP voting outcomes. We also find that, anticipating this impact, a significant number of boards of directors change their compensation programs in the time period *before* the formal shareholder vote in a manner that better aligns compensation programs with the recommendation policies of proxy advisory firms and subsequently realize a higher likelihood of a positive vote recommendation.

We interpret our result as evidence that boards of directors change executive compensation plans in order to avoid a negative SOP recommendation by proxy advisory firms, and thereby increase the likelihood that the firm will not fail the vote (or will garner a sufficient level of positive votes). The stock market reaction to these compensation program changes is statistically *negative*. Moreover, this effect is unique to the time prior to the initial SOP vote (2011) and a similar stock market reaction is not observed during the 2006-2010 time period.

As with all observational studies, there are a variety of alternative interpretations of this result. However, we believe the most parsimonious and plausible conclusion is that the confluence of free rider problems in the voting decision, regulation of voting in institutional investors, and the decision by the SEC to regard proxy advisor policies as appropriate for purposes of institutional investor compliance with regulation has led to policies of proxy advisory firms that induce the boards of directors to make compensation decisions that *decrease* shareholder value. While our findings provide insight into the shareholder value implications of outsourcing proxy research in the current economic and regulatory setting, we acknowledge that we cannot make inferences about the social welfare implications of the current regulatory regime relative to alternatives such as a prohibition on proxy advisory firms or a reduction in items presented to shareholders for vote.

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Appendix A. Compensation changes aligned with proxy advisor' voting policies

Feature	Description	Rationale
New Performance-Based Equity Plan	The award of equity compensation (stock options, restricted stock or restricted stock units) in which the vesting event and/or the number of shares earned is contingent on the achievement of pre-determined performance objectives where comparable awards were not granted in the prior fiscal year.	ISS' policies explicitly consider the performance-based vs. non-performance-based pay ratio. Equity awards that do not have performance contingencies are not considered performance-based (ISS 2011a). GL views the lack of performance-based long-term incentives as a concern which was cited in 41% of its negative recommendations.
New Cash Long-Term Incentive Plan	Award of new cash bonus opportunities in which the bonus is earned based on the achievement of performance objectives measured over a period greater than one year where comparable awards were not granted in the prior fiscal year.	ISS' policies explicitly consider the performance-based vs. non-performance-based pay ratio. Equity awards that do not have performance contingencies are not considered performance-based (ISS 2011a). GL views the lack of performance-based long-term incentives as a concern which was cited in 41% of its negative recommendations. Also, because cash-based plans are included as compensation when they are *earned* rather than when they are *awarded* in both the ISS and GL computations of pay, a new long-term cash plan will reduce pay in the current year relative to a comparable equity award.
Restrict Existing Equity Plan(s)	Amendments to existing equity compensation programs that restrict or eliminate features that are in the approved plan, including mandating minimum vesting periods, prohibiting stock option repricing without shareholder approval and reducing the number of shares available for grant under the plan.	ISS and GL oppose stock option repricings conducted without shareholder approval (Larcker, McCall, and Ormazabal, 2012). GL indicates that equity awards should be subject to minimum vesting period (Glass Lewis 2011a). Both ISS and GL measure equity plans using proprietary measures of the total plan dilution, which includes both outstanding equity awards and awards that can be granted under the plan (ISS 2011a, Glass Lewis 2011a).
Amend Outstanding Equity Awards	Amendments to previously awarded equity that are not advantageous to the recipient, including extending vesting periods, adding shareholding requirements and adding performance conditions to the awards.	Neither ISS nor GL consider stock options or restricted shares with time-based vesting to be performance-based. Both ISS and GL view stock ownership guidelines and holding requirements as good compensation practices (ISS 2010, Glass Lewis 2011a).

