



ARE PROXY ADVISORS **REALLY A PROBLEM?**

RECENT DATA ANALYSIS
AND SURVEY RESULTS
DEMONSTRATE THE
VALIDITY OF COMMON
CONCERNS

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SQUIRE PATTON BOGGS

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WHAT HAPPENS WHEN PROXY ADVISORS ARE WRONG?

FOREWORD

Proxy advisor recommendations are a key tool for institutional investors, particularly passive investors with hundreds, if not thousands, of proxy votes to submit each year. Unfortunately, as previous ACCF research has explored, there are institutions that automatically and without evaluation rely on proxy firms' recommendations. This phenomenon, called "robo-voting," has the potential to be a breach of fiduciary duty at the fund-level.

As explored in greater detail in this report, companies often complain that there is an immediate spike in voting after proxy advisors issue recommendations. This suggests that, at least in some cases, institutions do not take the time to fully vet proxy advisor reports to the potential detriment of shareholders at large. Some asset managers have separated themselves from this trend, increasing their investment in proxy due diligence and increasing the size of investment stewardship teams. Yet as more asset managers seek ways to cut costs in order to compete in the environment of low-expense fees, the concerning trend in robo-voting must be explored.

Further compounding this issue is the brief time companies have to respond to erroneous recommendations, leaving little room to correct proxy advisor mistakes before votes are cast. Since the voting spike happens within three days of the recommendation issuance, companies do not have the opportunity to adequately respond to the recommendation, even if it is factually incorrect.

When recommendations do contain errors, the main recourse a company has is to provide a supplemental proxy filing. As explored in this report, these voluntary filings provide written, public accounts of company disputes with ISS and Glass Lewis in a manner transparent to the SEC and help to quantify the universe of problems companies experience with proxy advisors each year. Unfortunately, many companies are unable to adequately respond to errors in these recommendations due to the reality that proxy advisors do not give prior notice and provide companies little time to respond to recommendations. Compounded with the prevalence of automatic voting, the deficiency in the process undermines an investor's right to accurate and timely information.

The American Council for Capital Formation (ACCF) has previously written on proxy advisors, noting that over reliance on their recommendations decreases the ability of companies to advocate for themselves or their businesses in the face of an adverse recommendation. The outsized power this places in the hands of proxy advisors has lasting implications for corporate policy, profits, and disclosures.

Timothy M. Doyle

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CONTENTS

Introduction	6
Concerns About Electronic Default Voting and its Impact	7
Is Robo-Voting Real?	7
Is Lack of Response Time a Problem?	10
How Prevalent are Errors in Proxy Advisor Reports?.....	10
Conclusion	12

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BY FRANK M. PLACENTI

INTRODUCTION

Proxy advisory firms have been a feature of the corporate landscape for over 30 years. Throughout that time, their influence has increased, as has the controversy surrounding their role.

In BlackRock's July 2018 report on the *Investment Stewardship Ecosystem*¹, the country's largest asset manager noted that, while it expends significant resources² evaluating both management and shareholder proposals, many other investor managers instead rely "heavily" on the recommendations of proxy advisors to determine their votes, and that proxy advisors can have "significant influence over the outcome of both management and shareholder proposals."

That "significant influence" has been a source of discomfort for many public company boards and executives, as well as organizations like the American Council for Capital Formation, the Society for Corporate Governance and the Business Roundtable. They have charged that proxy advisors employ a "one-size-fits all" approach to governance that ignores the realities of differing businesses. Some have also complained that the advisors' reports are often factually or analytically flawed, and that their voting recommendations increasingly support a political and social agenda disconnected from shareholder value.

Academics have written that there is no empirical evidence that proxy advisors' benchmark governance policies promote shareholder value, effective governance or any meaningful advancement of the advisors' championed social

causes. Indeed, a 2009 study by three Stanford economists concluded that, when boards altered course to implement the compensation policies preferred by proxy advisors, shareholder value was measurably damaged.³ A second Stanford study reported that those charged with making investment decisions within an investment manager were involved in voting decisions only 10% of the time, suggesting a troubling de-coupling of voting decisions from any investment selection or the company performance that motivates that selection.⁴

While proxy advisors have had a raft of detractors, some institutional investor groups have defended the proxy advisors' role, asserting that the outsourcing service they provide is indispensable if institutional investors are to fulfill their perceived regulatory responsibility to vote on every issue presented for shareholder action at the hundreds of companies in which they hold positions.

