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Investigating the Impact of Proxy Advisor Conflicts Of Interest on Shareholder Value

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Abstract

This paper examines the economic consequences of proxy voting results perceived by some investors to have been influenced by conflicts of interest. The proxy advisory industry operates as a duopoly, with Institutional Shareholder Services (ISS) and Glass Lewis estimated to hold a combined market share of 97%. These firms primarily sell voting recommendations on proxy proposals to institutional investors. However, ISS has a subsidiary, ISS Corporate Solutions, that sells consulting services to corporations seeking assistance with proposals to be presented to shareholders. Glass Lewis does not have a similar business. This paper examines the stock market reaction to voting outcomes in favor of management where ISS fully supported management and Glass Lewis did not. This paper finds that the excess return on the meeting date for this voting outcome is statistically negative, decreasing shareholder value, on average, by 0.15% (t-stat= -1.914). This significant negative excess returns is observed only on the meeting date; no estimate of excess returns within a trading week (-4 trading days, +4 trading days) of the meeting were statistically different from zero. Further, an ANOVA indicated none of the 7 other voting outcomes exhibited significant excess returns. A regression analysis comparing this "Conflict" scenario with a clustered group of all other voting outcomes shows a negative effect that is not statistically significant.

Keywords

business, stock market, proxy voting

Disciplines

Business

Investigating the Impact of Proxy Advisor Conflicts Of Interest on Shareholder Value

By

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THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

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Abstract

This paper examines the economic consequences of proxy voting results perceived by some investors to have been influenced by conflicts of interest. The proxy advisory industry operates as a duopoly, with Institutional Shareholder Services (ISS) and Glass Lewis estimated to hold a combined market share of 97%. These firms primarily sell voting recommendations on proxy proposals to institutional investors. However, ISS has a subsidiary, ISS Corporate Solutions, that sells consulting services to corporations seeking assistance with proposals to be presented to shareholders. Glass Lewis does not have a similar business. This paper examines the stock market reaction to voting outcomes in favor of management where ISS fully supported management and Glass Lewis did not. This paper finds that the excess return on the meeting date for this voting outcome is statistically *negative*, decreasing shareholder value, on average, by 0.15% (t-stat= -1.914). This significant negative excess returns is observed only on the meeting date; no estimate of excess returns within a trading week (-4 trading days, +4 trading days) of the meeting were statistically different from zero. Further, an ANOVA indicated none of the 7 other voting outcomes exhibited significant excess returns. A regression analysis comparing this “Conflict” scenario with a clustered group of all other voting outcomes shows a negative effect that is not statistically significant.

Introduction

Proxy Voting Explained

The Securities and Exchange Commission (SEC) requires corporations to hold an annual stockholders' meeting. At these meetings, shareholders of the firm have the opportunity to vote on a "variety of key issues that could potentially affect the corporations' value, such as the election of directors, executive compensation packages, and proposed mergers and acquisitions, as well as other, more routine, issues that may not affect value, such as approving an auditor and changing a corporate name."¹ Corporations send a proxy statement that allows shareholders to 1) view the upcoming meeting's voting issues and 2) appoint a third party (proxy) to vote on the shareholder's behalf. Shareholders may direct the third party on how to vote on each issue, typically: 'For' or 'Against' or 'Abstain'.

A sample proxy card can be found on the following page:

¹ .S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-07-765, REPORT TO CONGRESSIONAL REQUESTORS 6 (June 2007)

Rise of Proxy firms from 2003 SEC rule 30b1-4

In 2003, the SEC mandated that institutional investors vote on all matters on the corporate proxy and disclose their voting policies.² This rule created several challenges for institutional investor. Mutual funds typically have substantially large portfolios that make thoroughly researching every voting issue for all holdings an arduous task. Moreover, most proxy voting ballots are routine and mundane, having negligible effect on shareholder value. Also, free-rider problems are abound because should one mutual fund rigorously analyze a ballot and conclude its effect on shareholder value, the fund is incented to advocate for or against the ballot to other shareholders. The other shareholders do not incur any costs, but they reap just as much in benefits. These issues led to substantial growth in the proxy advisory firm industry. For a subscription fee, proxy advisory firms sell research reports and voting recommendations to institutional investors. Proxy firms appealed to institutional investors by alleviating tedious work, lessening free-rider issues, and, importantly, helping mutual funds demonstrate that they acted with appropriate diligence. The SEC allows institutional investors to satisfy their fiduciary obligations by relying on proxy advisory firms.³ In 2004, according to Harvard Law School's record of a letter, the SEC establishes that a "third party proxy advisory firm could be considered independent even though it receives compensation from an issuer for separately providing the issuer advice on corporate governance issues."⁴ Institutional investors have significant influence over shareholder voting, as some estimate they own approximately 70% of all publicly traded equity shares⁵. All of these

