Mr. Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
via SEC internet submission form

Re: File No. 4-725 - SEC Staff Roundtable on the Proxy Process

Dear Mr. Fields,

I am Assistant Professor of Finance at Warrington College of Business, the University of Florida. During my academic career, I have spent significant time studying and researching corporate governance and I welcome the opportunity to provide a submission to the roundtable.

The Securities and Exchange Commission has sought comment on the role of proxy advisors in the proxy process. The focus of my recent research is related to two of the questions posed by the SEC:

- *Whether there is sufficient transparency about a proxy advisory firm's voting policies and procedures so that companies, investors, and other market participants can understand how the advisory firm reached its voting recommendations on a particular matter, and whether comparisons of recommendations across similarly situated companies have value.*
- *Whether there are conflicts of interest, including with respect to related consulting services provided by proxy advisory firms, and, if so, whether those conflicts are adequately disclosed and mitigated.*

I have attached in full my research paper, titled "*Outsourcing Corporate Governance: Conflicts of Interest within the Proxy Advisory Industry,"* and I provide a brief overview of the paper hereafter.

Proxy advisors generally play a positive role in both the proxy process and capital markets. However, in light of the cost effective offering of those proxy advisors, regulatory guidance,[1] a growth in institutional shareholdings, and evidence that some investors may be overly reliant on their recommendations, the influence of proxy advisors continues to grow.[2] Consequently, it remains imperative that market participants are aware of any potential conflicts of interest within the industry and whether those conflicts are impeding the role of proxy advisors as independent providers of information and recommendations.

[1] In 2003, the SEC required 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.
[2] The effect of ISS's recommendations has been estimated between 13-30%, depending on the type of proposal (e.g., Bethel and Gillan, 2002; Cai, Garner, and Walkling, 2009; Iliev and Lowry, 2015; Malenko and Shen, 2016).

As an example, the leading advisory firm, ISS, provides consulting services to issuers as well as recommendations on how to vote at issuer AGMs to shareholders. A GAO study from 2007 observed that this potentially creates opportunities for making more favorable recommendations for its corporate clients. Essentially, the implicit threat of a negative (and influential) recommendation might spur issuers to use the consulting arm of the proxy advisor to avoid contested resolutions at their AGM by making an adverse recommendation less likely.

In the paper, I study potential conflicts of interest in proxy voting recommendations in a market dominated by an incumbent advisor that serves both corporations and investors. I find that for most types of proposals (e.g., shareholder proposals, governance- and compensation-related proposals submitted by management, and elections of directors that are nominated for the first time), competition from a new entrant reduces the incumbent advisor's favoritism towards management of potential corporate clients. Similar to other information intermediaries such as credit rating agencies, potentially biased advice by proxy advisors is shown to have real negative consequences, which allow management to enjoy greater private benefits, including higher executive compensation. These results suggest conflicts of interest are a real concern in the proxy advisory industry and increasing competition could help alleviate them.

The research I have conducted was not designed to pass judgement on the overall role that proxy advisors play in the proxy process. Instead, it was an attempt to explore whether potential conflicts of interests in the proxy advisory industry can negatively impact the quality of recommendations and analysis issued which, on the basis of my analysis, appears to be the case.

With the growth of institutional shareholdings in the United States, and the increasing role proxy advisors play as a result, it seems such potential conflicts of interests are worth greater discussion, oversight and scrutiny by the SEC.

I would be happy to provide more information or to discuss the issue with the Commission staff in advance of the Roundtable on November 15, 2018.

Sincerely,

Tao Li

Assistant Professor of Finance
Warrington College of Business
University of Florida

Outsourcing Corporate Governance: Conflicts of Interest Within the Proxy Advisory Industry*

Tao Li†

University of Florida

Abstract

Proxy advisory firms wield large influence with voting shareholders. However, conflicts of interest may arise when an advisor sells services to both investors and issuers. Using a unique data set on voting recommendations, I find that for most types of proposals, competition from a new entrant reduces favoritism towards management by an incumbent advisor that serves both corporations and investors. The results are not driven by factors that influence the entrant's coverage decision, such as the marginal cost of new coverage or previously biased recommendations by the incumbent. Similar to other information intermediaries, biased advice by proxy advisors is shown to have real negative consequences, which allow management to enjoy greater private benefits. These results suggest conflicts of interest are a real concern in the proxy advisory industry, and increasing competition could help alleviate them.

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†Assistant Professor of Finance, Warrington College of Business, University of Florida. Phone: [redacted], E-mail: [redacted], Webpage: `https://site.warrington.ufl.edu/tao-li`.

1 Introduction

Shareholder voting is a primary means by which investors can influence a company's operations and corporate governance. As institutional shareholders have become the dominant players in the stock market, they vote billions of shares each year on thousands of ballot items. Those diversified investors often lack proper incentives or necessary expertise to do research in order to vote in the best interests of clients, and many of them rely on the advice of proxy advisory firms. These are third-party advisors that provide independent proxy voting research and recommendations on each issue on a company's agenda.

Academic research has documented the influence proxy advisory firms exert on voting outcomes. Their recommendations are estimated to sway between 13-30% of shareholder votes, depending on the type of proposal (e.g., Bethel and Gillan, 2002; Cai, Garner, and Walkling, 2009). Industry participants have also commented on the power of these advisors. For example, Exxon Mobil Corporation recently stated that "proxy advisors hold a position of unparalleled influence," and estimated that "between 20-25% of the votes cast at ExxonMobil's most recent annual meeting were voted automatically in accordance with proxy advisor recommendations" (Rosenthal, 2012). Given their considerable clout, it is vital that these independent advisory firms issue accurate and unbiased recommendations because shareholder value may be adversely affected otherwise.

Investors and policymakers, however, are concerned about potential conflicts of interest inherent in some proxy advisors' business models. As an example, the leading advisory firm, Institutional Shareholder Services, Inc. ("ISS"), sells both proxy voting services to investors and consulting services to corporate issuers seeking assistance with proposals to be voted on by shareholders. The Government Accountability Office ("GAO") has observed that this potentially creates opportunities for making more favorable recommendations for its corporate clients (GAO, 2007). After dropping ISS's services in the mid-2000s, the Ohio Public Employees Retirement System—the 11th-largest public pension

fund in the U.S.—commented that "the thing that tipped us was [ISS's] actual or perceived conflicts due to the corporate consulting" (Starkman, 2006). A 2010 SEC Concept Release on the U.S. proxy voting system also remarked 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."

This is the first paper seeking to empirically examine whether and when conflicts of interest can arise from serving both shareholders and issuers. Entry into the proxy advisory market by Glass, Lewis & Co. ("Glass Lewis"), a major competitor offering no consulting services, has potentially disciplined ISS, the incumbent advisor. Since entering the market in early 2003, Glass Lewis has grown into a credible competitor of ISS, capturing a market share of over 40% in 2011, measured by client assets (see Figure 1). In the buyer-pay business model adopted by proxy advisory firms, institutional investors now have an outside option (a competitor's reports) generated by competition (Hörner, 2002). Given this competitor's reports, investors can make a more informed evaluation about the incumbent's truthfulness. Such increased market pressure is expected to affect the incumbent's subsequent judgments and recommendations.

I start by examining what factors drive Glass Lewis's coverage decision. Although its coverage is believed to be largely driven by client portfolios, Glass Lewis might have some discretion in choosing clients or firms with certain characteristics. Understanding these factors allows me to control for them or disentangle their effects when studying the impact of Glass Lewis's coverage on ISS's subsequent recommendations. The results show that Glass Lewis is more likely to cover larger companies with more institutional holdings, consistent with the fact that it is institutions who hire proxy advisory firms like Glass Lewis. The advisor also tends to cover better performing firms and those with higher corporate governance quality. Although coverage by ISS only marginally predicts Glass Lewis's coverage, it is more likely to initiate coverage of firms for which ISS issues potentially biased recommendations, as reflected in voting disagreements between investors and ISS. Furthermore, if a firm is held by

institutions whose portfolios are already substantially covered by Glass Lewis, it will have a relatively high probability of being covered. This is likely due to a lower marginal cost of coverage when the advisor already covers a large proportion of a potential client's portfolio.

A key contribution of this paper is to show empirically that increased competition brought by Glass Lewis's entry into the proxy advisory market has reduced ISS's favoritism to corporate managers. Using a difference-in-differences framework, I find that after Glass Lewis's initial coverage of a new firm, ISS begins to take a tougher stance towards its possible corporate clients (proxied by large firms), compared to non-client firms. Relative to major shareholder and management-sponsored proposals such as governance-related proposals and executive compensation plans, the effect of competition on uncontested director elections is weaker, consistent with the fact that voting guidelines for director elections, especially those for re-appointed director nominees, are more transparent, and there may be less room for bias without competition. However, if we separately examine first-time director nominees who potentially involve greater information asymmetry and uncertainty, the results suggest that competition makes ISS tougher with these new director nominees at possible client firms, proxied by large firms. I find similar results for director elections at underperforming firms, for which correct advice would be more valuable. Similar to "routine" director elections, I do not detect any effect of competition for routine, miscellaneous and social proposals.

A potential concern is that Glass Lewis's coverage might be a proxy for a potentially biased recommendation by ISS as the two variables are positively correlated. In other words, given market pressure, a potentially biased recommendation itself could lead to a change in ISS recommendations on this firm's future proposals. To disentangle this effect, I examine whether ISS's current recommendations are affected by its previously potentially biased recommendations for firms that are not covered by Glass Lewis. The results show that ISS's potentially biased recommendations *alone* are not likely to drive changes in ISS recommendations for the firm later, which suggests that competition from Glass Lewis does have a disciplinary effect. To address another concern that Glass Lewis might

have some discretion in choosing clients, in robustness analysis, I control for factors that predict the timing of Glass Lewis's coverage, following Naidu and Hornbeck (2014) and Chen et al. (2012). The results are similar to my main findings. These results are also robust to non-linear specifications using propensity score matching estimators similar to Guadalupe, Kuzmina and Thomas (2012).

Some may argue that there could be efficiency gains from combining the business consulting and proxy advisory services in the same firm. Although both ISS and Glass Lewis tend to rely on company filings and other publicly available sources to make their recommendations, the business model ISS adopts could lead to a unique information acquisition process—ISS's corporate clients could have received valuable advice and thus deserve a better recommendation. For example, assuming ISS has value-increasing advice on compensation policies, it makes sense that it would advise its institutional clients to vote for a compensation proposal that it helps to draft. Even in such a case, it alone cannot explain why competition would lead to a larger drop in ISS's support rate for its possible client firms, compared to control companies. In other words, in the absence of conflicts of interest, it would be difficult to explain why competition would differentially affect ISS's support rates for its possible client companies and non-client firms.

Shareholder value would be negative affected if biased recommendations have real negative consequences beyond effects on voting outcomes. It is thus important to study whether potential bias in ISS's recommendations has incremental impact on firm outcomes. In order to mitigate endogeneity concerns, I compare proposals with potentially biased recommendations from ISS that pass to those that fail within a narrow margin. Firms with such proposals that narrowly pass perform marginally worse subsequently. However, executives at these firms have higher abnormal compensation, higher growth in pay and more cash payments. This suggests that potential bias in ISS's recommendations allows managers to enjoy greater private benefits.