Appendix A. Compensation changes aligned with proxy advisor' voting policies (cont´d)

Feature	**Description**	**Rationale**
Eliminate "Poor" Features From Change in Control Agreements	Amendment of existing agreements or the disclosure of new agreements that eliminate excise tax gross-ups or that eliminate single-trigger provisions (that provide payment to an executive without that executive having been involuntarily terminated).	Both ISS and GL oppose excise tax gross-ups and single trigger agreements (ISS 2011a, Glass Lewis 2011a).
New Clawback Arrangement	Implementation of a "Clawback" policy, which provides for recoupment of compensation if it is deemed to have been inappropriately earned (e.g., due to restatement).	ISS examines whether a firm has a Clawback policy as part of its Compensation Committee Communication & Effectiveness evaluation. GL considers Clawback policies a "best practice" (Glass Lewis 2011a) and highlighted the lack of a Clawback policy in a significant number of their negative recommendations (Ertimur, Ferri, and Oesch, 2013).
Reduction or Elimination of Executive Benefits	A reduction in or elimination of benefits or perquisites available only to senior executives(e.g., use of corporate aircraft, automobile payments, financial planning, supplemental retirement plans and supplemental insurance plans). Also includes the elimination of tax gross-up payments associated with executive benefits.	The value of executive benefits is captured in the computation of compensation for both ISS and GL. ISS provides detailed review of executive benefits in its Non-Performance-Based Pay Elements analysis (ISS 2011a). Both ISS and GL oppose the payment of taxes due to executives for the receipt of benefits (ISS 2011a, GL 2011a).
Reduction in CEO Cash Compensation	A reduction to the CEO's salary or to the target bonus opportunity.	Both ISS and GL compare a firms CEO pay levels and firm performance to industry peers in order to determine the pay/performance alignment under their proprietary analyses. For poor performers, one way to align the pay with performance is to reduce the level of pay.

Appendix B. Example disclosures of compensation changes aligned with proxy advisor' voting policies

New performance-based equity plan:

"The final component of the 2011 equity awards consists of performance units. Fifty percent (50%) of the performance units will vest on March 15, 2013, and the remaining fifty percent (50%) will vest on March 17, 2014, subject to the provisions of the Performance Unit Award Agreement. The number of performance units awarded will be adjusted based on the achievement of RONOA (our Adjusted Operating Income divided by the sum of average Property, Plant and Equipment, average Goodwill and Other Intangible Assets, and average Operating Working Capital). RONOA will be measured for the period beginning on January 1, 2011, and ending on December 31, 2012. Target RONOA is 10.0%."

Source: Boise Inc. SEC Form 8-K, March 18, 2011.

New cash long-term incentive plan:

"SUPERVALU INC. (the "Company") finalized a long-term incentive program for the Fiscal 2012-2014 performance period pursuant to which participants, including the Company's named executive officers, will be eligible to receive incentive compensation based on the increase in the Company's market capitalization during the performance period, if any, using a fixed number of common shares outstanding. The maximum amount of increase in the Company's stock price is capped at $25, and the maximum percent of the increase in market capitalization that will be paid to all participants will be 4.8% of such increase. The Company's top 800 employees will be eligible for a share of the payments, if any, under the program. The program provides for a minimum, performance-based payout opportunity equal to 25% of the target award value assuming $5.7 billion or more of EBIDTA is generated over the three-year performance period. Payments under the program, if any will be made half in cash and half in shares of the Company's stock following the end of the performance period. The three-year measurement period aligns with the estimated time to fully realize the business transformation currently underway at the Company."

Source: SUPERVALU INC., SEC Form 8-k, April 28, 2011.

Restrict existing equity plan(s):

"Termination of Option Buyout Provisions in Equity Plans. On January 28, 2011, the Board of Directors of The Progressive Corporation (the "Company") approved the Third Amendment to The Progressive Corporation 2010 Equity Incentive Plan (the "Plan") and the Third Amendment to The Progressive Corporation 2003 Incentive Plan (together, the "Amendments," copies of which are attached hereto as Exhibits 10.1 and 10.2, respectively). Under each of these plans, prior to the Amendments, the Company had the authority to buyout certain outstanding stock option awards (and, in the case of the 2010 Equity Incentive Plan, stock appreciation rights), on terms and conditions acceptable to the Compensation Committee of the Board of Directors. In each case, the Amendments have modified the applicable plan to terminate the Company's authority to buyout such outstanding stock options and stock appreciation rights."

Source: The Progressive Corporation, SEC Form 8-K, filed February 2, 2011.