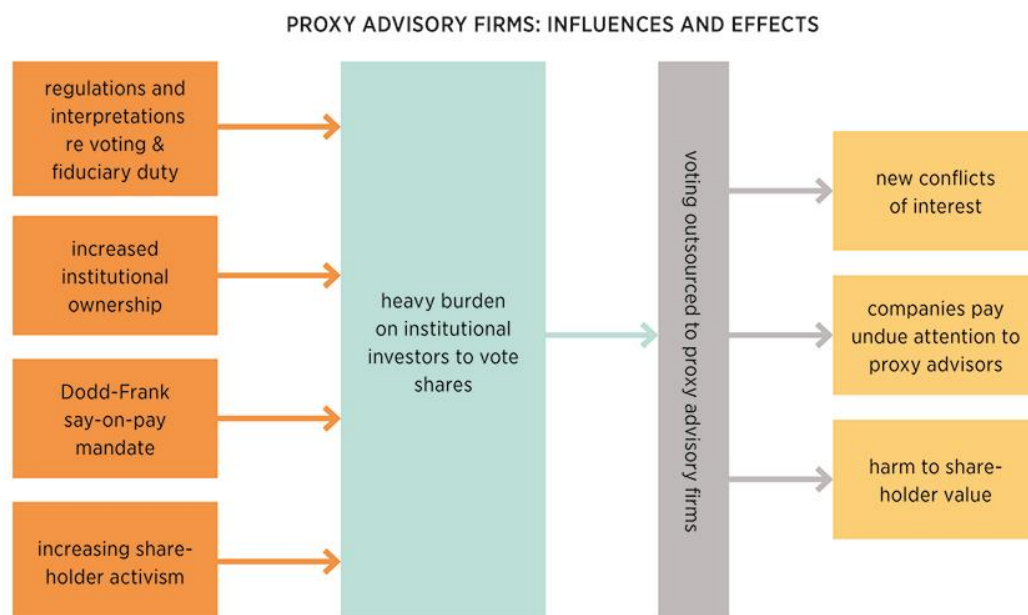
² Disclosure of Proxy Voting Policies Voting Records by Registered Management Investment Companies, Investment Company Act Release No. 25,739, 17 C.F.R. §§ 239, 249, 274 (Sept. 20, 2002).

³ Ibid.

⁴ "Cydney Posner and Cooley LLP, SEC No-Action Letters Related to Proxy Advisory Firms, September 15, 2018, <https://corpgov.law.harvard.edu/2018/09/15/sec-no-action-letters-related-to-proxy-advisory-firms/>)

⁵ James R. Copland and Rafael A. Mangual, "Proxy Advisory Firms: Empirical Evidence and the Case for Reform," Manhattan Institute, January 23, 2020, <https://www.manhattan-institute.org/html/proxy-advisory-firms-empirical-evidence-and-case-reform-11253.html>)

trends lead to the de facto concentration of voting power in two companies, Institutional Shareholder Services (ISS) and Glass Lewis (GL), proxy advisory firms that hold an estimated combined market share of 97%.⁶



Source: James K. Glassman and Hester Peirce, "How Proxy Advisory Services Became So Powerful" (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, June 2014), <http://mercatus.org/publication/how-proxy-advisory-services-became-so-powerful>.



Produced by James K. Glassman and Hester Peirce, Mercatus Center at George Mason University.

Institutional Shareholder Services (ISS), and ISS Corporate Solutions (ICS)

ISS is the oldest and most prominent proxy advisory firm. According to some researchers "ISS claims over 1,700 institutional clients managing \$26 trillion in assets, including 24 of the top 25 mutual funds,

⁶ James K. Glassman and Hester Peirce, "How Proxy Advisory Services Became So Powerful," Mercatus on Policy Series, Mercatus Center at George Mason University (June 18, 2014).