As an information intermediary in financial markets, proxy advisors play an important role in monitoring corporate governance practices at public firms, and providing objective advice to their

institutional clients. The failure of such functions can exacerbate agency problems and adversely affect shareholder value, as evidenced by the failure of credit ratings agencies before the recent financial crisis or the overly optimistic recommendations by stock analysts during the "dot-com bubble" in the early 2000s (e.g., Bolton, Freixas, and Shapiro, 2012; Barber, Lehavy, and Trueman, 2005). Furthermore, proxy advisory firms' coverage and recommendations can serve as a screening mechanism for activist investors, who often seek changes in target firms' operations and corporate governance (Jiang, Li, and Mei, 2016). Relatedly, I show that when firms are targeted by activists in the previous year, the likelihood that ISS's potential bias occurs drops by almost three percentage points. Interestingly, the effect is stronger for firms targeted by activist hedge funds and for companies going through proxy contests, consistent with the notion that activist hedge funds are an effective force in corporate governance (e.g., Brav, Jiang, Partnoy, and Thomas, 2008; Fos, 2015).

Overall, my results suggest that conflicts of interest is a real concern in the proxy advisory industry, and increasing competition can help to alleviate them to a certain extent. Although increased competition could reduce the magnitude of these conflicts, competition itself may not be enough to completely eliminate them. Competition is likely to remain imperfect in financial markets if agency problems exist. Bolton and Scharfstein (1990) study imperfect competition under moral hazard, and their "theory of predation" suggests the termination threat of a firm's funding amid poor performance is costly in a competitive environment. In my setting, it is asymmetric information that makes some institutional investors unsure about the quality of the new entrant's services, which can enable the incumbent proxy advisor to keep some of its market power. Because investment advisers are required to vote in the best interests of clients (a fiduciary duty), some institutions may find it safer to buy ISS's services even if they prefer the competitor's. As the more powerful player, ISS's "certification effect" could be valuable in case a lawsuit occurs. Relatedly, Malenko and Malenko (2016) find that decreasing the incumbent proxy advisor's market power could be detrimental if the advisor's information is not precise.

Finally, it is important to note that while I find ISS's advisory services can be improved when it makes recommendations for possible client firms, this paper does not discredit ISS's positive effects on financial markets overall. Proxy advisory firms provide a range of services that investment advisers find useful in fulfilling their proxy voting responsibilities, as detailed in the SEC's 2010 Concept Release.

This study contributes to the literature in several ways. First, it is related to a large literature on information intermediaries in both microeconomics and finance (e.g., Biglaiser, 1993; Lizzeri, 1999). A parallel topic within this literature is credit ratings agencies. Bolton, Freixas, and Shapiro (2012) analyze credit ratings agencies' conflicts of interest, and find that increased competition leads to more ratings inflation, as issuers are able to more easily shop for ratings. Becker and Milbourn (2011) provide empirical support, finding that competition in corporate bond markets contributes to higher and less informative ratings. This work also relates to the literature on conflicts of interest in other financial markets. For example, Davis and Kim (2007) study mutual funds' business ties with their portfolio firms, and find a positive relation between business ties and the propensity to vote with management. Hong and Kacperczyk (2010) show that competition among stock analysts reduces their optimism bias in their research.

Regarding the proxy advisory industry itself, a handful of papers have documented a strong association between ISS's recommendations and shareholder votes. The effect of ISS's recommendations has been estimated between 13-30%, depending on the type of proposal (e.g., Bethel and Gillan, 2002; Cai, Garner, and Walkling, 2009; Iliev and Lowry, 2015; Malenko and Shen, 2016). To my knowledge, only a few papers have studied the effects of Glass Lewis's recommendations, in addition to ISS's. Choi, Fisch, and Kahan (2009) show that the outcomes of director elections in 2005 and 2006 are influenced by ISS and Glass Lewis's recommendations. Ertimur, Ferri, and Oesch (2013) and Larker, McCall, and Ormazabal (2015) focus on Say-on-Pay votes in 2011, and they find a negative recommendation from proxy advisors is associated with more votes against the Say-on-Pay proposal. These papers, however, explore only a small portion of the data. My paper is the first to use Glass

Lewis's comprehensive voting recommendations for the period 2004-2011. Together with ISS's voting recommendations, this panel dataset enables me to study the impact of competition on the incumbent advisor's (ISS's) recommendations during that period.

This paper also relates to the literature on shareholder activism (e.g., Gillan and Starks, 2007; Brav, Jiang, Partnoy, and Thomas, 2008; Klein and Zur, 2009; He and Li, 2016). As minority shareholders, activist investors often rely on proxy advisory firms to overcome coordination and information problems.[1] Alexander, Chen, Seppi, and Spatt (2010) find that a pro-dissident recommendation from ISS is a significant predictor of a dissident victory in proxy contests.

2 Hypothesis Development

In this section, I provide a simple theoretical framework to develop my hypotheses, which will be tested in the empirical sections. Conflicts of interest may arise when an incumbent proxy advisory firm (ISS in this case) sells both proxy voting services to investors and consulting services to issuers seeking assistance with proposals to be voted on by shareholders. In order to generate more revenue, the advisory firm is tempted to offer more favorable voting recommendations for its corporate clients, everything else being equal. However, there is some probability that institutional investors will discover that the advisory firm did not act in good faith by issuing biased recommendations.[2] And in that state of the world, the advisor is punished as investors will refuse to buy its reports in future periods. The advisory firm thus suffers an expected reputation cost, which equals the present value of all future revenue from proxy services.

When a competitor that does not offer corporate services enters the market, institutional investors now have an outside option created by competition (Hörner, 2002). Investors will be able to observe

[1] In addition to voting recommendations, researchers have studied other forms of market solutions. For example, Christoffersen, Geczy, Musto, and Reed (2007) and Aggarwal, Saffi and Sturgess (2014) show how the equity lending market can mitigate informational frictions in proxy voting.

[2] Recent high-profile shareholder lawsuits for breach of fiduciary duty involve Janus Capital Group Inc. and the AXA Group Mutual Funds.

the competitor's report, and make a more informed guess about the incumbent advisor's truthfulness. When the two advisors disagree on their recommendations, investors may examine the incumbent's report more carefully. Choi, Fisch, and Kahan (2009) suggest that some investors automatically vote for management proposals if multiple advisors issue positive recommendations, but not if one of them issues a negative recommendation. The disciplinary effect brought by competition (a higher probability of getting caught for issuing biased recommendations) will thus lead to less bias by the incumbent advisor.

It is important to note that competition is expected to bring a larger change in the incumbent advisor's recommendations for its corporate clients versus non-client firms. The new entrant introduces a universal standard for all corporations, which pressures the incumbent to treat both groups of firms more equally.

In theory, when the incumbent advisor becomes less biased, it should lose corporate clients due to diminished benefits the recommendations bring to these firms. It would be interesting to study such an effect if we had the identity of the clients. As discussed in Subsection 5.1.1, however, the incumbent ISS does not disclose a list of its clients, nor is it possible to hand-collect client names as no firm has disclosed its use of ISS's services.

2.1 Main hypotheses

Having discussed the theoretical underpinnings, I proceed to outline the major hypotheses below.

Hypothesis 1 *Increased competition lowers the incumbent advisor's support rate for its corporate clients, compared to non-client firms.*

As Glass Lewis, the new entrant without corporate clients, entered the marketplace, it should treat ISS's consulting clients and non-client firms equally. This pressures ISS to treat both groups of companies more equally, leading to a larger drop in its support rate for client firms. It is possible that

ISS's corporate clients might have received valuable advice or initially had better governance quality. However, this alone cannot explain why there would be a larger drop in ISS's support rate for its client firms, compared to non-client companies.

I note that although this paper focuses on how competition affects ISS's advice for existing clients versus non-client firms, increased competition could also affect its future clients. For instance, analysts may write reports favoring companies from which their affiliated investment bank could obtain underwriting business in the future (e.g., Michaely and Womack, 1999). It would be interesting to examine this in future studies.

Hypothesis 2 *The drop in the incumbent advisor's support rate for its corporate clients is smaller for proposal types associated with less information asymmetry or importance.*

It is reasonable to believe that the differential change in the incumbent's recommendations is expected to be smaller for proposal types that involve less information asymmetry. Uncontested director election is one type of such proposals. Proxy advisors' policy guidelines are well developed for uncontested director elections, and institutional investors in general have a good idea about who they should vote for. For example, ISS generally recommends against a director if he attends fewer than 75% of board meetings. Directors have a support rate close to 95% on average, as my data shows. Due to the high reputation cost relative to additional consulting revenue, the incumbent advisor would be less likely to issue biased recommendations for its consulting clients even in the absence of additional information brought by the competitor. However, elections for first-time directors typically involve more information asymmetry and uncertainty, and competition should have a significant effect on the quality of the incumbent's advice.

Similarly, the differential drop in the incumbent advisor's recommendations is expected to be smaller for proposals that firms may deem as less important, such as management routine and miscellaneous proposals. These proposals are more transparent as well, which have an average shareholder

approval rate of 92.4%. Inflating recommendations for such proposals would bring little additional revenue from consulting clients. Social and miscellaneous proposals sponsored by shareholders have a similar pattern, with the rejection rate for them being at 97.2% on average.

It might not be always the case that there is more bias in advice with higher information asymmetry. This is because although correct advice is more valuable amid higher information asymmetry, it is also more costly to issue correct recommendations. For proposals with higher information asymmetry, however, investors generally have a far less precise guess of the correct recommendation than ISS itself. Thus there is potentially more room for bias for such proposals if ISS exerts reasonable effects.

2.2 Institutional background: Concerns over conflicts of interest

The most common concern about proxy advisory firms, especially ISS, relates to the potential for conflicts of interest inherent in their business models. As discussed above, ISS provides services to both institutional investors and corporate issuers on the same governance issues, while Glass Lewis, which entered the market in 2003, serves only institutional clients. A GAO study summarizes ISS's potential conflicts of interest as follows: "For example, some industry professionals stated that ISS could help a corporate client design an executive compensation proposal to be voted on by shareholders and subsequently make a recommendation to investor clients to vote for this proposal. Some industry professionals also contend that corporations could feel obligated to subscribe to ISS's consulting services in order to obtain favorable proxy vote recommendations on their proposals and favorable corporate governance ratings" (GAO, 2007). Section A of the Online Appendix provides an example of such potential conflicts of interest.

In the early 1990s, ISS responded to these public charges by installing a "Chinese wall" between its proxy advisory services and corporate consulting services, creating a separate subsidiary, ISS Corporate Solutions Inc. ("ICS"), to serve corporate issuers (Crystal, 1994). According to ISS, the "Chinese wall" includes "legal, physical and technological separations." ISS also makes substantial disclosure

to its institutional clients, as well as adopts a "Code of Ethics" that applies to all employees regarding conflicts of interest. However, these measures do not solve inherent conflicts of interest embedded in its business model (see Tuch (2014) for a review of the failure of such "Chinese walls" in the financial services industry). This paper studies whether ISS's potential conflicts could become actual conflicts, and whether increased competition from Glass Lewis has mitigated them.