Amend outstanding equity awards:

"On October 29, 2010, SYNNEX Corporation ("SYNNEX") amended the restricted stock unit award (the "RSUs") granted to each of Dennis Polk, SYNNEX' Chief Operating Officer, and Peter Larocque, SYNNEX' President, U.S. Distribution (each, an "Officer"). Subject to certain conditions, the RSUs will continue to vest in full on the fifth anniversary of April 29, 2010 (the "Original Grant Date"). A portion of the RSUs will vest upon the fourth and fifth anniversary of the Original Grant Date provided that the Officer remains in continuous employment by SYNNEX through the vesting date. An additional portion of the RSUs will vest on the fourth and fifth anniversary of the Original Grant Date provided, that (i) the Officer remains in continuous employment by SYNNEX through the vesting date and (ii)(A) on the fourth anniversary of the Original Grant Date, SYNNEX achieves on a cumulative basis, 5% compound annual growth rate ("CAGR") in earnings before income and taxes ("EBIT") from continuing operations in fiscal years ending November 30, 2011 through 2013, and (B) on the fifth anniversary of the Original Grant Date, SYNNEX achieves on a cumulative basis, 5% CAGR in EBIT from continuing operations in fiscal years ending November 30, 2011 through 2014. In the event of an Officer's death prior to the fifth anniversary of the Original Grant Date, SYNNEX will transfer to such Officer's estate the number of shares that would have vested on an annual basis on or prior to such Officer's death. The amended form of stock unit agreement is filed herewith as Exhibit 10.1."

Source: SYNNEX Corporation, SEC Form 8-K filed November 4, 2010.

Appendix B. Example disclosures of compensation changes aligned with proxy advisor' voting policies (cont´d)

Eliminate "poor" features from change in control agreements:

"The existing employment agreements were amended and restated to:

- *extend the term of the agreements for one year, to June 22, 2014 in the case of Mr. Bordelon and to June 22, 2013 in the case of the Executive Vice Presidents;*
- *remove the prior provisions that permitted the agreements to be automatically extended for an additional year on the annual anniversary date of the agreement unless either party to the agreement has given notice that the term will not be extended (commonly referred to as an "evergreen" provision); and*
- *revise the provision in Mr. Bordelon's agreement with the Company which requires the Company to (1) reimburse Mr. Bordelon for any 20% excise tax incurred under Section 280G of the Internal Revenue Code of 1986, as amended ("Section 280G"), upon severance of employment after a "change-in-control", as defined under Section 280G, and (2) pay the additional federal, state and local income taxes and excise taxes on such reimbursement in order to place Mr. Bordelon in the same after-tax position he would have been in if the excise tax had not been imposed (commonly referred to as a "Section 280G gross-up" provision) such that the Company will be obligated to pay a Section 280G gross-up to Mr. Bordelon only with respect to a change-in-control which occurs on or before June 22, 2014.*

The determination to remove the evergreen provisions in the agreements and, in the case of Mr. Bordelon's agreement with the Company, limit the provision providing for a 280G gross-up payment to change-in-control transactions occurring on or before June 22, 2014, were undertaken primarily upon consideration of the governance risk indicators ("GRId") published by RiskMetrics Group (formerly known as Institutional Shareholder Services or "ISS"). The Company has taken other actions related to its GRId score, including the adoption of chief executive officer and director stock ownership guidelines and of a compensation clawback policy."

Source: Home Bancorp, Inc., SEC Form 8-K filed March 30, 2011.

New clawback arrangement:

"On March 18, 2011, the Board of Chelsea adopted a recoupment policy that requires all executive officers to repay or return cash bonuses and/or equity awards in the event: (i) the Company issues a material restatement of its financial statements and where the restatement was caused by the employee's intentional misconduct; (ii) the executive officer was found to be in violation of non-compete provisions of any plan or agreement; or (iii) the executive officer has committed ethical or criminal violations."

Source: Chelsea Therapeutics International, Ltd., SEC Form 8-K filed March 18, 2011.

Reduction or elimination of executive benefits:

"On December 1, 2010, Mueller Water Products, Inc. (the "Company") and Gregory E. Hyland, the Company's Chairman of the Board of Directors, President and Chief Executive Officer, entered into an amendment (the "Amendment") to Mr. Hyland's employment agreement (the "Agreement"). The Amendment deletes a provision from the original Agreement that entitled Mr. Hyland to reimbursement for membership dues in one country club and one luncheon club in the Atlanta, Georgia area. The Amendment is consistent with a recent determination by the Company's Compensation and Human Resources Committee to modify the Company's policy for executive club reimbursement, such that the Company will no longer reimburse executives for club membership fees."