25 of the top 25 asset managers and 17 of the top 25 public pension funds.”⁷ ISS is unique from its counterpart Glass Lewis in one significant way: rather than solely advising investors on corporate governance matters, ISS provides “governance counseling” to an undisclosed list of corporate issuers. This practice has led many investors, regulators, and politicians to claim ISS is subject to conflicts of interest.

Influence of Proxy Advisors

Researchers have documented the extraordinary influence proxy advisors have on shareholder voting decisions. Choi, Fisch, and Kahan identify that “an ISS recommendation shifts 6%-10% of shareholder votes.”⁸ In another paper, the same scholars note that ISS has been described the as: “exercising ‘tremendous clout,’⁹ wielding ‘extraordinary’ influence,¹⁰ getting ‘[w]hatever [it] wants,¹¹ and being able to sway up to 30 percent of the vote in any particular proxy contest.^{12,13}

In 2012, an Exxon Mobil executive commented “proxy advisors hold a position of unparalleled influence” and that “between 20%–25% of the votes cast at ExxonMobil’s most recent annual meeting were voted automatically in accordance with proxy advisor recommendations”¹⁴ ISS disagrees with this kind of characterization of the firm’s power, claiming “there are no artificial

⁷ Choi et al., “Director Elections and the Role of Proxy Advisors,” SSRN, August 16, 2008, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1225963)

⁸ Choi et al., “The Power of Proxy Advisors: Myth or Reality?,” SSRN, October 20, 2010, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1694535)

⁹ Dennis K. Berman & Joann S. Lublin, Advisor ISS Puts Itself on Sale, Could Fetch Up to \$500 Million, WALL ST. J., Sept. 6, 2006, at C4.

¹⁰ Robert D. Hershey, Jr., A Little Industry with a Lot of Sway on Proxy Votes, N.Y. TIMES, June 18, 2006, § 3, at 6.

¹¹ William J. Holstein, Is ISS Too Powerful? And Whose Interests Does It Serve?, BNET: THE CORNER OFFICE, Feb. 7, 2008, <http://blogs.bnet.com/ceo/?p=1100&tag=content;coll>.

¹² Id

¹³ Choi et al., “Director Elections and the Role of Proxy Advisors,” SSRN, August 16, 2008, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1225963)

¹⁴ Rosenthal DS (2012) Comment on the concept release on the U.S. proxy system, nos. 34-62495; IA-3052; IC-293.

barriers into the proxy advisory industry in the United States,” the company “operate[s] in a competitive market”, and “institutional investors are not required to purchase [their] services.”¹⁵

FIGURE 2.

Funds Voting with ISS When ISS Recommends “For/Against” (2017)

Institutional Investor	Say on Pay	Equity Plans	Directors	Proxy Contest	Assets (\$ billions)
BNY Mellon	61.9%/65.3%	84.8%/63.9%	90.7%/38.0%	83.3%/75.0%	1,800
Dimensional Fund Advisors, Inc.	84.7%/61.6%	75.3%/68.5%	91.8%/33.8%	100.0%/80.0%	414
California Public Employees' Retirement System	92.1%/66.4%	93.1%/60.6%	93.3%/29.6%	100.0%/70.0%	324
Charles Schwab Investment Management, Inc.	91.2%/61.6%	91.4%/67.3%	92.6%/73.6%	100.0%/90.0%	302
California State Teachers' Retirement System	90.0%/66.8%	87.4%/62.0%	43.6%/91.2%	83.3%/70.0%	222
The New York State Common Retirement Fund	81.5%/85.0%	83.0%/78.0%	86.0%/78.9%	100.0%/88.9%	192
Florida State Board of Administration	72.8%/91.6%	49.3%/95.7%	84.7%/90.6%	80.0%/90.0%	191
New York City Pension Funds	71.9%/85.1%	49.6%/82.2%	83.3%/62.6%	100.0%/90.9%	158
Ohio Public Employees Retirement System	85.5%/76.3%	92.7%/72.0%	85.8%/77.8%	100.0%/80.0%	86
Wespath Investment Management	84.9%/79.2%	54.5%/82.0%	74.3%/84.4%	n/a/100.0%	20

Source: Proxy Insight

Concerns about Proxy Advisors

As the proxy advisory market has grown dramatically, so too have the concerns about the industry. Copland et.al note the widespread distrust of the industry by illustrating that “[c]ritics of the proxy advisory firm market have included the U.S. Government Accountability Office (GAO), former SEC commissioners, academic researchers, and think-tank scholars.”¹⁶ A major concern about proxy advisors has been the presence of conflicts of interest, which is the focus of this paper.