Although this type of conflict is widely considered the most damaging, by no means it is the only source of potential conflicts of interest. For example, the fact that proxy advisory firms are owned by parent companies providing other financial services to clients has drawn scrutiny. Before April 2014, ISS was owned by MSCI Inc., a leading provider of investment decision support tools to institutions, and Glass Lewis is partly owned by the Ontario Teachers' Pension Plan Board, a pension fund in Canada. These issues are beyond the scope of this paper. Section B of the Online Appendix provides a detailed account of important market and regulatory developments in the proxy advisory industry.

3 Data Description

This study draws data from a number of sources. My primary datasets are ISS's Voting Analytics database and Glass Lewis's Proxy Paper database. Both datasets cover annual and special shareholder meetings during the period 2004-2011. Voting Analytics provides the identity of companies, description of ballot items, shareholder meeting dates, management and ISS recommendations, and the number of "For" and "Withhold/Against" votes, as well as other information. Before 2005, the dataset includes most of the Russell 3000 companies, and the coverage becomes universal after 2005. This dataset is becoming popular among corporate governance experts, as well as academics. Most published papers use only data before 2005 (e.g., Cai, Garner, and Walkling, 2009; Matvos and Ostrovsky, 2010). My dataset on Voting Analytics is comprehensive.

Glass Lewis's Proxy Paper database contains similar information to Voting Analytics. (It also

covers shareholder meetings at mutual fund companies.) My paper is unique in its reliance upon Glass Lewis in addition to Voting Analytics, and only this allows for the analysis of differential changes in ISS's recommendations under competition for its possible corporate clients (proxied by large firms) versus non-client firms. Prior research has only explored a small portion of the data (e.g., Choi, Fisch, and Kahan, 2009; Ertimur, Ferri, and Oesch, 2013). My own work matches these two databases using CUSIP, meeting date and ballot item number. I exclude proxy contests which yield 26,304 shareholder meetings at 4,807 unique companies.[3]

[Insert Figure 1 here.]

For the same period, I collect numbers on ISS and Glass Lewis's institutional clients, total client assets, as well as numbers of U.S. meetings covered, all of which are annual figures. The main sources are LexisNexis and Glass Lewis's website. Evolution of Glass Lewis's market share based on client assets is plotted in Figure 1.

My primary data source to identify all activism events is SharkRepellent, a data provider that specializes in corporate governance. I collect the following information: the target company's identity, the event date—the activist's filing date of its Schedule 13D or the date of its press release, an indicator for whether the activist is a hedge fund, and a flag for proxy contests. A Schedule 13D filing is required by the SEC when a stockholder's beneficial ownership is above 5% of outstanding stock and that investor plans to launch activism. Some 13Ds are filed without specific purposes, which are excluded from our main analysis in Section 7. However, including these events yields similar results.

I obtain additional data from the following sources: stock information from Center in Research for Security Prices, company accounting data from Compustat, Top-5 executives' compensation and stock

[3]This paper studies proposals at uncontested meetings. Proxy contests are excluded from this study mainly because both datasets from ISS and Glass Lewis cover only a small proportion of contested meetings. In addition, proxy contests rarely occurred multiple times at the same company during 2004-2011 (93 events per year on average at U.S. public firms), making it difficult to examine the effects of competition on voting recommendations at the firm level. Interested readers are referred to Fos (2015), and Fos and Jiang (2015).

holdings from ExecuComp, firm governance characteristics and the identify of sponsors for shareholder proposals from RiskMetrics, and institutional holdings from Thomson Reuters (13F). Voting data are matched with these datasets on CUSIP and fiscal year. This is my main dataset. Additionally, I match director characteristics, also obtained from RiskMetrics, to the voting data, using the director's last name, CUSIP and year.

3.1 Voting and company characteristics

Every public company in the U.S. holds an annual general meeting to elect the Board of Directors and to transact other business such as executive compensation plans, ratification of auditors, and mergers and acquisitions. These are categorized as management proposals. Shareholders who own more than $2,000 in stock or 1% of the firm are permitted to sponsor non-binding proposals, which will be added to the meeting agenda. In my sample, 90% of companies use a plurality voting system for directors under which shareholders can vote "For", "Withhold" or "Abstain." ISS and Glass Lewis make "For" or "Withhold" recommendations. The remaining 10% of firms use a majority voting rule under which ISS and Glass Lewis recommend "For" or "Against." Under a plurality rule, a director will be elected in uncontested meetings even if she receives less than 50% of the base. Under a majority rule, a director has to step down if she fails to receive 50% of total votes. The base for director elections is usually defined as "For+Against/Withhold." Thus I measure director election outcomes as the number of "Against/Withhold" votes divided by the sum of "For" and "Against/Withhold" votes. ISS and Glass Lewis recommend "For" or "Against" for all other ballot items. The base for these items is usually "For+Against+Abstain."

[Insert Table 1 here.]

Panel A of Table 1 reports the yearly frequencies of major shareholder and management proposals. Following ISS's categorization, shareholder-sponsored proposals are grouped into two sub-categories:

Governance-related and Other. The former category includes proposals regarding the Board of Directors, governance issues such as shareholder rights plan (poison pill) and majority voting for directors, as well as compensation issues (Danielson and Karpoff, 1998). Other proposals include those related to social, environmental, human rights, and miscellaneous issues. During the sample period, 4,759 proposals are sponsored by shareholders, of which about 65% are related to governance issues. Management proposals are categorized into five sub-categories: Governance-related, Executive Compensation Plan, Capitalization, Director Election, and Other. The first category includes proposals related to the Board of Directors and anti-takeover issues. Executive Compensation Plan involves equity-based and cash incentive plans, deferred compensation, and stock purchase plans. Capitalization proposals are related to stock authorization, share repurchases/dividends, and takeover/reorganization. Proposals in the Other category include routine proposals such as auditor ratification and miscellaneous proposals. Mandatory advisory votes on executive compensation are excluded from the sample as these started only in 2011—the last year of my sample period. In the sample, Director Election is by far the largest category, representing 77.9% of all management proposals.

In Panel B of Table 1, for each company-year pair I calculate the percent of positive (negative) recommendations for each type of shareholder (management) proposals. They are done for ISS and Glass Lewis separately for the period 2004-2011. Panel B shows that 79.0% of the times ISS issues positive recommendations for governance-related shareholder proposals, 8.0 percentage points higher than Glass Lewis (t-statistic = 7.44). For social and miscellaneous proposals, ISS appears to support shareholders much more frequently than Glass Lewis, at 36.0% versus 14.0% (t-statistic of the difference = 18.04). For management proposals, ISS issues negative recommendations 6.0-19.0% of the times, lower than Glass Lewis's 7.0-23.0% for each category. Other than governance-related proposals and the routine and miscellaneous category, the differences are significant at the 1% level.

[Insert Table 2 here.]

In the formal regression tests, I control for previous-year firm performance using both market-based and accounting-based returns. The market-based return is a firm's stock return in the 12 months prior to its annual meeting. I also use 1-year excess return, 3-year excess return and abnormal return from the Fama-French four factor model. The results are similar and are not reported due to space. For the accounting-based return, I use return on assets (ROA) in the previous fiscal year, which is defined as earnings before interest, taxes, depreciation, and amortization (EBITDA) divided by total assets. Table 2 reports that for my sample firms, the average return on assets is 9.0%, while the previous-year stock return is about 13.3% on average.

Since 2007, RiskMetrics no longer produces the governance index of Gompers, Ishii and Metrick (2003). I use an alternative governance indicator which equals 1 if a company has both a classified board and a poison pill (Bebchuk and Cohen, 2005; Cai, Garner, and Walkling, 2009). A combination of a classified board and a poison pill makes corporate control change more difficult, and is seen as a decrease in corporate governance quality. As shown in Table 2, 28.7% of the sample firms have both policies in place. In Table 2, I also collect information on board size, the percent of independent directors, and institutional and management holdings. The median board has nine members and comprises 75% independent directors. Institutional investors hold almost three-quarters of the outstanding stock. These figures are consistent with findings in the extant literature (e.g., Cai, Garner and Walkling, 2009).

As in Hartzell, Ofek and Yermack (2004), I use executive compensation as another measure of corporate governance. I estimate abnormal compensation as the residual from a linear compensation regression of all ExecuComp firms during my sample period. Firm size (log assets), prior-year stock return, and industry and year dummies are included as independent variables.

4 Determinants of Glass Lewis's Coverage

This section studies what factors drive Glass Lewis's coverage decision. Although its coverage is believed to be mainly driven by client portfolios, the advisor could potentially pick clients or companies with certain attributes. Understanding these characteristics allows me to control for them or disentangle their effects when studying the impact of Glass Lewis's coverage on ISS's recommendations in Section 5. Table 3 reports results from estimating a probit regression that predicts Glass Lewis's coverage, in which the set of regressors include ISS's coverage, firm size, performance metrics, executive compensation measures, governance indicators, institutional and management ownership. Each column displays the coefficients (and their associated marginal probabilities) representing the marginal effect of each regressor on the likelihood of coverage by Glass Lewis.

[Insert Table 3 here.]

Column 1 shows that Glass Lewis is 1.7 percentage points more likely to cover firms that are already covered by ISS. However, the coefficient estimate is significant only at the 10% level. Larger firms with higher institutional ownership are also more likely to be covered by Glass Lewis. A one-standard deviation increase in institutional ownership is associated with an increase in the marginal probability of 0.8%. This is intuitive because it is institutional investors who hire proxy advisors like Glass Lewis. A larger institutional shareholder base thus increases the chance that the firm will be covered by Glass Lewis. The coefficient estimates for *Prior-year stock return*, *Cash/total compensation*, *Classified board & poison pill*, and *Ratio of independent directors* suggest that Glass Lewis tend to cover better performing companies, as well as firms with higher governance quality.

In column 2 of Table 3, I examine whether Glass Lewis is more or less likely to cover firms for which ISS provides potentially biased recommendations, controlling for the same covariates as in column 1. The key independent variable, *Potentially biased recommendation by ISS in* t-1, is an indicator equal to 1 if ISS issues a "For" ("Against") recommendation for a management (shareholder) proposal in the

previous year, but the vote fails (passes). This is a "market proxy" for potential bias in ISS's advice. In a relatively efficient voting market, institutional voters would be more likely to disagree with ISS if it provides a biased recommendation for a proposal.[4] The coefficient estimate suggests that firms for which ISS issues potentially biased recommendations tend to attract Glass Lewis's coverage, with the marginal probability being 2.8%. This suggests that Glass Lewis might cover firms for which there is a higher demand for their alternative voting services. Estimates for all other covariates are similar to those in column 1.