Source: Mueller Water Products, Inc., SEC Form 8-K, filed Decenber 6, 2010.

Reduction in CEO cash compensation:

"On February 3, 2011, following the recommendation of the Compensation Committee of the Board of Directors (the "Board") of Intuitive Surgical, Inc. ("Intuitive" or the "Company"), the Board approved a decrease of $100,000 in the base salary for Lonnie Smith, the Company's executive officer as well as the Chairman of the Board. Mr. Smith's new base salary, effective January 1, 2011, will be $100,000 and he will not participate in the Company's bonus plan."

Source: Intuitive Surgical, Inc., SEC Form 8-K filed February 3, 2011.

Figure 1. Distribution of shareholder meeting dates

Figure 1 presents the distribution of annual shareholder meetings in a window around January 21st (day 0) in both 2010 and 2011. Say on pay is required under Dodd-Frank at annual meetings on or after January 21st, 2011. The vertical axis indicates the number of companies that had the annual meeting that day. The horizontal axis indicates the number of days before or after January 21st. For example "−4" means 4 days before January 21st and "4" means 4 days after January 21st. The darker bars refer to meetings in 2010 and the lighter bars to meetings in 2011.

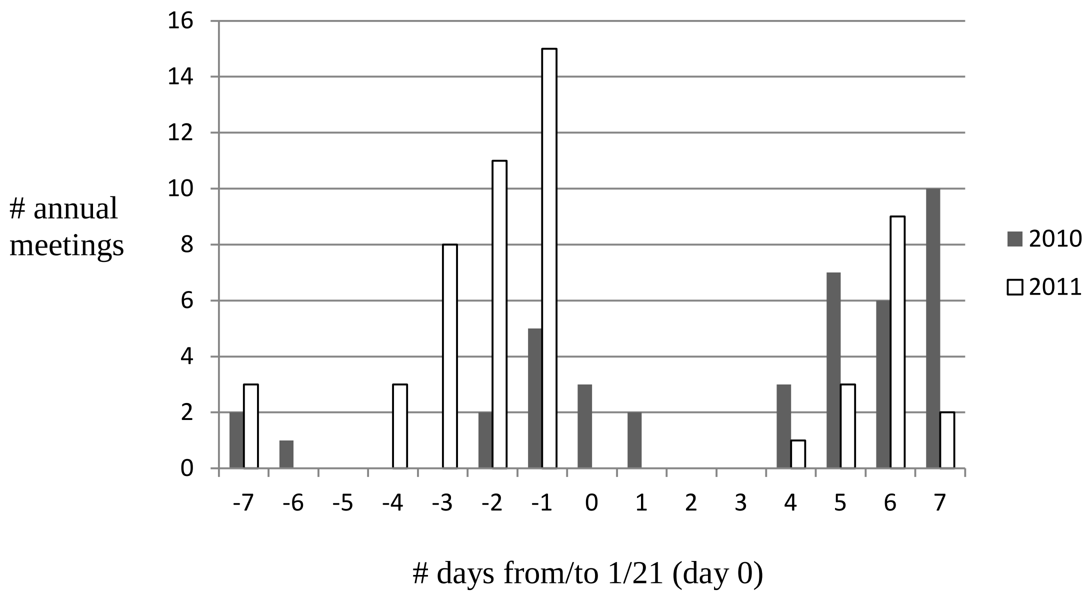

Table 1. Descriptive statistics for the sample firms

This table reports selected descriptive statistics for our sample of 2,008 firms and the 4,513 benchmark firms in the Compustat-CRSP universe with fiscal year end date between 6/30/2010 and 3/31/2011. Panel A presents descriptive statistics of variables related to firm characteristics. *Size* is the firm´s equity market value (in millions of dollars). *BM* is the Book-to-market ratio. *Leverage* is total liabilities divided by total assets. *Volatility* is the annualized return volatility, computed as the standard deviation of daily returns over 365 days prior to fiscal year end. *ROA* is return on assets (operating income scaled by total assets). *Pctinstit* is the percentage of the firm´s shares owned by institutions. Panel B presents the industry distribution of the sample and Compustat firms using Fama and French industry classification.

