Diminishing the Power of Proxy Advisory Firms

A debate is raging in Washington among financial regulators, lawmakers, trade associations, public company CEOs, academics and investment advisors over how to regulate an important industry many Americans have little familiarity with: proxy advisors.

Momentum is building in the financial industry and at the Securities and Exchange Commission to bring transparency and oversight to proxy advisory firms, which advise public company shareholders how to vote on topics ranging from executive pay to environmental policies.

As proxy season comes to a close, the SEC has signaled that it is preparing to enact new standards to rebalance the proxy advisory industry to protect the interests of shareholders, especially retail investors with 401(k)s and public sector workers with pensions.

There is a definite market for proxy advisory services, given that the management of any investment fund is a complicated endeavor. A typical fund may contain the stock of hundreds of different companies, the proportions of which change daily. Myriad factors impact investment management, including relative stock movements, interest rate changes, economic indicators and news of any sort from around the globe.

The people who manage money in such funds tend to be very smart, immensely curious and somewhat monomaniacal when it comes to their job. Those who earn high returns also tend to be well-rewarded for their performance, which helps explain some of the job obsession.

These investors want to concentrate on things important to them that they are skilled at—namely, making investment decisions. They outsource many other tasks required of them. One of those ancillary tasks involves voting the proxies for the many shares in public companies in which they invest. The SEC requires investment funds vote their proxies so they cannot simply ignore it. Instead, sections of the industry tend to outsource part or all of this duty to a proxy advisory firm.

Just two firms—Institutional Shareholder Services (ISS) and Glass Lewis—control more than 97 percent of the proxy advisory market. Proxy advisers provide market-moving guidance on a plethora of issues, including corporate governance, gender equity and political spending policies. The two firms effectively control nearly 38 percent of shareholder votes.

Unfortunately, these firms have grown so powerful that they now serve akin to quasi-regulators to capital markets—despite no statutory authority—with independent academic research suggesting they can sway proxy votes by as much as 30 percent.

Asset managers rely on these recommendations to provide a supposedly independent, unbiased layer of review as they frequently must consider thousands of votes at annual meetings: an estimated 600 billion shares will be voted at about 13,000 shareholder meetings in 2019.

This information overload has ushered in a concept known as robo-voting, or asset managers voting proxies automatically without evaluation, relying completely on proxy firms' recommendations.

Robo-voting potentially breaches an asset manager's fiduciary duty to their investors. While managers receive recommendations from proxy advisor firms, they still have a responsibility to evaluate the issue themselves, and not just automatically follow the recommendations they receive. Furthermore, many votes are cast electronically with default mechanisms that must be manually overridden to vote differently than the advisor recommends.

A recent study of 175 asset managers by the American Council of Capital Formation found that the firms follow ISS' recommendations 95 percent of the time (for half of the entities, it's 99 percent).

Investment recommendations are subjective, of course, and often depend on the strategic goals of the decision-maker. A surge in so-called Environmental, Social and Governance (ESG) investing has empowered activist institutional investors to increasingly push public companies to take a stand on political issues such as climate change, no matter the impact on profits or shareholder value. So, proxy advisory firms also need a modicum of guidance from a fund manager as to their priorities.

ISS' creation of standardized reports, which sometimes reach different conclusions on the same vote at the same company, suggests that there is an element of providing clients with recommendations for hire. Of course, there is nothing wrong with an investor choosing how to vote on an issue, but they should not be able to do so and still claim that they have cleansed themselves of a potential conflict of interest through the use of a third party. They can have either, but not both.

Worse, these specialty reports are virtually free from scrutiny, with many issuers not even aware they exist. Unsubstantiated claims and errors are perpetuated, often without potential to be challenged.

Under Taft-Hartley proxy voting guidelines, ISS openly states that it votes certain investors' shares, rather than only being employed to provide independent, third party research, effectively confirming that robo-voting is happening. The vast majority, if not all, of these policies are orientated towards social investment strategies rather than shareholder wealth maximization, allowing activist investors to vote in any direction without fear of being criticized over potential conflicts of interest.

ISS' acknowledgment that its specialty reports meet both fiduciary and social objectives belies the fact that the two are not inherently the same: the reality is that ESG priorities will not automatically lead to value maximization.

Average investors are starting to pay attention to these industry problems. A recent study by the wealth management research firm Spectrem Group details significant concerns among retail investors about how the proxy advisory industry issues guidelines to institutional shareholders on how to vote their interests. The survey, formulated by George Mason University Law Professor J.W. Verret, measured support for increased regulatory oversight of the proxy industry among thousands of individual investors with assets of at least $10,000.

Of those familiar with proxy advisors, 96 percent supported increased SEC oversight of the industry. Further, 84 percent of retail investors indicated robo-voting was at least a slight concern, and 79 percent support the SEC adopting changes to address this issue. Only three percent of respondents indicated they were not concerned about robo-voting.

Beyond broader reforms to the proxy industry, one concrete step the SEC could take to fix the industry would be to modernize voting requirements to prevent robo-voting.

While voting shares can generate value for investors, sometimes refraining from voting may be in a client's best interest if the costs exceed the expected benefits. In 2017, 95 percent of shareholder proposals were rejected. Institutional investors should have the option to establish a default voting process that votes with company directors' recommendation, absent a red flag suggesting further inquiry is necessary.

By limiting the discretion of institutional investors, the SEC's regulatory status quo effectively distorts the collective influence of those same investors via just two proxy advisors—neither of which owns a single share in a public company nor has a fiduciary obligation to any Main Street investor.

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