In column 3, I use the Thomson Reuters 13F ownership data to study whether the composition of a potential institutional client's portfolio drives Glass Lewis's coverage. Interestingly, even conditioning on institutional ownership, if a company is held by more institutions that already have Glass Lewis cover more than 50% of their portfolio firms, then it will be more likely to be covered as well. For a one-standard deviation increase in the number of institutions that hold the firm and that already have Glass Lewis cover over 50% of their portfolios, the marginal probability of coverage increases by 8.4%. (The result is similar if this 50% threshold is changed to 75%.) This is likely due to the fact that the marginal cost of covering a new firm will be lower when an advisor already covers a substantial part of a potential institutional client's portfolio.

To further compare ISS and Glass Lewis's coverage decisions, I test whether companies covered by ISS and Glass Lewis have different characteristics. Untabulated results show that relative to firms covered by ISS, those covered by Glass Lewis on average have significantly higher profitability, as measured by return on assets. Companies covered by Glass Lewis also have a higher leverage ratio, a faster growth of executive compensation, and a higher institutional ownership. All of these differences are significant at the 5% level. However, the differences are not significant for other major characteristics. Overall, relative to ISS, Glass Lewis appears to initiate coverage of firms with higher

[4] It is worth noting that this market measure is a proxy, which might be non-zero even if ISS issues an unbiased recommendation for a particular proposal due to differences in beliefs between investors and ISS. However, it is reasonable to believe ISS is more likely to be biased when disagreements occur as institutional investors are sophisticated players, and at least some of them understand ISS's incentives.

profitability and institutional ownership, although these firms are riskier and experience more rapid growth of executive compensation.

5 Effects of Glass Lewis's Coverage

5.1 Estimation Strategy: Difference-in-Differences

Having studied Glass Lewis's coverage decision, we now proceed to examine whether ISS adjusts its recommendations for a corporate client after Glass Lewis begins to cover that firm for the first time. When Glass Lewis begins to cover a company, this creates a shock to ISS's voting recommendations for the firm. As discussed in Section 2, Glass Lewis's coverage can provide investors an alternative source of information, and ISS may adjust its recommendations in subsequent years for that company. This effect would be more pronounced if this company is its corporate client as it is more likely to receive a biased recommendation from ISS in the absence of competition.[5] To evaluate this effect, I run the following regression:

$$\begin{aligned} ISS_Rec_{it} = \alpha + \theta GL_Cover_{it-1} + \lambda GL_Cover_{it-1} \cdot Client_{it} \\ + \rho Client_{it} + X'_{it}\beta + \psi_i + \eta_t + \eta_j + \epsilon_{it} \end{aligned} \tag{1}$$

In equation (1), the dependent variable is ISS's recommendations for firm i's proposals in year t, GL_Cover_{it-1} is a dummy indicating Glass Lewis's new coverage in year $t-1$,[6] $Client_{it}$ is an indicator variable equal to 1 if company i is ISS's corporate client in year t, and X_{it} is a vector of firm attributes defined in Table 2. Time fixed-effects η_t control for economy-wide trends, and company fixed-effects

[5] These clients contribute to a significant portion of ISS's profit—30% of ISS's total revenue in 2013 came from consulting services (see MSCI Inc.'s 2013 annual report).

[6] I use Glass Lewis's new coverage in year $t-1$ not t because Glass Lewis sometimes makes voting recommendations later than ISS in the proxy season. ISS thus may not know which companies Glass Lewis covers in the same year. However, ISS is more likely to learn this in the following year, through Glass Lewis's publications and their institutional clients.

ψ_i control for all time-invariant firm-level variables. Standard errors are clustered at the firm level. The coefficient of interest λ, a difference-in-differences estimator, measures the differential impacts of competition on ISS's recommendations for its client firms versus non-client firms before and after coverage by Glass Lewis. As ISS's voting recommendations for different ballot items may respond to competitive pressure differently, I run this regression separately for five major individual ballot categories: governance-related proposals, executive compensation plans, capitalization proposals, director elections, and Other proposals. This is consistent with ISS's broad categorization, as discussed in Section 3. Importantly, I also include proposal-type fixed effects, η_j, when analyzing each ballot category except for director elections. This is because each of these categories includes proposals from a wide spectrum and they may differ in terms of importance, their effects on the firm, as well as shareholder friendliness. In addition, during the sample period, there may also be changes in the types of proposals at the firm level; for example, the issues raised by the sponsors and how they are written could change over time. Including proposal-type fixed effects helps alleviate these concerns.

5.1.1 Proxy for corporate clients

ISS does not publicly disclose a comprehensive list of its corporate clients due to confidentiality considerations. Although for compliance purposes, its institutional clients have the right to request a list of the corporate clients, ISS has insisted that the list "may not be used for research purposes."[7] However, it does state on its corporate services portal that "ICS works with more than 1,100 clients located in the U.S., Canada, U.K., Europe and Asia." It is reasonable to believe that a majority of these corporations are based in the U.S. as ICS began to provide consulting services in other countries only recently. As discussed in Section B of the Online Appendix, the largest fraction of ISS's consulting revenue comes from selling its compensation models. Intuition suggests that the most likely

[7]Due to a confidentiality agreement with ISS, I am not allowed to use the exact list of its clients. Manual collection of data on ISS's corporate clients appears to be infeasible. To the best of my knowledge, no listed company in the U.S. has publicly disclosed its use of ISS's corporate services.

corporate client of ISS is a large and profitable firm that can afford to pay for these services. In fact, according to ISS, a great majority of their corporate clients are S&P 500 firms, and a majority of the rest come from S&P 1500 firms. ISS issues recommendations for a company when its institutional clients have significant holdings in the firm. Given that most of ISS's institutional clients are large fund companies, many of which are indexers and quasi-indexers, I believe the largest 1,000 firms by assets are a reasonable proxy for ISS's corporate clients. Although this criterion may slightly overstate the number of its consulting clients in earlier years, using the largest 25% of Russell 3000 firms actually yields stronger results.

It is worth noting that adding proposal-type fixed effects, η_j, also mitigates the concern that using large firms as a proxy for ISS's corporate clients may not perfectly capture ISS's clientele. The competition from Glass Lewis arrived just after significant changes in disclosure and governance rules for U.S. firms (e.g., the Sarbanes-Oxley Act), which might lead to more shareholder-friendly management proposals and better-positioned shareholder proposals for some firms, especially larger ones. Proposal-type fixed effects control for such possible changes.

5.1.2 Results

Column 1a, Panel A of Table 4 reports difference-in-differences estimates for governance-related shareholder proposals. The dependent variable is an indicator equal to 1 if ISS issues a positive recommendation for a shareholder-sponsored proposal. In addition to major firm characteristics and fixed-effects, I also include the types of proposal sponsors. That is, whether the sponsor is a labor union, a public pension fund, a religious group or an investment manager. The coefficient estimate for the interaction term implies that after Glass Lewis's initial coverage, ISS's average "For" recommendation for shareholder proposals at large firms, a proxy for its clients, increases by 11.9 percentage points, compared to control companies. As the management almost always recommended against shareholder propos-

als,[8] this suggests that ISS is more likely to be lenient with its possible corporate clients before Glass Lewis brings its own governance standards to the firms, after which it would be more difficult for ISS to treat client firms more favorably. The magnitude is also economically significant, as ISS's overall positive recommendation for shareholder governance proposals is about 79%. Interestingly, the positive coefficient on the growth in executive compensation indicates that ISS tends to favor shareholder governance measures when the management is perceived as more entrenched. Estimates for the types of sponsors reveal that ISS is more likely to support proposals sponsored by labor unions. Labor union pension funds often act as activist investors and advocate for worker interests, as documented by Agrawal (2012). This is also consistent with ISS's relatively high support rate for non-governance shareholder proposals (shown in Table 1), many of which are proposed by labor unions.

[Insert Table 4 here.]

Similarly, as shown in column 2a, ISS's negative recommendations for governance-related proposals submitted by management at possible client firms (proxied by large companies), increase by 2.7 percentage points on average after Glass Lewis begins to cover them, relative to control firms. The magnitude appears to be considerably smaller than that for shareholder-sponsored proposals. However, considering that ISS makes negative recommendations for management-sponsored proposals on governance 10% of the times, this change is actually sizable in relative terms.

The effects of Glass Lewis's coverage on executive compensation plans and capitalization proposals are presented in Panel B. Column 1a (2a) shows that ISS's negative recommendations for compensation plans (capitalization proposals) at possible corporate clients (proxied by large firms), grow by 4.3 percentage points (2.9 percentage points) after Glass Lewis begins to cover them, relative to ISS's non-client firms. The magnitude is large, considering that ISS opposes compensation plans and capitalization proposals 19% and 12% of the times, respectively.

[8] When the management/board supports a shareholder proposal, the board will typically convert the proposal into a management proposal.

Column 1a, Panel C presents results for all director elections. I fail to identify any differential impacts of Glass Lewis's coverage on large firms versus control companies. The coefficient on the interaction term is small and statistically insignificant. The contrast with governance proposals, compensation plans or capitalization proposals is not entirely surprising. Compared to these proposal types, uncontested director elections, especially those for re-appointed directors, tend to be more transparent. Both ISS and Glass Lewis have a set of established guidelines regarding director elections (while their guidelines on other proposal types generally are less developed and often considered case-by-case), and institutional investors typically have a reasonable expectation on how to vote their shares for these directors. Thus there may be less room for bias in recommendations without competition.

As shown in Fos, Li, and Tsoutsoura (2016), however, directors appear to care about elections, and elections have a meaningful effect on directors' decisions on governance issues. Given the importance of director elections, I further exploit heterogeneity in the director election process. Column 2a, Panel C shows results for a subsample of first-time director nominees. The lack of track record for these nominees likely introduces greater information asymmetry. The coefficient for the interaction term suggests that competition makes ISS tougher with first-time director nominees at possible client firms (proxied by large companies), compared to non-client firms. Similarly, unreported results also show that under competition, ISS is more likely to oppose director nominees when a large company underperforms relative to its peers, measured by return on assets or the prior-year stock return. This is consistent with correct advice from ISS being more valuable under these circumstances.

Lastly, I examine how competition affects ISS's recommendations for Other proposals. Panel D of Table 4 reports that for both shareholder and management-sponsored proposals, there is little evidence that Glass Lewis's entry affects ISS's recommendations for its possible clients (proxied by large firms) and control firms differentially. As the majority of these proposals are routine/miscellaneous or social ones, investors usually overwhelmingly approve or reject them (the approval rate for such management proposals is 92.4%, and the rejection rate for such shareholder proposals is 97.2%), it would not pay

to issue biased recommendations for such proposals submitted by client firms.

Overall, the results suggest that increased competition makes the incumbent advisor, ISS, tougher with corporate managers, with much of the effect for its possible corporate clients, proxied by large firms. It is possible that there are efficiency gains from combining the business consulting and proxy advisory activities in the same firm. It might be that ISS's corporate clients could have received more valuable advice or initially had better governance quality. For example, assuming ISS provides value-increasing advice on remuneration policies, it makes sense that it would advise its institutional clients to vote for a compensation proposal that it helps to draft. Even in such a case, it alone cannot explain why competition would lead to a larger drop in ISS's support rate for its possible client firms (proxied by large firms), compared to non-client companies. In other words, in the absence of conflicts of interest, it would be hard to explain why competition should differentially affect ISS's support rates for its possible client companies and control firms.