Conflicts of Interest

¹⁵ Gary Retelny and Institutional Shareholder Services, Inc., “ISS Senate Hearing Statement,” The Harvard Law School Forum on Corporate Governance ISS Senate Hearing Statement Comments, July 12, 2018, <https://corpgov.law.harvard.edu/2018/07/12/iss-senate-hearing-statement/>

¹⁶ See 5

According to the U.S. Government Accountability Office, “[T]he business model of the dominant proxy advisory firm—Institutional Shareholder Services (ISS)—has been the most commonly cited potential conflict. Specifically, ISS advises institutional investors how to vote proxies and provides consulting services to corporations seeking to improve their corporate governance. Critics contend that corporations could feel obligated to retain ISS’s consulting services in order to obtain favorable vote recommendations.”¹⁷ In fact, a concept release from the SEC mentioned that an issuer “may purchase consulting services from the proxy advisory firm in an effort to garner the firm’s support for the issuer when the voting recommendations are made”¹⁸

Contribution of Research

The Related Works section of this paper discusses much of the progress that has been made in relation to the effects of proxy advisors and, specifically, conflicts of interest associated with them. Researchers have focused on understanding the level of influence of proxy advisors , agency theory associated with proxy firms, the factors that influence proxy firms’ recommendations, and effect of new entrants in the industry. This research, however, seeks to measure the impact of perceptions of conflict of interest on shareholder value. Proxy advisory firms are notoriously opaque, so there has not been much research into empirical cases of conflicts of interest. It is not possible to perfectly measure a conflict of interest without ISS’ confidential data, but the analysis of excess return could capture investor perceptions.

¹⁷ See 1

¹⁸ “Securities and Exchange Commission - SEC.gov.” Accessed May 4, 2020. <https://www.sec.gov/rules/concept/2010/34-62495fr.pdf>.

Methodology

Data

The paper's initial sample consists of all firms included in the S&P 500 index during 2020. The datasets used for this paper include ISS Voting Analytics – Company Vote Results US, Beta Suite by WRDS, and ISS Voting Analytics – Mutual Fund Vote Records. While ISS' voting recommendations are readily accessible, Glass Lewis does not have a similar public database. To get a historical record of Glass Lewis voting recommendations, this paper uses mutual fund voting records in a method similar to that of Larcker, McCall and Ormazabal¹⁹. So, this paper generates a subset of Glass Lewis voting recommendations, by using Form N-PX voting records of Neuberger Berman, a fund that disclosed its "guidelines adopt the voting recommendations of Glass Lewis" in Form N-CSR documents from 2013 to 2017.²⁰ This limits available data to annual meetings that Neuberger Berman voted on. The paper uses ISS Voting Analytics – Company Vote Results to generate ballot-level data for meetings from 2013 to 2017 for all current S&P 500 firms. The most relevant columns are: 'MeetingID,' 'MGMTRec,' 'voteResult,' 'ticker,' and 'ISSrec'. The paper uses ISS Voting Analytics to generate ballot-level data for Neuberger Berman's (InstitutionID= 5102137) voting history from 2013 to 2017. The most relevant columns are: 'MeetingID', 'MgtRec', and 'FundVote'. Additionally, this paper uses Beta Suite by WRDS to generate daily excess return data for all current members of the S&P 500 index ranging from 2013 to 2017. The Market model method is to calculate excess returns (which are expressed as log returns), with an estimation window of 252 days and a

¹⁹ Larcker et al., "Outsourcing Shareholder Voting to Proxy Advisory Firms," SSRN, July 19, 2012, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2101453

²⁰ For ex) 2017: <https://sec.report/Document/0000898432-17-000016/>

minimum window of 126 days. The paper then uses Python to consolidate the data on a meeting-level basis. This is done by matching the Neuberger Berman vote records and the S&P 500 ballot results on 'MeetingID'. From there, the paper matches the meeting data with the stock return data by using the 'ticker' and 'MeetingDate'. The paper creates additional columns based on the voting outcome:

'ISS Fully Supported Management' : (True/False)

'GL Fully Supported Management' : (True/False)

'All Results Favored Management' : (True/False)

These variables are generated for each meeting by checking relevant information for all the ballots in a meeting. There is a check for whether elements of 'ISSrec' correspond exactly to elements of 'MGMTRec', a check for whether elements of 'FundVote' correspond exactly to 'MgtRec', and a check for whether elements of 'voteResult' correspond exactly to 'MgtRec'.