Panel A. Descriptive Statistics

	Sample		*Compustat*	
Firm characteristic	*mean*	*median*	*mean*	*median*
Market Cap (millions)	5,982	1,173	3,750	499
BM	0.57	0.51	1.09	0.60
Leverage	0.22	0.17	0.20	0.14
ROA	0.06	0.07	0.07	0.05
Volatility	0.40	0.37	0.48	0.42
Pctinstit	0.72	0.78	0.51	0.55

Panel B. Industry Sectors

Fama and French 12 industry groups	*Sample*	*Compustat*
Business equipment	17.13%	13.45%
Chemicals and allied products	2.19%	2.34%
Consumer durables	2.02%	2.09%
Oil, gas, and coal extraction and products	5.14%	5.13%
Healthcare, medical equipment and drugs	10.86%	10.41%
Manufacturing	8.62%	10.46%
Financial firms	22.71%	23.66%
Consumer nondurables	4.30%	4.13%
Other	13.34%	12.20%
Wholesale, retail, and some services	7.73%	8.67%
Telephone and television transmission	3.08%	3.14%
Utilities	2.88%	4.33%

Table 2. Descriptive statistics for measures used in the analyses

This table reports descriptive statistics for the measures used in subsequent analyses for our 2,008 sample firms. *ISS_against* equals one if ISS recommended against and zero otherwise. *GL_against* equals one if Glass Lewis recommended against and zero otherwise. *P4P* is a pay-for-performance indicator variable that equals one (and zero otherwise) if: (i) the CEO's compensation increases from 2009 to 2010, (ii) total shareholders' returns in the last year (*TSR1Y*) is lower than the median *TSR1Y* among the companies in the same GICS code, (iii) total shareholders' returns in the last three years (*TSR3Y*) is lower than the median *TSR3Y* among the companies in the same GICS code, and (iv) the CEO's total compensation is above the median compensation of the peer companies (the peer group is defined following ISS's criteria). *PayDisparity* is the ratio between CEO compensation and the average compensation of the other named executive officers (NEO's). *PctLTincentives* is the present value of long-term incentives divided by the sum of the present value of both long term and short term incentives. *PctPBincentives* is the present value of performance-based equity incentives divided by the sum of the present value of both performance-based and non-performance-based equity incentives. *nPM* is the number of different performance measures used by the LTIP´s, stock and option grants to the CEO. *GRID_comp* equals one if the compensation GRId score computed by ISS is labeled as "high concern", two if it is labeled as "medium concern" and three if it is labeled as "low concern". *WithholdRec* is the number of "withhold" or negative recommendations issued by ISS on directors of the company in the previous proxy season. *PctSupport* is the percentage of favorable advisory votes on SOP. *Fail* equals one if the SOP proposal failed to obtain majority support and zero otherwise. *ISS_influence* is calculated as the sum across funds in that company of the probability of voting with ISS conditional on disagreement multiplied by the holdings of each fund in the company.

Panel A. Variables used in subsequent analyses

	25^{th} pct	*mean*	*median*	*75^{th} pct*
SOP voting recommendations				
ISS_against	0	0.13	0	0
GL_against	0	0.21	0	0
Proxy advisors' SOP policies				
P4P	0	0.13	0	0
Paydisparity	1.88	2.76	2.51	3.35
PctLTincentives	0.51	0.62	0.73	0.83
PctPBincentives	0	0.32	0	0.71
nPM	1	2.39	2	4
Other variables				
GRID_comp	2	1.97	2	2
WithholdRec	0	0.13	0	0.08
Voting outcomes				
Pctsupport	0.87	0.90	0.95	0.98
Fail	0	0.016	0	0
Measure of ISS influence				
ISS_influence (in %)	5.18	8.85	8.40	11.85

Panel B. ISS and GL recommendations

	Only ISS		*Only GL*		*ISS and GL*			
ISS recommendation	*For*	*Against*	-	-	*For*		*Against*	
GL recommendation	-	-	*For*	*Against*	*For*	*Against*	*For*	*Against*
Pass (PctSupport ≥ 50%)	1,747	229	1,462	357	1,339	271	123	86
Fail (PctSupport < 50%)	0	32	1	29	0	0	1	29
#firms	1,747	261	1,463	386	1,339	271	124	115