5.1.3 Firm characteristics around Glass Lewis's coverage

In order for the difference-in-differences estimation to work, there should be no difference in pre-existing trends in ISS recommendations for proposals between firms that are covered and not covered by Glass Lewis. For each of the eight proposal types studied in this paper, the average ISS recommendation is plotted for firms covered and not covered by Glass Lewis from two years before the coverage starts to the year of coverage. For all proposal types, ISS recommendations for the two groups exhibit parallel trends before Glass Lewis initiates coverage.

[Insert Table 5 here.]

I further provide statistics on large firms (a proxy for ISS clients) before and after competition from Glass Lewis is introduced. Column 1, Table 5 reports changes in firm characteristics (and their associated t-statistics) for large firms covered by Glass Lewis. It appears that after Glass Lewis

initiates coverage of a company, the cash portion of the firm's executive compensation goes down by 2.4 percentage points. However, this could be due to a secular trend in the mix of compensation. Column 2 shows that for large firms not covered by Glass Lewis, their cash portion of executive pay also drops by 1.9 percentage points. Interestingly, institutional ownership for covered firms increases by 1.2 percentage points (t-statistic = 3.20), while there is no significant change in institutional holdings for non-covered firms. This may be partly due to Glass Lewis's coverage, which could have made the stock more popular with institutional investors. Certain other firm attributes also see marginal changes (significant at the 10%), but there is no substantial difference in magnitude between covered and non-covered firms. To the extent that the estimation already controls for institutional ownership (and other covariates), the difference-in-differences results are unlikely to be driven by the variation in this variable.

5.2 Robustness analysis

5.2.1 Alternative interpretation

As shown in Section 4, Glass Lewis appears to be more likely to cover firms for which ISS provides potentially biased recommendations in the prior year. That is, when ISS is tougher with shareholder-sponsored proposals, or is more friendly with management proposals than it should be in the absence of bias. A potential concern is that Glass Lewis's coverage might simply be a proxy for a potentially biased recommendation by ISS, as a biased recommendation itself could lead to a change in ISS's recommendations for this company later. To disentangle this effect, I regress ISS's recommendations in t on *Potentially biased recommendation by ISS in* t-1 for companies that are not covered by Glass Lewis, controlling for various firm characteristics and fixed effects. For all major proposal types studied in this section, the coefficient estimates on *Potentially biased recommendation by ISS in* t-1 are not statistically significant at the 10% level. This indicates that ISS's potentially biased recommendations *alone* are not likely to drive changes in ISS's recommendations on the firm's subsequent proposals,

and increased competition from Glass Lewis does have a disciplinary effect.[9]

5.2.2 Exploring the timing of coverage

Another potential concern is that the composition of a potential institutional client's portfolio could also drive Glass Lewis's coverage decision, which is shown in Section 4. The estimated coefficient on the interaction term would overestimate the average effect of Glass Lewis's coverage on ISS's recommendations if firms are covered in different times due to reasons unrelated to the effect of competition on ISS's assessment of these firms' policies (e.g., potential institutional clients' portfolios), and if firms covered earlier experience negative shocks after initial coverage. To address this potential bias, I follow Naidu and Hornbeck (2014) and Chen et al. (2012) by controlling for differential changes over time that are correlated with pre-2004 company characteristics. My baseline model is modified below:

$$\begin{aligned} ISS_Rec_{it} = \alpha + \theta GL_Cover_{it-1} + \lambda GL_Cover_{it-1} \cdot Client_{it} + \gamma GL_Cover_{it-1} \cdot TF_{i,2003} \\ + \varphi GL_Cover_{it-1} \cdot Client_{it} \cdot TF_{i,2003} + \rho Client_{it} + X'_{it}\beta + \psi_i + \eta_t + \eta_j + \epsilon_{it} \end{aligned} \tag{2}$$

where $TF_{i,2003}$ are *timing factors* capturing the timing of firm i's initial coverage by Glass Lewis that are uncorrelated with changes in ISS's recommendations, measured by their 2003 values. This specification controls for changes over each time period that are correlated with initial differences in firm attributes—the time-invariant firm characteristics in 2003. In the regression above, standard errors are clustered at the firm level. We can interpret $\hat{\lambda}$ as the effect of Glass Lewis's coverage on ISS's recommendations. Candidates for timing factors include institutional ownership, the number of institutional holders, liquidity, the book-to-market ratio, and stock returns. Firms with higher institutional ownership before Glass Lewis's entry are more likely to be covered earlier due to high demand

[9] Reverse causality is less of a concern because if investors expect that ISS is going to be more truthful (less likely to issue biased proposals), they would tend to subscribe to ISS more often. This will likely produce a downward bias in my results. In other words, without this type of reverse causality, the magnitude would be even larger.

for proxy advisory services. Likewise, stocks held by more investors, defined in Chen, Hong and Stein (2002) as "breadth," could be covered earlier by Glass Lewis. Given the fact that institutions have a strong preference for liquid stocks, which they can purchase and sell with a low price impact (Ferreira and Matos, 2008), I also control for the Amihud illiquidity measure (Amihud, 2002). Furthermore, institutions could be value investors who invest in high book-to-market stocks to earn high excess returns, as suggested by Gompers and Metrick (2001). Similarly, institutions are potentially momentum investors who understand the"momentum effect" in return patterns. Thus I also control for the book-to-market ratio and stock returns in 2003.

I test the validity of these potential timing factors by estimating a hazard model. The dependent variable is the hazard ratio, in which the duration or survival time is the number of years between 2003 and when a firm began to be covered by Glass Lewis. Data indicates that Glass Lewis eventually covered almost all Russell 3000 firms during the sample period. I fit both a proportional hazards model (Cox model) and a Weibull parametric model. Results (not tabulated) from both models indicate that coefficient estimates for institutional ownership and the Amihud illiquidity measure are different from zero at the 1% level.

The results from estimating equation (2) for governance-related proposals are presented in columns 1b and 2b, Panel A of Table 4. For shareholder-sponsored proposals, the coefficient estimate for $GL_Cover_{it-1} \cdot Client_{it}$ is 0.141 (t-statistic = 3.67). It is 0.036 (t-statistic = 1.99) for management sponsored ones. Both are larger in magnitude than those without including the timing factors. I note that there are fewer observations in column 1b than column 1a because some firms are missing certain timing factors, which are taken from 2003. This is also the case for other proposal types. Regarding executive compensation plans, capitalization proposals (shown in Panel B), and first-time director elections (shown in Panel C), I also find slightly larger results, compared to the estimates without controlling for the timing factors. In short, my main finding—Glass Lewis's initial coverage leads to a tougher stance by ISS towards corporations generally—is not sensitive to endogenous choices by Glass

Lewis on when to cover a firm.

5.2.3 Alternative specification

To check whether the results are sensitive to the linear model in equation (1), I use a propensity score estimator to reweight companies to reflect differences in their probabilities of receiving Glass Lewis's coverage based on time-varying attributes that affect selection. Similar to Guadalupe, Kuzmina and Thomas (2012), I construct each firm's propensity score as follows. For each year, firms covered by Glass Lewis in that year are considered as treated observations and those that are never covered are used as controls. Treated and control observations are pooled across all years to estimate the coverage probability as a function of firm covariates. This estimated probability is the propensity score p. The covariates are *Assets, Prior-year stock return, Cash/total compensation, Classified board & poison pill, Ratio of independent directors, Institutional ownership,* and *Management holdings*, the seven firm-level variables that are correlated with Glass Lewis's coverage decision, as shown in Table 3. To address the potential bias from endogenous timing of coverage, I also include the timing factors in equation (2) as matching covariates. Adding additional compensation and governance measures, which do not appear to be correlated with Glass Lewis's coverage decision, does not materially change our results.

After obtaining the propensity scores,[10] I weight each treated firm by $1/p$, and weight each control firm by $1/(1\text{-}p)$ before fitting the data. Dehejia and Wahba (1999), and Busso, DiNardo, and McCrary (2014) show that this weighting scheme yields consistent estimates and is superior to the standard propensity score matching method. The covariates are balanced (not tabulated) after being adjusted by the propensity scores. This implies that controlling for the propensity score, the probability of being covered by Glass Lewis does not depend on the value of the covariates. To test the common support condition, I plot the distribution of estimated propensity scores across the six major proposal

[10]This paper uses nearest-neighbor matching, which matches a firm from the comparison group to the corporate client closest in terms of propensity score. Results are similar if other matching algorithms are used. See Smith and Todd (2005) or Imbens (2004) for more technical details.

types for both treated and control groups. For all of these proposal types, there are a large number of treatment-control matches that fall within the common support, although they are less evenly distributed for all director nominees.

[Insert Table 6 here.]

I now use the propensity score-adjusted sample to estimate the effects of Glass Lewis's coverage on ISS's recommendations. Column 1a, Table 6 shows for governance-related shareholder proposals, Glass Lewis's coverage causes ISS's average recommendation to increase by 15.4 percentage points for its possible clients (proxied by large firms), compared with control firms. The order of magnitude is slightly larger than that from the fixed effect model. For management-sponsored governance proposals, compensation plans, and capitalization proposals, the results are similar to those from the fixed effect model. Column 4 confirms that increased competition does not appear to affect ISS's recommendations for uncontested director elections on average. However, for elections for first-time nominees which potentially involve greater information asymmetry, Glass Lewis's entry does have a differential effect on ISS's advice for its potential clientele versus non-client firms. Due to space, results for Other proposals are not reported, which are similar to those in Panel D of Table 4.

6 Bias in Recommendations and Real Effects

Market participants who are critical of ISS's business model implicitly assume that bias in ISS's recommendations has a negative effect on shareholder value. However, one may argue that ISS tends to provide biased advice only when these recommendations are inconsequential. Thus it is important to examine whether potential bias in ISS's recommendations has incremental effects on real outcomes at the firm level. I focus on firms that receive potentially biased recommendations from ISS and compare those that have the proposals narrowly pass to those that have the proposals narrowly fail, within a 7.5% margin. As defined in Section 4, a potentially biased recommendation occurs when

ISS issues a "For" ("Against") recommendation for a management (shareholder) proposal, but the vote fails (passes). Restricting the sample to proposals that narrowly pass or fail can facilitate causal interpretation—within a narrow margin, proposals tend to pass or fail randomly (Cuñat, Gine, and Guadalupe, 2012; Malenko and Shen, 2016). The sample size for firms with proposals that narrowly pass (fail) is 148 (163). The sample will be smaller if we use a 5.0% margin, but the magnitude of the differences remains similar.

[Insert Table 7 here.]