Based on these 3 True/False variables, 8 voting scenarios were constructed:

Scenario 1 = ISS & GL & Results

Scenario 2 = ISS & GL & ! Results

*Scenario 3 = ISS & !GL & Results

Scenario 4 = ISS & !GL & !Results

Scenario 5 = !ISS & GL & Results

Scenario 6 = !ISS & GL & !Results

Scenario 7 = !ISS & !GL & Results

Scenario 8 = !ISS & !GL & !Results

*Scenario 3 represents the Conflict Scenario (an additional variable is established as well:

Perceived_Conflict = True, if “Scenario” is “Scenario 3”, Perceived_Conflict = False otherwise)

ISS, GL, and Results are abbreviations for ISS Fully Supported Management, Glass Lewis Fully Supported Management, and All Results Favored Management. The “!” indicates falsehood. The final sample size was 1,366 annual meetings.

Identification of Meetings that Suggested Conflicts of Interest

Conflicts of interest are difficult to explicitly identify due to the fact that ISS does not release its ICS client list and we do not know which ballots may have been swayed by the proxy advisor’s relationship with the management. However, stock market reaction is often driven by perceptions, so I attempt to identify the conditions a wary institutional investor would find the most likely to indicate a value-destroying conflict of interest. I identify this situation as a meeting where ISS fully supported management, Glass Lewis did not fully support management, and all results favored management. The paper assumes that some investors believe favoritism toward management by ISS accounts for the divergence from Glass Lewis, which only serves shareholders. The paper further assumes that investors believe the success of management in these scenarios would destroy shareholder value.

Methods

Regression Procedure

The paper conducts OLS regression analysis in the form of the following equation:

$$\text{Predicted Abnormal Stock Return on Meeting Date} = B_0 + B_1 * \text{Perceived_Conflict[False]}$$

Perceived_Conflict[False] is an indicator variable that is equal to 0 when the aforementioned conflict conditions are met: ISS fully supports management, GL does not fully support management, and all results favored management. The indicator variable is 1 otherwise. This form of regression implies that intercept B_0 is the mean predicted abnormal return for meetings with a conflict present and that B_1 is the difference between the mean abnormal return for meetings without a conflict against meetings with a conflict.

T-test of Excess Returns for Meetings with a Perceived ISS Conflict of Interest

This paper examines the impact on shareholder value of annual meetings with voting outcomes that indicate a conflict of interest stemming from ISS Consulting Services. To estimate this effect, the paper conducts a t-test of equality to 0 for the mean excess return experienced by a firm on meeting days that have the aforementioned ‘suspicious’ characteristics: ISS fully supported management, Glass Lewis did not fully support management, and all results favored management. In addition to conducting a t-test of equality to 0 for mean excess return on the event date (the meeting date), this paper conducts additional analysis to gain insight on the effect of these meetings relative to normal trading days. The paper examines and conducts t-tests of equality to 0 on the average excess returns observed in the 4 trading days before the meeting and the 4 trading days after for meetings with a perceived ISS Conflict of Interest. This analysis allows for a broader understanding of the significance of events by juxtaposing nearby observed excess returns.

Results and Discussion

Regression of Excess Return on PercievedConflict = True

This paper measures the impact on shareholder value of annual meetings with voting outcomes that indicate a conflict of interest stemming from ISS Consulting Services. To estimate this effect, the paper examines excess stock market reaction on a firm's meeting date and whether a meeting was classified as *PercievedConflict = True*.

PercievedConflict = True when *ISS_Fully_Supported_Management = True*,
GL_Fully_Supported_Management = False, and *All_Results_Favored_Mangement = True*.