Table 3. Proxy advisors' SOP Recommendations

This table reports results of probit regressions testing the determinants of ISS SOP recommendations. Panel A and panel B analyze the determinants for ISS and Glass Lewis recommendations, respectively. *P4P* is a pay-for-performance indicator variable that equals one (and zero otherwise) if:(i) the CEO's compensation increases from 2009 to 2010,(ii) total shareholders' returns in the last year (*TSR1Y*) is lower than the median *TSR1Y* among the companies in the same GICS code, (iii) total shareholders' returns in the last three years (*TSR3Y*) is lower than the median *TSR3Y* among the companies in the same GICS code, and (iv) the CEO's total compensation is above the median compensation of the peer companies (the peer group is defined following ISS's criteria). *PayDisparity* is the ratio between CEO compensation and the average compensation for the other named executive officers (NEOs). *PctLTincentives* is the present value of long-term incentives divided by the sum of the present value of both long term and short term incentives. *PctPBincentives* is the present value of performance-based equity incentives divided by the sum of the present value of both performance-based and non-performance-based equity incentives. *nPM* is the number of different performance measures used by the LTIP´s, stock and option grants to the CEO. *GRID_comp* equals one if the compensation GRId score computed by ISS is labeled as "high concern", two if it is labeled as "medium concern" and three if it is labeled as "low concern". *WithholdRec* is the number of "withhold" or negative recommendations issued by ISS on directors of the company in the previous proxy season. *, **, and *** denote significance at the 10, 5 and 1% significance level (two-tail).

Panel A. ISS recommendations

Variable	Expected Sign	*ISS_against* coef	*t*-stat	*ISS_against* coef	*t*-stat
Constant		−1.41***	−32.14	−1.04***	−6.51
P4P	+	1.30***	14.71	1.30***	14.04
PayDisparity	+			0.13***	5.08
PctLTincentives	-			0.04	0.29
PctPBincenties	-			−0.03	−0.35
nPM	-			−0.06***	−2.72
GRID_comp	-			−0.35***	−5.40
WithholdRec	+			0.50***	3.72
Pseudo R^2			13.87%		20.75%
N			2,008		2,008

Panel B. GL recommendations

Variable	Expected Sign	*GL_against* coef	*t*-stat	*GL_against* coef	*t*-stat
Constant		−0.92***	−25.24	−1.43***	−8.85
P4P	+	0.71***	7.98	0.58***	6.37
PayDisparity	+			0.17***	6.94
pctLTincentives	-			0.61***	4.64
pctPBincenties	-			−0.04	−0.41
nPM	-			−0.01	−0.49
GRID_comp	-			−0.19***	−3.20
WithholdRec	+			0.15	1.15
Pseudo R^2			3.30%		8.52%
N			1,849		1,849

Table 4. Proxy advisors' SOP Recommendations and Voting Outcomes

This table reports results of the association between voting outcomes ISS SOP recommendations and ISS recommendations. Panel A presents results of the cross-sectional determinants of voting support. *PctSupport* is the percentage of favorable advisory votes on SOP. *ISS_influence* is calculated as the sum across funds in that company of the probability of voting with ISS conditional on disagreement multiplied by the holdings of each fund in the company. *PctInstit* is the percentage of shares owned by institutions. *ISS_against* equals one if ISS recommended against the company's compensation practices and zero otherwise. Panel B compares the influence of recommendations by ISS and GL on voting support. *, **, and *** denote significance at the 10, 5 and 1% significance level (two-tail).

Panel A. Influence of ISS on voting support

Dep. Var: PctSupport	*(1)*		*(2)*		*(3)*		*(4)*	
Variable	coef	*t*-stat	coef	*t*-stat	coef	*t*-stat	coef	*t*-stat
Constant	0.93***	568.18	0.96***	267.28	0.95***	300.96	0.96***	196.51
ISS_against	−0.25***	−25.68	−0.25***	−26.63	−0.15***	−9.07	−0.08***	−2.89
ISS_influence			−0.002***	−7.19	−0.001***	−3.98		
*ISS_against*ISS_influence*					−0.01***	−6.67		
PctInstit							−0.04***	−5.61
*ISS_against*PctInstit*							−0.24***	−6.36
Pseudo R^2		49.21%		50.66%		53.16%		53.77%
N		2,008		2,008		2,008		2,008