In Column 1, Table 7, I perform this comparison for operating performance, investment decisions, and private benefits to management in the following year after the firms receive potentially biased recommendations from ISS. For operating profit margin, firms with proposals that narrowly pass perform worse, compared to those with proposals that narrowly fail. However, the difference is significant only at the 10% level. The difference for capex-to-assets is also marginal, while I do not detect significant differences for return on assets or dividend yield. However, potential ISS bias appears to allow management to enjoy greater private benefits, as reflected in their compensation. Executives at firms with proposals that narrowly pass have abnormal compensation that is $82.0 thousand higher (significant at the 10%). The growth in their compensation is also 23.7 percentage points higher than executives at firms with proposals that narrowly fail, while the cash portion of their pay is 2.0 percentage points higher. Results for the second year after ISS issues potentially biased recommendations are largely consistent, as shown in column 2. Overall, these results suggest that ISS's potential bias has real negative consequences, allowing management to enjoy more generous pay packages.

As an important information intermediary in financial markets, proxy advisors are expected to monitor firms' governance performance, and provide objective advice to their institutional clients. The failure of such functions can worsen agency problems and have adverse real effects as suggested above. The costs are similar to those associated with the failure of credit ratings agencies before the

2008 financial crisis or the overly optimistic stock recommendations during the "dot-com bubble" (e.g., Bolton, Freixas, and Shapiro, 2012; Barber, Lehavy, and Trueman, 2005). On the other hand, proxy advisory firms' coverage and recommendations are likely to draw the attention of activist investors, as suggested by Jiang, Li, and Mei (2016). Relatedly, in Section 7, I examine whether activists' ownership affects potential bias in ISS's advice for the firm.

7 Bias in Recommendations and Shareholder Activism

Recent years have seen a surge in activities by activist shareholders, who are often sophisticated institutional investors that target underperforming firms. Although prior papers have shown that proxy advisory firms can play an important role in such events, especially during proxy contests in which the dissident shareholders and management fight for board seats (Alexander, Chen, Seppi, and Spatt, 2010; Fos and Jiang, 2015; Jiang, Li, and Mei, 2016), there is little evidence on whether ownership by these investors can affect potential bias in ISS's recommendations. To examine this, I use additional data on activism events, as described in Section 3.

[Insert Table 8 here.]

Table 8 shows results from regressing a dummy variable indicating ISS's potential bias for a firm's proposals on whether the firm is targeted by activist investors in the previous year. Because the construction of the dependent variable involves the actual voting outcome (it is defined as an indicator equal to 1 if ISS issues a "For" ("Against") recommendation for a management (shareholder) proposal, but the vote fails (passes)), which is a function of major firm characteristics and fixed effects, these covariates are not controlled for in the regressions. Due to space, I pool all proposal types in this analysis. Column 1 reports that when the firm is targeted by activist investors in the previous year, occurrence of ISS's potential bias decreases by 2.7 percentage points (significant at the 10% level). Interestingly, when the event is launched by an activist hedge fund, the likelihood of ISS's potentially

biased recommendations drops by 3.6 percentage points (significant at the 1% level), as shown in column 2. The more significant impact exerted by activist hedge funds is consistent with the notion that hedge funds are a more effective force of governance than other types of activists (see Brav, Jiang, and Kim (2010) for a review of hedge fund activism). Similarly, column 3 reports that if a company is involved with a proxy contest, the probability that ISS's biased recommendations occur decreases by 5.0 percentage points. This is consistent with the positive governance role activists play in proxy contests, as discussed in Fos (2015).

It would be interesting to study whether firms purchasing ISS's services would be more likely to experience an activism event or a proxy contest. The intuition is that firms using ISS's services are more likely to receive biased recommendations, which could be discovered by activist hedge funds or other sophisticated activist investors. This can be analyzed if a list of ISS's actual corporate clients is available.

8 Conclusion

With ever growing institutional shareholdings and recent regulatory reforms to enhance shareholder rights, proxy advisory firms, ISS and Glass Lewis in particular, have a large influence on shareholder votes. It is thus critical that these independent advisory firms issue unbiased recommendations and be free of potential conflicts of interest. This is the first paper that empirically examines whether conflicts of interest exist when an advisor sells services to both investors and issuers.

I begin by examining factors that drive Glass Lewis's coverage. The advisor tends to cover better performing firms with a lower marginal cost of coverage, as well as those receiving potentially biased recommendations from ISS. Most importantly, using a difference-in-differences methodology, I find that after Glass Lewis's initial coverage of a company, ISS becomes tougher with its possible corporate clients (proxied by large firms), compared to non-client firms. The effect of competition is strong for

major shareholder and management-sponsored proposals, although it is weaker for elections involving re-appointed directors, and routine, miscellaneous and social proposals. I show that the results are not driven by the factors that influence Glass Lewis's coverage decision. Overall, these results suggest that ISS has reacted to competitive pressure by becoming less conflicted.

This paper also provides evidence that biased recommendations have real negative consequences. By exploiting close votes, I find that although potential ISS bias has only marginally negative effects on firm value, it allows management to enjoy greater private benefits in the form of compensation. This relates to the monitoring role other information intermediaries, such as credit ratings agencies and stock analysts, play in financial markets. Finally, I show evidence that activist investors can also decrease ISS bias.

It is worth noting that although this type of conflict is widely considered the most damaging (GAO, 2007), there exist other types of potential conflicts, including conflicts related to making recommendations on proposals sponsored by institutional clients. As shown in this paper, ISS is more likely to support proposals sponsored by labor unions. At least in theory, proxy advisors could face potential conflicts when a labor union becomes their institutional client. It will be interesting to analyze these types of conflicts in detail in future studies.

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Figure 1: Evolution of Glass Lewis's Market Share

This figure shows Glass Lewis client assets and its market share from 2003 to 2011. The solid bars (left axis) plot Glass Lewis client assets in each year. The dashed line (right axis) plots Glass Lewis's market share for the same period. It is calculated as below:

$$\text{Glass Lewis's market share} = \frac{\text{Glass Lewis client assets}}{\text{ISS client assets} + \text{Glass Lewis client assets}}$$

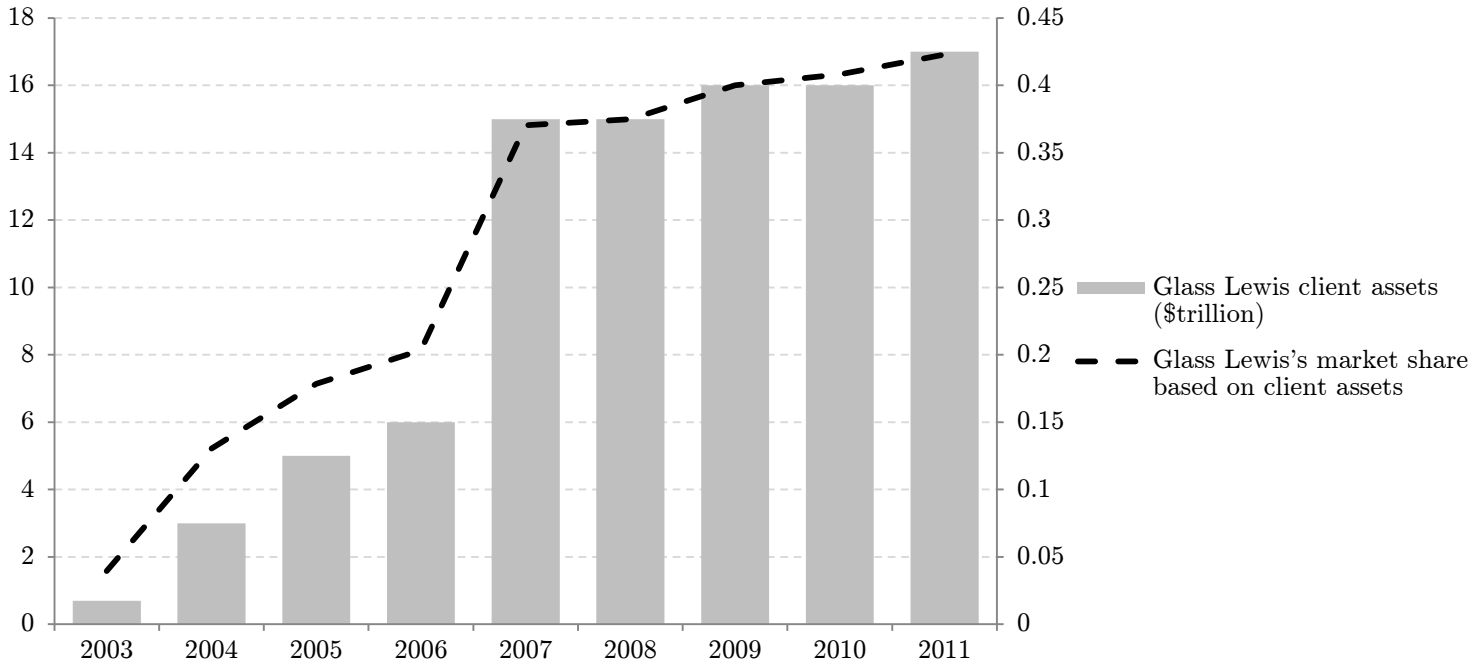

Table 1: Summary Statistics

Panel A presents the number of proposals by year for both shareholder and management proposals at Russell 3000 companies from 2004 to 2011. Shareholder proposals are categorized into two sub-categories: Governance-related and Other. Other proposals include those related to social, environmental and human rights issues, as well as miscellaneous issues. Management proposals are categorized into five sub-categories: Governance-related, Executive Compensation Plan, Capitalization, Director Election, and Other. Proposals in the Other category include routine proposals such as auditor ratification, and miscellaneous proposals. Mandatory advisory votes on executive compensation are excluded from the analysis as these started only in 2011. Panel B provides average voting recommendations for various types of proposals by ISS and Glass Lewis, respectively. Details of the sample are discussed in Section 3.