These scenarios are isolated because there has been widespread speculation among investors, regulators, and public officials, that ISS is particularly affected by conflicts of interest due to the firm's consulting business. If investors thought this way, the stock market reaction to meetings that could reflect this conflict should, on average, be statistically negative. Meetings that would most likely reflect this particular conflict of interest harming investors would be meetings where ISS fully supports management, Glass Lewis does not fully support management, and all the ballot results favor management. The correlation between ISS recommendations and Glass Lewis recommendations is very high, so cases where there is a divergence could lead investors to suspect a conflict of interest. Moreover, the excess return for a meeting impacted by this conflict of interest could be negative because investors view one or more of the ballots passed as value destroying. ISS's alignment with management on what investors perceive to be value destroying ballots could signify a conflict of interest.

The paper examines the market reaction to meetings that have characteristics signifying an ISS conflict of interest. The dependent variable, *excessReturn*, is the daily excess return on the meeting date for each firm computed based on the CAPM market model. The coefficients of the risk factors are estimated using daily data over a period of a 252 day estimation window. To test whether the stock market reaction to shareholder meetings is associated with characteristics that signify an ISS conflict of interest, the paper regress excess returns on *Perceived_Conflict*.

$$excessReturn = \delta_0 + \delta_1 * Perceived_Conflict [True]$$

Table 1 Estimated dummy coefficients for Regression of Excess Return on *Perceived_Conflict*

Parameter	Estimate	Std Error	t-statistic	P-value
Intercept	-0.063969	0.035889	-1.78	0.0749*
Perceived_Conflict[True]	-0.089129	0.085822	-1.04	0.2992
Mean of excess returns = -0.07956	R-squared = 0.00077	F Ratio = 1.0785		
Root Mean Square Error = 1.220232	Adjusted R-squared = 5.61e-5	Prob > F = 0.2992		

Table 1 shows that the estimated coefficient for *Perceived_Conflict [True]* is -.089129 (t-stat = -1.04), which indicates a perceived conflict having a negative impact on shareholder value, but the estimate is not statistically significant. The intercept's estimate coefficient is -0.102857, which is statistically different from zero at $\alpha = .1$ (t-stat = -1.78). These results show a weak negative relationship: meetings with a perceived ISS conflict of interest lead to excess returns on the day of the meeting that are, on average, 0.089% lower than meetings without the perceived conflict (which are, on average, -0.064%).

T-test for mean excess return when PercievedConflict = True

This paper examines the impact on shareholder value of annual meetings with voting outcomes that indicate a conflict of interest stemming from ISS Consulting Services. To estimate this effect, the paper conducts a t-test for the mean excess return experienced by a firm on meeting days that have the aforementioned characteristics: ISS fully supported management, Glass Lewis did not fully support management, and all results favored management. In our sample, the mean excess return on a meeting day with those characteristics is -0.154144% and a two-sided t-test for that excess return being 0 yields a t-stat of -1.9194 and p-value of 0.0561. (A one-sided test for the mean excess return yields p-value of 0.0281). These results suggest that annual meetings with voting outcomes that indicate a conflict of interest stemming from ISS Consulting Services lead to a decrease in shareholder value. Additionally, in Table 2, this paper conducts an analysis of excess returns (calculated the same way as previously described) in the 4 trading days leading up to the meeting and the 4 trading days after the meeting. None of the excess returns on these days are significantly different from 0. The excess return is calculated on a daily basis and the event window is the day of the meeting because, unlike other events which may occur after trading day close, annual meetings typically occur between 9am-11am ET.

Table 2 Average Abnormal Returns & t-values of stocks with Perceived Conflicts of Interest

Before Proxy Vote			After Proxy Vote		
Days	AAR	t-test	Days	AAR	t-test
-4	0.0521247	0.4838	0	0.154144	-1.9194*
-3	-0.0720924	-0.7298	1	-0.0385	-0.5178
-2	-0.013891	-0.1469	2	-0.0769	-0.9258
-1	0.075205	0.8767	3	-0.0687	-1.0383
0	0.154144	-1.9194*	4	0.02371	0.3274

Conclusion

Proxy advisory firms have gained significant influence in recent history. Their effects on corporate governance cannot be understated, so it is important that shareholders gather more information about these firms, their methods, and potential conflicts of interest. Without a publicly disclosed list of relationships, it is impossible for the investor public to understand the impact proxy advisory firms can have on shareholder value. However, this research has shown at least a few interesting observations about shareholder voting outcomes. This paper finds that the excess return on the meeting date for a suspected conflict scenario is statistically negative, thus decreasing shareholder value. Pending future regulations on relationship disclosure requirements, it may be possible to accurately estimate the impact of conflicts of interest. Until then, institutional investors ought to be wary of the advice they pay for.