Panel B. Influence of GL on voting support

Dep. Var: PctSupport	*(1)*		*(2)*		*(3)*	
Variable	coef	*t*-stat	coef	*t*-stat	coef	*t*-stat
Constant	0.94***	460.74	0.96***	771.07	0.94***	160.67
GL_against	−0.18***	−22.88	−0.13***	−24.34	−0.10***	−3.65
ISS_against			−0.21***	−24.62		
PctInstit					−0.01	−1.42
*GL_against*PctInstit*					−0.09**	−2.55
Pseudo R^2		35.66%		69.16%		36.32%
N		1,849		1,849		1,849

Table 5. Characterization of compensation changes preceding the annual meeting

Panel A presents descriptive statistics of selected characteristics of firms making compensation changes within the eight-month window previous to the filing of the proxy statement prior to the 2011 annual meeting. The first two columns of Panel A present descriptive statistics of firms that filed 8-Ks announcing compensation changes that conform to ISS´s policies. The second set of columns of Panel A present descriptive statistics of the remaining sample firms. The third set of columns of Panel A present descriptive statistics of firms that filed 8-Ks announcing compensation changes that are unrelated to ISS´s policies. Compensation changes that conform with ISS policies are the following (see Appendix A): Amendment to outstanding awards, reduction of burn rate, new cash LTIP, reduction in cash comp, changes/amendments to change of control plans, new performance-based equity plan and reduction in benefits. *P4P* is a pay-for-performance indicator variable that equals one (and zero otherwise) if: (i) the CEO's compensation increases from 2009 to 2010, (ii) total shareholders' returns in the last year (*TSR1Y*) is lower than the median *TSR1Y* among the companies in the same GICS code, (iii) total shareholders' returns in the last three years (*TSR3Y*) is lower than the median *TSR3Y* among the companies in the same GICS code, and (iv) the CEO's total compensation is below the median compensation of the peer companies (the peer group is defined following ISS's criteria). *ISS_influence* is calculated for each company as the average probability of each fund voting with ISS conditional on disagreement multiplied by the holdings of each fund in the company. *PctInstit* is the percentage of shares owned by institutions. Panel B presents similar statistics using a random sample of compensation-related 8-Ks filed within the eight-month window previous to the filing of the proxy statement corresponding to the 2006 - 2010 annual meetings. *, **, and *** denote significance at the 10, 5 and 1% significance level (two-tail).

Panel A. 2011 annual meeting (the initial SOP vote)

	Firms with PA aligned 8-Ks (1)		*Remainder of sample firms (2)*		*Firms with other compensation 8-Ks (3)*		*Diff. (1)-(2) p-values*		*Diff. (1)-(3) p-values*	
	Mean	Median	Mean	Median	Mean	Median	t-test	Wilcx	t-test	Wilcx
P4P	0.18	0.00	0.13	0.00	0.11	0.00	0.067	0.067	0.015	0.015
ISS_influence	9.34	8.74	8.77	8.27	9.09	8.76	0.090	0.043	0.496	0.442
PctInstit	0.77	0.81	0.71	0.77	0.72	0.77	0.000	0.001	0.004	0.033
Number of firms	275		1,733		377					
Number of changes	297				436					

Table 5. Characterization of compensation changes preceding the annual meeting (cont´d)

Panel B. 2006-2010 annual meetings (before the requirement of a SOP vote)

	Firms with PA aligned 8-Ks (1)		*Firms with other compensation 8-Ks (2)*		*Diff. (1)-(2) p-values*	
	Mean	Median	Mean	Median	t-test	Wilcx
P4P	0.07	0.00	0.06	0.00	0.539	0.539
ISS_influence	10.03	9.72	9.79	9.25	0.548	0.517
PctInstit	0.80	0.84	0.80	0.83	0.530	0.603
Number of firms	188		450			
Number of changes	201		532			