Panel A: Type of Proposal by Year

	Shareholder proposals								
	2004	2005	2006	2007	2008	2009	2010	2011	Total
Governance-related proposal	374	338	402	423	375	451	435	296	3,094
Other (social and miscellaneous)	264	211	219	220	222	181	180	168	1,665
All shareholder proposals	638	549	621	643	597	632	615	464	4,759
	Management proposals								
	2004	2005	2006	2007	2008	2009	2010	2011	Total
Governance-related proposal	165	203	188	224	261	262	298	327	1,928
Executive compensation plan	1,607	1,526	1,434	1,214	1,336	1,526	1,255	1,329	11,227
Capitalization proposal	442	299	350	336	302	348	334	478	2,889
Director election (individual level)	14,869	14,534	15,642	15,501	15,756	16,755	16,791	17,793	127,641
Other (routine and miscellaneous)	1,965	2,111	2,453	2,532	2,703	2,848	2,989	2,628	20,229
All management proposals	19,048	18,673	20,067	19,807	20,358	21,739	21,667	22,555	163,914

Panel B: Average Proxy Voting Recommendations per Firm-Year

	Shareholder proposals		
	ISS "For"	Glass Lewis "For"	*t*-stat of Diff.
Governance-related proposal	0.79	0.71	7.44
Other (social and miscellaneous)	0.36	0.14	18.04
All shareholder proposals	0.66	0.56	16.37
	Management proposals		
	ISS "Against/ Withhold"	Glass Lewis "Against/Withhold"	*t*-stat of Diff.
Governance-related proposal	0.10	0.11	-0.93
Executive compensation plan	0.19	0.23	-10.21
Capitalization proposal	0.12	0.19	-9.88
Director election	0.13	0.19	-26.13
Other (routine and miscellaneous)	0.06	0.07	-1.10
All management proposals	0.14	0.20	-26.88

Table 2: Firm Characteristics, Compensation and Governance Measures

This table presents firm characteristics, compensation and governance measures for Russell 3000 companies from 2004 to 2011. The sample consists of 23,874 company-year pairs. *Assets* are total assets in billions of dollars. *Return on assets* (ROA) is defined as earnings before interest, taxes, depreciation, and amortization (EBITDA) in the previous fiscal year scaled by assets. *Prior-year stock return* is the 12 months buy-and-hold return prior to the shareholder meeting. *Book-to-market* is defined as the market value of equity divided by the book value of equity. *Dividend yield* is (common dividend + preferred dividend)/(market value of common stock + book value of preferred stock). *Leverage* is defined as (book value of debt − cash)/assets. *Capex-to-assets* is defined as capital expenditures less the sale of PP&E divided by total assets. *Abnormal compensation ($million)* is the residual from a compensation regression where the dependent variable is the total CEO compensation and the independent variable include log assets, prior-year stock return, industry and year dummies, estimated with all ExecuComp firms for 2004–2011. Δ*Executive compensation YOY* is the percentage change in total executive compensation year-on-year. *Cash/total compensation* is the ratio of salary and cash bonus to total compensation. *Classified board & poison pill* is a dummy variable equal to 1 if the company has both a classified board and a poison pill, 0 otherwise. A classified board (or "staggered" board) is one in which the directors are placed into different classes and serve overlapping terms. A poison pill provides shareholders with special rights in the case of a triggering event such as a hostile takeover bid. Typical poison pills give the target's stockholders other than the bidder the right to purchase stock in the target or the bidder's company at a steep discount, making the target unattractive or diluting the acquirer's voting power. *Board size* is the number of board members. *Ratio of independent directors* is the number of independent directors divided by the total number of directors at the firm. *Institutional ownership* and *Management ownership* are the percent of outstanding shares held by intuitional investors and top-5 company executives, respectively, as reported by the Thomson Reuters and ExecuComp. *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

	Average	Median	Std. Dev.
	(1)	(2)	(3)
Firm characteristics			
Assets ($billion)	7.814	1.529	20.069
Return on assets (ROA)	0.090	0.111	0.150
Prior-year stock return	0.133	0.090	0.471
Book-to-market	0.551	0.479	5.191
Dividend yield	0.017	0.005	0.062
Leverage	0.214	0.157	0.247
Capex-to-assets	0.044	0.028	0.062
Executive compensation measures			
Abnormal compensation ($million)	-0.005	-0.172	2.156
ΔExecutive compensation YOY	0.301	0.104	1.249
Cash/total compensation	0.425	0.373	0.217
Governance measures			
Classified board & poison pill	0.287	0.000	0.453
Board size	9.537	9.000	2.501
Ratio of independent directors	0.739	0.750	0.132
Institutional ownership	0.682	0.750	0.252
Management ownership	0.019	0.000	0.044

Table 3: Determinants of Glass Lewis's Coverage

This table examines the determinants of Glass Lewis's coverage decision using probit regressions. The dependent variable, *Glass Lewis's coverage,* is a dummy variable equal to 1 if the company is covered by Glass Lewis in year *t*. *ISS's coverage in t*-1 is an indicator equal to 1 if the firm is covered by ISS in year *t*-1. *Potentially biased recommendation by ISS in t*-1 is an indicator equal to 1 if ISS issues a "For" ("Against") recommendation for a management (shareholder) proposal, but the vote fails (passes). *#institutions whose portfolios are substantially covered by GL* is the number of Thomson Reuters 13F institutions that hold the company, and that already have Glass Lewis cover more than 50% of their portfolio firms in year *t*. All other independent variables are as defined in Table 2, and are measured in year *t*. The sample period is 2004-2011. In each column we report probit coefficients, their heteroscedasticity-robust *t*-statistics (clustered at the firm level), and the marginal probability change induced by a one-unit change in the value of a specific covariate from its sample average. *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

	Dependent variable: Glass Lewis's coverage								
	Coefficient (1a)	*t*-stat. (1b)	Marg. Prob. (1c)	Coefficient (2a)	*t*-stat. (2b)	Marg. Prob. (2c)	Coefficient (3a)	*t*-stat. (3b)	Marg. Prob. (3c)
ISS's coverage in *t*-1	0.411*	1.83	1.73%						
Potentially biased recommendation by ISS in *t*-1				0.399***	7.09	2.79%			
#institutions whose portfolios are substantially covered by GL							0.060***	5.42	0.18%
Assets (log $bn)	0.200***	7.74	0.72%	0.208***	7.90	0.74%	0.212***	8.14	0.76%
Return on assets (ROA)	0.136	0.53	0.49%	0.098	0.37	0.35%	0.168	0.66	0.61%
Prior-year stock return	0.807***	7.13	2.89%	0.811***	11.40	2.88%	0.809***	7.16	2.93%
Abnormal compensation ($m)	0.015	0.85	0.05%	0.039*	1.82	0.14%	0.024	1.34	0.09%
ΔExecutive compensation YOY	0.008	0.97	0.03%	0.009	0.49	0.03%	0.009	1.03	0.03%
Cash/total compensation	-0.903***	-6.68	-3.23%	-0.848***	-6.28	-3.01%	-0.899***	-6.68	-3.25%
Classified board & poison pill	-0.236***	-4.56	-0.93%	-0.282***	-5.36	-1.12%	-0.242***	-4.73	-0.96%
Board size	0.015	1.06	0.05%	0.009	0.71	0.03%	0.010	0.71	0.04%
Ratio of independent directors	1.460***	7.95	5.23%	1.290***	7.47	4.58%	1.478***	8.17	5.34%
Institutional ownership	0.839***	5.61	3.00%	0.828***	5.76	2.94%	0.871***	5.94	3.15%
Management ownership	31.489***	3.31	112.74%	31.204***	10.13	110.80%	32.111***	3.32	116.07%
Observations	8,206			8,206			8,206		
Pseudo R-squared	0.25			0.26			0.27		

Table 4: Effects of Glass Lewis's Coverage

The dependent variable in column 1, Panel A is a dummy variable equal to 1 if ISS issues a "For" recommendation for governance-related shareholder proposals. Similarly, the dependent variable in column 2 is an indicator equal to 1 if ISS issues an "Against" recommendation for governance-related management proposals. *GL's coverage t*-1 is a dummy variable equal to 1 if the firm is covered by Glass Lewis in year *t* -1, 0 otherwise. *Large firm (client proxy)* is an indicator equal to 1 if the firm is one of the largest 1,000 Russell 3000 firms by assets. *Sponsor is a labor union/public pension/religious group/investment manager* is a dummy variable equal to 1 if the sponsor of the proposal is a labor union/public pension/religious group/investment manager. Timing factors include institutional ownership, the number of institutional holders, Amihud illiquidity, book-to-market, and prior-year stock return, all of which are measured in 2003. All other independent variables are as defined in Table 2, and are measured in year *t*. The sample period is 2004-2011. Heteroscedasticity-robust *t*-statistics (clustered at the firm level) are reported in brackets. *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

	Dependent variable: ISS's recommendations for governance-related proposals			
	"For" shareholder proposals		"Against" management proposals	
Panel A	(1a)	(1b)	(2a)	(2b)
GL's coverage *t*-1	-0.077***	-0.070***	-0.022*	-0.031*
	[-3.85]	[-4.38]	[-1.94]	[-1.82]
GL's coverage *t*-1 × Large firm (client proxy)	0.119***	0.141***	0.027**	0.036**
	[3.23]	[3.67]	[2.08]	[1.99]
Large firm (client proxy)	-0.138***	-0.157***	-0.030**	-0.037*
	[-3.17]	[-3.35]	[-2.00]	[-1.94]
Return on assets (ROA)	0.319	0.321	-0.645	-0.798
	[1.16]	[1.19]	[-1.38]	[-1.15]
Prior-year stock return	0.086*	0.077*	0.041	0.036
	[1.90]	[1.88]	[0.85]	[0.63]
Abnormal compensation ($m)	-0.008	-0.007	0.004	0.004
	[-0.80]	[-0.88]	[0.30]	[0.32]
ΔExecutive compensation YOY	0.002***	0.002***	0.003***	0.003***
	[4.69]	[4.75]	[5.33]	[5.58]
Cash/total compensation	0.025	0.009	0.034	0.016
	[0.15]	[0.06]	[0.24]	[0.07]
Classified board & poison pill	0.094	0.088	0.020	0.014
	[1.31]	[1.33]	[0.26]	[0.15]
Board size	-0.012	-0.016*	-0.012	0.014
	[-1.29]	[-1.71]	[-0.80]	[-0.74]
Ratio of independent directors	-0.019	-0.012	-0.033	-0.028
	[-1.34]	[-1.05]	[-0.45]	[-0.31]
Institutional ownership	0.185	0.180	0.120	0.251
	[0.64]	[0.65]	[0.63]	[1.13]
Management ownership	0.736	0.672	-1.675***	-1.482**
	[1.45]	[1.29]	[-2.68]	[-2.20]
Sponsor is a labor union	0.076**	0.094**		
	[2.45]	[2.54]		
Sponsor is a public pension	0.033	0.034		
	[0.65]	[0.53]		
Sponsor is a religious group	-0.055	-0.041		
	[-1.00]	[-0.77]		
Sponsor is an investment manager	-0.134*	-0.134*		
	[-1.80]	[-1.66]		
Timing factors		√		√
Firm FEs	√	√	√	√
Fiscal-year FEs	√	√	√	√
Proposal-type FEs	√	√	√	√
Observations	2,292	1,810	747	567
R-squared	0.62	0.63	0.68	0.71

Table 4 – Continued

The dependent variable in column 1, Panel B is a dummy variable equal to 1 if ISS issues an "Against" recommendation for executive compensation plans. The dependent variable in column 2 is an indicator equal to 1 if ISS issues an "Against" recommendation for capitalization proposals. The dependent variable in Panel C is the fraction of ISS's negative recommendations for director elections. Column 1 uses the sample for all director nominees, while column 2 reports results for a subsample of first-time director nominees. *GL's coverage t*-1 is a dummy variable equal to 1 if the firm is covered by Glass Lewis in year *t* -1, 0 otherwise. *Large firm (client proxy)* is an indicator equal to 1 if the firm is one of the largest 1,000 Russell 3000 firms by assets. All other independent variables are identical to those in Panel A. The sample period is 2004-2011. Heteroscedasticity-robust *t*-statistics (clustered at the firm level) are reported in brackets. *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