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-1	0.075205	0.8767	3	-0.0687	-1.0383
0	0.154144	-1.9194*	4	0.02371	0.3274

Related work

There is a significant body of literature on corporate governance issues related to proxy advisory firms. Several papers document the significant influence proxy firms have on shareholder voting patterns in several settings. Moreover, there has been research focusing on the existence and potential sources of conflicts of interest in proxy firms. While many researchers have determined that proxy firms have a substantial impact on shareholder voting, there has not been exhaustive empirical research on the negative effect of conflicts of interest within the industry.

In their *Outsourcing Shareholder Voting to Proxy Advisory Firms*, Larcker, McCall, and Ormazabal investigate 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.” They primarily analyze data from companies within the Russell 3000, and they specifically look into shareholder say-on-pay voting. The choice of examining say-on-pay voting was driven by the recent implementation of the Dodd-Frank Act, which required firms to annually vote on executive compensation. Larcker, McCall, and Ormazabal find that, consistent with other research, proxy advisory firms have a significant impact on voting outcomes for say-on-pay matters. Additionally, they find that many firms will alter their compensation programs ahead of a formal vote in a way that is expected to align with commonly-held preferences by proxy advisory firms. Moreover, Larcker, McCall, and Ormazabal determine that the stock market reaction to those compensation changes are statistically negative. Their results imply that the outsourcing of shareholder voting to proxy advisory firms decreases shareholder value. While their research documents the negative influence of proxy advisory firms, they do not focus

on the conflicts of interest present within certain proxy firms. Instead, they identify 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” as the source of proxy advisors’ negative impact on shareholder value.

In his *Outsourcing Corporate Governance: Conflicts of Interest Within the Proxy Advisory Industry*, Li claims to have “the first paper seeking to empirically examine whether and when conflicts of interest can arise from serving both shareholders and issuers.” His approach focuses on analyzing how recommendations by Institutional Shareholder Services (ISS) change when Glass Lewis starts covering a particular firm. His research focuses on the fact that ISS provides advisory services to institutional shareholders as well as consulting services to some management teams, while Glass Lewis only provides advisory services to institutional shareholders. So, he expects that when ISS is in an uncompetitive market (where they are the only one giving a recommendation), they are more likely to be biased in favor of the clients that they provide consulting services to due to their conflicts of interest. As evidence of this, he determines that after Glass Lewis starts covering one of these companies, ISS becomes less “friendly” to the firm. This implies that shareholders will more heavily scrutinize a recommendation from ISS in the event that the ISS recommendation disagrees with that of Glass Lewis (which overall tends to be less “friendly” to firms). So, Li asserts that “conflicts of interest are a real concern in the proxy advisory industry, and increasing competition can help to alleviate them to a certain extent.”

In their article *The power of proxy advisors: Myth or reality*, Choi, Fisch, and Kahan analyze the “significance of voting recommendations issued by four proxy advisory firms in connection with uncontested director elections.” They determine that these firms do have a meaningful impact on shareholder voting. They identify Institutional Shareholders Services and Glass Lewis as the most and second most powerful proxy advisory firms (respectively). More specifically they estimate that “an ISS recommendation shifts 6%-10% of shareholder votes.” Additionally, they conclude that “a major component of ISS’s influence stems from its role as an information agent, aggregating factors that its subscribers consider important.” Their research serves as a seminal piece, identifying the significant impact proxy firms have on shareholder voting.

In their article *Proxy Advisory Firms: The Economics of Selling Information to Voters*, Malenko and Malenko analyze how proxy advisors affect corporate decision-making. They examine several regulatory proposals on proxy advisors and conclude that “some suggested policies, such as reducing proxy advisors’ market power or decreasing litigation pressure, can have negative effects.” Moreover, they provide an overview of the rise in proxy advisory firms from a policy standpoint. They identify the 2003 SEC rule requiring mutual funds to vote in their clients’ best interests as a reason for the popularity of proxy advisory firms. Additionally, they credit the “growth in the volume and complexity” of corporate governance issues as a source of increased demand for the services. Their research presents a comprehensive overview of the proxy advisory firm industry.