Table 6. Compensation changes and proxy advisors´ SOP recommendations

This table presents results of probit regressions testing the association between ISS recommendations and changes in compensation previous to the proxy season. The dependent variable *ISS_against* equals one if ISS recommended a vote against the company's compensation practices and zero otherwise. The first set of columns includes all sample firms. The second set of columns includes 8-Ks filed during the 8 months previous to the proxy statement of the 2011 proxy season. *Sum_PA_Aligned* is the sum of *PA_Aligned* across all of the 8-Ks for each firm in the 8 months prior to the proxy statement of the 2011 proxy season. Proxy advisor aligned compensation changes are the following (see Appendix A): Amendment to outstanding awards, reduction of burn rate, new cash LTIP, reduction in cash comp, changes/amendments to change of control plans, new performance-based equity plan and reduction in benefits. *PA_Aligned* is the number of Proxy advisor aligned compensation changes announced in each 8-K. *P4P* is a pay-for-performance indicator variable that equals one (and zero otherwise) if: (i) the CEO's compensation increases from 2009 to 2010, (ii) total shareholders' returns in the last year (*TSR1Y*) is lower than the median *TSR1Y* among the companies in the same GICS code, (iii) total shareholders' returns in the last three years (*TSR3Y*) is lower than the median *TSR3Y* among the companies in the same GICS code, and (iv) the CEO's total compensation is below the median compensation of the peer companies (the peer group is defined following ISS's criteria). *, **, and *** denote significance at the 10, 5 and 1% significance level (two-tail).

Dep. Var: ISS_against	*All sample firms*		*8-Ks with some type of compensation change*	
Indep. Variables:	coef	*t*-stat	coef	*t*-stat
Constant	1.38***	−30.56	−1.24***	−15.52
Sum_PA_Aligned	−0.16*	−1.73		
PA_Aligned			−0.22*	−1.94
P4P	1.31***	14.77	1.03***	7.07
Pseudo R^2		14.07%		8.73%
N		2,008		733

Table 7. Market reaction to compensation changes preceding SOP

This table analyzes cross-sectional differences in the market reaction to compensation-related 8-Ks filed during the eight months prior to the proxy statement release date. The dependent variable, *AdjRet*, is the average daily risk-adjusted return on the day of the 8-K filing, estimated using the Fama and French three-factor model plus momentum. *AdjRet* is expressed as a %. Column (1) includes 8-Ks filed during the 8 months preceding the proxy statement filing date in fiscal year 2011. Column (2) includes a random sample of 8-Ks from previous (2006-2010) fiscal years. *PA_Aligned* is the number of ISS-friendly compensation changes announced in the 8-K. ISS-friendly compensation changes are the following (see Appendix A): Amendment to outstanding awards, reduction of burn rate, new cash LTIP, reduction in cash comp, changes/amendments to change of control plans, new performance-based equity plan and reduction in benefits. Panel B compares *AdjRet* on the 8-K filing day to the average *AdjRet* on the 30 days preceding the 8-K filing date and the 30 days following the 8-k filing date. The *t*-stats are in parenthesis. *, **, and *** denote significance at the 10, 5 and 1% significance level (two-tail).

Panel A. Market reaction and comparison to previous proxy seasons

Dependent variable: AdjRet *Variable*	*2011 proxy season* *(1)*	*2006-2010 proxy seasons* *(2)*	*Difference in coefficients* *(1)-(2)*
Constant	0.096	0.162	−0.065
	(0.86)	(1.21)	(−0.89)
PA_Aligned	−0.444***	0.043	−0.488*
	(−2.91)	(0.21)	(−1.91)
N	733	733	
R^2	1.15%	0.01%	

Panel B. Comparison to market reaction on other days around the 8-K filing date

	AdjRet on days preceding the 8-k filing date (days −30 to −1) *(1)*	*AdjRet on 8-k filing date (day 0)* *(2)*	*AdjRet on days following the 8-k filing date (days 1 to 30)* *(3)*	*Difference in AdjRet* *(1)-(2)*	*Difference in AdjRet* *(2)-(3)*
8-Ks aligned with PA policies	0.011	−0.345***	0.019	0.356***	−0.365***
(N=297)	(0.41)	(−2.14)	(0.81)	(2.85)	(−3.19)
Other compensation 8-Ks	0.037	0.059	−0.001	−0.022	0.060
(N=436)	(1.51)	(0.58)	(−0.02)	(−0.19)	(0.60)