	Dependent variable: ISS's "Against" recommendations for			
	Executive compensation plans		Capitalization proposals	
Panel B	(1a)	(1b)	(2a)	(2b)
GL's coverage *t*-1	-0.024	-0.025	-0.027*	-0.024
	[-1.14]	[-1.19]	[-1.81]	[-1.41]
GL's coverage *t*-1 × Large firm (client proxy)	0.043**	0.049**	0.029**	0.031*
	[2.35]	[2.42]	[2.05]	[1.94]
Large firm (client proxy)	-0.046**	-0.057**	-0.032**	-0.028*
	[-2.42]	[-2.48]	[-2.00]	[-1.65]
Firm characteristics	√	√	√	√
Timing factors		√		√
Firm FEs	√	√	√	√
Fiscal-year FEs	√	√	√	√
Proposal-type FEs	√	√	√	√
Observations	4,301	3,283	604	460
R-squared	0.51	0.48	0.87	0.89

	Dependent variable: Fraction of ISS's "Against/Withhold" recommendations for			
	All director nominees		First-time director nominees	
Panel C	(1a)	(1b)	(2a)	(2b)
GL's coverage *t*-1	-0.031*	-0.025*	-0.044**	-0.050***
	[-1.82]	[-1.67]	[-2.32]	[-2.78]
GL's coverage *t*-1 × Large firm (client proxy)	0.020	0.021	0.035**	0.037**
	[0.95]	[1.00]	[2.16]	[2.26]
Large firm (client proxy)	-0.021	-0.022	-0.027*	-0.031**
	[-0.88]	[-1.05]	[-1.69]	[-2.07]
Firm characteristics	√	√	√	√
Timing factors		√		√
Firm FEs	√	√	√	√
Fiscal-year FEs	√	√	√	√
Observations	7,598	6,922	5,814	4,462
R-squared	0.40	0.39	0.37	0.35

Table 4 – Continued

The dependent variable in column 1, Panel D is an indicator equal to 1 if ISS issues a "For" recommendation for Other shareholder proposals (social and miscellaneous). The dependent variable in column 2 is a dummy variable equal to 1 if ISS issues an "Against" recommendation for Other management proposals (routine and miscellaneous). *GL's coverage t-1* is a dummy variable equal to 1 if the firm is covered by Glass Lewis in year *t* -1, 0 otherwise. *Large firm (client proxy)* is an indicator equal to 1 if the firm is one of the largest 1,000 Russell 3000 firms by assets. All other independent variables are identical to those in Panel A. The sample period is 2004-2011. Heteroscedasticity-robust *t*-statistics (clustered at the firm level) are reported in brackets. *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

	Dependent variable: ISS's recommendations for Other proposals			
	"For" Other shareholder proposals		"Against" Other management proposals	
Panel D	(1a)	(1b)	(2a)	(2b)
GL's coverage *t*-1	-0.030*	-0.028*	-0.012	-0.014
	[-1.76]	[-1.69]	[-0.80]	[-0.75]
GL's coverage *t*-1 × Large firm (client proxy)	0.023	0.026	0.010	0.009
	[1.22]	[1.24]	[0.62]	[0.60]
Large firm (client proxy)	-0.024	-0.026	-0.024	-0.020
	[-1.59]	[-1.58]	[-0.77]	[-0.61]
Firm characteristics and sponsor type	√	√	√	√
Timing factors		√		√
Firm FEs	√	√	√	√
Fiscal-year FEs	√	√	√	√
Proposal-type FEs	√	√	√	√
Observations	1,203	993	8,549	6,505
R-squared	0.60	0.62	0.74	0.72

Table 5: Firm Characteristics Before and After Glass Lewis's Coverage

This table shows firm characteristics, compensation and governance measures for large firms (client proxy) covered and not covered by Glass Lewis. Large firms (client proxy) are the largest 1,000 Russell 3000 firms by assets. Columns 1a and 1b report the average differences between *t* and *t*-1, in which *t*-1 is the fiscal year of coverage by Glass Lewis. Columns 1b and 2b present the associated *t*-statistics. All variables are as defined in Table 2. The sample period is 2004-2011. *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

	Large firms (client proxy) covered by Glass Lewis in *t*-1		Large firms (client proxy) *not* covered by Glass Lewis in *t*-1	
	Avg. Diff. Between *t* and *t*-1	*t*-stat. of Diff.	Avg. Diff. Between *t* and *t*-1	*t*-stat. of Diff.
	(1a)	(1b)	(2a)	(2b)
Firm characteristics				
Assets ($bn)	1.060	1.22	0.398	0.38
Return on assets (ROA)	0.003	1.12	-0.002	-0.39
Prior-year stock return	0.028*	1.94	0.027*	1.91
Book-to-market	-0.030	-0.93	-0.004	-0.01
Dividend yield	-0.001*	-1.86	-0.000	-0.20
Leverage	-0.004	-1.37	-0.002	-0.49
Capex-to-assets	0.001	1.31	-0.000	-0.16
Executive compensation measures				
Abnormal compensation ($m)	-0.008	-0.30	0.069	0.93
ΔExecutive compensation YOY	0.029	0.36	0.145*	1.91
Cash/total compensation	-0.024**	-2.41	-0.019**	-2.09
Governance measures				
Classified board & poison pill	-0.022*	-1.85	-0.019*	-1.68
Board size	0.023	0.65	0.039	0.36
Ratio of independent directors	0.015*	1.91	0.011*	1.65
Institutional ownership	0.012***	3.20	0.008	1.45
Management ownership	-0.002*	-1.77	-0.001	-0.66

Table 6: Effects of Glass Lewis's Coverage: Propensity Score Matching

The dependent variable in column 1a is a dummy variable equal to 1 if ISS issues a "For" recommendation for governance-related shareholder proposals. Similarly, the dependent variable in column 1b is an indicator equal to 1 if ISS issues an "Against" recommendation for governance-related management proposals. The dependent variable in column 2 (column 3) is a dummy variable equal to 1 if ISS issues an "Against" recommendation for executive compensation plans (capitalization proposals). The dependent variable in column 4a (column 4b) is the fraction of ISS's negative recommendations for all director nominees (first-time director nominees). *GL's coverage t*-1 is a dummy variable equal to 1 if the firm is covered by Glass Lewis in year *t* -1, 0 otherwise. *Large firm (client proxy)* is an indicator equal to 1 if the firm is one of the largest 1,000 Russell 3000 firms by assets. All other independent variables are as defined in Table 2, and are measured in year *t*. The sample period is 2004-2011. Heteroscedasticity-robust *t*-statistics (clustered at the firm level) are reported in brackets. *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

	Governance-related proposals				Director elections	
Dependent variable: ISS's recommendations	"For" shareholder proposals	"Against" management proposals	"Against" executive compensation plans	"Against" capitalization proposals	"Against/Withhold" all nominees	"Against/Withhold" first-time nominees
	(1a)	(1b)	(2)	(3)	(4a)	(4b)
GL's coverage *t*-1	-0.078***	-0.037**	-0.029	-0.028*	-0.033*	-0.053***
	[-4.11]	[-2.15]	[-1.45]	[-1.65]	[-1.83]	[-2.94]
GL's coverage *t*-1 × Large firm (client proxy)	0.154***	0.041**	0.052**	0.032**	0.026	0.045**
	[3.63]	[2.14]	[2.17]	[1.98]	[1.13]	[2.50]
Large firm (client proxy)	-0.183***	-0.049**	-0.064**	-0.031*	-0.015	-0.027*
	[-3.39]	[-2.26]	[-2.21]	[-1.87]	[-0.56]	[-1.81]
Timing factors	√	√	√	√	√	√
Firm FEs	√	√	√	√	√	√
Fiscal-year FEs	√	√	√	√	√	√
Proposal-type FEs	√	√	√	√		
Propensity score weighting	√	√	√	√	√	√
Observations	1,810	567	3,283	460	6,922	4,462
R-squared	0.68	0.78	0.53	0.90	0.40	0.38

Table 7: Bias in Recommendations and Real Effects

This table shows operating performance, investment decisions and private benefits to management in the following two years (years t+1 and t+2) for firms receiving potentially biased recommendations from ISS. A potentially biased recommendation occurs when ISS issues a "For" ("Against") recommendation for a management (shareholder) proposal, but the vote fails (passes). Columns 1a and 2a present results for firms receiving potentially biased recommendations and the votes pass within a 7.5% margin (sample size = 148). Columns 1b and 2b show results for firms receiving potentially biased recommendations but the votes fail within a 7.5% margin (sample size = 163). Columns 1c and 2c report the differences (and their associated t-statistics) between 1a and 1b, and 2a and 2b, respectively. *Operating profit margin* is defined as operating income divided by net sales. All other variables are as defined in Table 2, and are measured in year t. The sample period is 2004-2011. *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

	Company proposals receiving potentially biased recommendations from ISS					
	Year t+1			Year t+2		
	Narrowly pass in t	Narrowly fail in t	Diff.	Narrowly pass in t	Narrowly fail in t	Diff.
	(1a)	(1b)	(1c)	(2a)	(2b)	(2c)
Operating performance						
Return on assets (ROA)	0.081	0.088	-0.007	0.087	0.096	-0.009*
			[-1.52]			[-1.90]
Operating profit margin	0.039	0.048	-0.009*	0.037	0.049	-0.012**
			[-1.68]			[-2.18]
Investment decisions						
Capex-to-assets	0.045	0.041	0.003*	0.042	0.039	0.003*
			[1.75]			[1.86]
Dividend yield	0.016	0.018	-0.002	0.018	0.019	-0.001
			[-1.38]			[-1.14]
Private benefits to management						
Abnormal compensation ($m)	0.263	0.181	0.082*	0.378	0.262	0.116**
			[1.84]			[2.37]
ΔExecutive compensation YOY	0.678	0.441	0.237***	0.599	0.409	0.190**
			[2.78]			[2.21]
Cash/total compensation	0.429	0.409	0.020**	0.410	0.392	0.018*
			[2.05]			[1.83]

Table 8: Bias in Recommendations and Shareholder Activism

This table examines whether ownership by activist investors affects potential bias in ISS's recommendations. The dependent variable, *Potentially biased recommendation by ISS*, is an indicator equal to 1 if ISS issues a "For" ("Against") recommendation for a management (shareholder) proposal, but the vote fails (passes). *Firm is targeted by activist investors/activist hedge funds in t*-1 is a dummy variable equal to 1 if the firm is targeted by activist investors/activist hedge funds in year *t*-1. *Firm is targeted in a proxy contest in t*-1 is a dummy variable equal to 1 if the firm is involved with a proxy contest in year *t*-1. The sample period is 2004-2011. Heteroscedasticity-robust *t*-statistics (clustered at the firm level) are reported in brackets. *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

	Dependent variable: Potentially biased recommendation by ISS		
	(1)	(2)	(3)
Firm is targeted by activist investors in *t*-1	-0.027*		
	[-1.80]		
Firm is targeted by activist hedge funds in *t*-1		-0.036***	
		[-2.83]	
Firm is targeted in a proxy contest in *t*-1			-0.050**
			[-2.38]
Observations	9,342	9,342	9,342
R-squared	0.06	0.06	0.06