Ma and Xiong, in their *Information Bias in the Proxy Advisory Market*, focus on the bias in the information sold by proxy advisory firms. They identify that “the proxy advisor provides

both unbiased and desirable voting advice when it has no conflicts of interest.” However, “in general, the proxy advisor sends biased voting advice, and there is no inherent link between information bias and desirability.” From a theoretical perspective, their article shows that there is the possibility for proxy advisory firms to increase shareholder value so long as “the nature of the shareholder voting is cooperative” and “the information seller in the voting context will not dilute the value of information.”

Hayne and Vance, in their *Information Intermediary or De Facto Standard Setter? Field Evidence on the Indirect and Direct Influence of Proxy Advisors*, analyze whether proxy advisory firms serve primarily as information providers or have a direct influence on firms’ executive compensation practices. They perform a field study and determine that proxy advisory firms play both roles: “we find that PAs are perceived as both information intermediaries and agenda setters and that these roles provide leverage to enable PAs to exercise significant influence over executive pay practices.” In many cases, there is evidence that boards yield to proxy advisory firms’ “best practices” even “in the absence of overt PA scrutiny or negative shareholder votes.” Moreover, they identify that proxy advisory firms suffer from conflicts of interest and do not thoroughly analyze each case, instead opting for a “one-size-fits-all approach.” Hayne and Vance’s paper significantly contributes to research on the impact of proxy advisory firms by outlining the sources of their power.

Malenko and Shen quantitatively analyze the extent of proxy advisor’s influence in their paper, *The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design*. They examined data from 2010 to 2011 and found that a negative say-on-pay recommendation from ISS “leads to a 25 percentage point reduction in say-on-pay voting support.” They quantify the

causal effect of proxy recommendations by using an ISS cutoff rule and applying a regression discontinuity design. Their results further underscore the significant influence proxy firms have on swaying shareholder votes.

In the Government Accountability Office's *Corporate Shareholder Meetings: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting*, several potential sources of conflicts of interest are identified within proxy advisory firms, specifically ISS. They describe the aspects of ISS's business model that potentially generate conflicts of interest: "ISS advises institutional investor clients on how to vote their proxies and at the same time provides consulting services to help corporations develop management proposals and improve their corporate governance." In the research, it is shown that, despite efforts by ISS to reduce that conflict of interest, "some industry analysts [they] contacted said there remains reason to question the steps' effectiveness." Additionally, the paper identifies several other areas of potential conflicts of interest, including proxy firms having "ownership interest" in or serving on the board of companies they are covering. This paper serves as a significant overview of conflicts of interest within proxy firms.

Rather than solely focusing on proxy advisory firms, Cuñat, Gine, and Guadalupe, in their paper, *The Vote is Cast: The Effect of Corporate Governance on Shareholder Value*, detail the impact of corporate governance, in general, on shareholder value. They apply a regression model on companies within the S&P1500 to find that passing a governance provision "generates a 1.3% abnormal return on the day of the vote." They also determine the impact of corporate governance decisions on long term shareholder value. Their research serves to highlight the significant influence corporate governance decisions have on shareholder value.

In their *Director Elections and the Role of Proxy Advisors*, Choi, Fisch, and Kahan examine the decision-making processes of several proxy advisory firms and identify how the structure could lead to such firms pursuing their own agenda. They find that there are vast differences between the criteria focused on by four prominent firms – Institutional Shareholder Services, Glass Lewis, PROXY Governance, and Egan-Jones. They determine that “ISS focuses on governance-related factors, PG on compensation-related factors, GL on audit/disclosure-related factors, and EJ on an eclectic mix of factors.” However, the authors identify that the differences between proxy firms may not be well understood by investors. They determine that “if these differences are not known, then proxy advisors may lack accountability for—and can pursue their own agenda in making—their voting recommendations, thereby impairing the effectiveness of the shareholder franchise.” This research highlights how proxy firms’ opaque decision-making processes could encourage conflicts of interest.

The body of literature on proxy advisors clearly identifies the outsized influence such firms exhibit. While progress has been made on identifying the presence of conflicts of interest, there has not been exhaustive research into the impact of such conflicts of interest on shareholder value.

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