For their part, proxy advisors contend that complaints about the quality of their analysis are overblown, that they make few material errors, and that disputes with companies most often represent mere "differences of opinion," as recently claimed in a May 30, 2018 letter from Institutional Shareholder Services (ISS) to six members of the Senate Banking, Housing, and Urban Affairs Committee.⁵

As in many such debates, where you stand depends on where you sit, and the absence of data has hindered an informed discussion.

1 Available at: <https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-investment-stewardship-ecosystem-july-2018.pdf>

2 BlackRock reports that it employs over 30 professionals dedicated to reviewing proxy proposals. The investment made by BlackRock and similar companies should serve as a model for the type activity needed for investment managers to exercise their fiduciary voting duties.

3 Rating the Ratings: How Good are Commercial Governance Ratings: Robert Daines, Ian D. Goe and David F. Larcker, *Journal of Financial Economics*, December 2010, Vol. 98, Issue 3, pages 439-461.

4 2015 Investor Survey: Deconstructing Proxy Statements — What Matters to Investors, David F. Larcker, Ronald Schneider, Brian Tayan, Aaron Boyd. Stanford University, RR Donnelley, and Equilar. February 2015.

5 Available at: <https://www.issgovernance.com/file/duediligence/20180530-iss-letter-to-senate-banking-committee-members.pdf>

CONCERNS ABOUT ELECTRONIC DEFAULT VOTING AND ITS IMPACT

For years, companies have anecdotally reported an almost immediate spike in voting after an advisor's recommendation is issued, with the vote demonstrating near lock-step adherence to the recommendation.

A few companies have been bold enough to contend that the immediacy of the vote reveals that institutional investors are not taking time to digest the information in the advisors' often-lengthy reports, only to experience the sting of investor backlash.

Moreover, many of these votes are cast through electronic ballots with default mechanisms that must be manually overridden for the investor to vote differently than the advisor recommends.⁶ This practice allows no time for companies to digest the advisor's report and effectively communicate to their investors any objections they may have to it. The combination of default electronic voting and the speed with which votes are cast has been dubbed "robo-voting."

Public companies who do not receive the advisors' reports in advance are caught flat-footed by an adverse recommendation and are left to scramble to file supplemental proxy materials and otherwise struggle to communicate their message to investors. When those investors have already cast their vote by default electronic ballot, getting them to engage in a discussion of the issues, let alone reverse their vote, has proven to be practically impossible in most cases.⁷

IS ROBO-VOTING REAL?

Although many public companies and even proxy solicitation firms have anecdotally reported the existence of an immediate spike in voting in the

wake of ISS and Glass Lewis recommendations, the size and prevalence of that spike has not been empirically examined in published reports.

In an effort to generate relevant data, four major U.S. law firms including Squire Patton Boggs recently collaborated on a survey of public companies seeking information about the existence, size and nature of the voting spike in the wake of an adverse proxy advisor recommendation. An adverse recommendation was defined as one urging a vote against a management proposal or in favor of a shareholder proposal opposed by the company's board of directors.

One hundred companies were asked about their experiences in the 2017 and 2016 proxy seasons. In particular, they were asked to report on the number of adverse recommendations they had received from proxy advisors in those years.

Thirty-five companies in 11 different industries reported an adverse proxy advisor recommendation during that period, totaling 93 separate instances. Responses ranged from one to 11 adverse recommendations in a single year. A hyperlink to a summary of the survey is [available here](#).

More specifically, companies were asked to quantify the amount of advance notice they received from the relevant proxy advisor regarding adverse recommendations. Almost 37% of companies reported that ISS did not provide them the opportunity to respond at all. Companies indicated that Glass Lewis was even worse – with 84% of respondents indicating they did not receive any notice from the advisor before an adverse recommendation.

When a company did receive notice, it was often not enough time to generate a response. Nearly 85% of companies that were given notice from ISS indicated they received less than 72 hours to respond to the

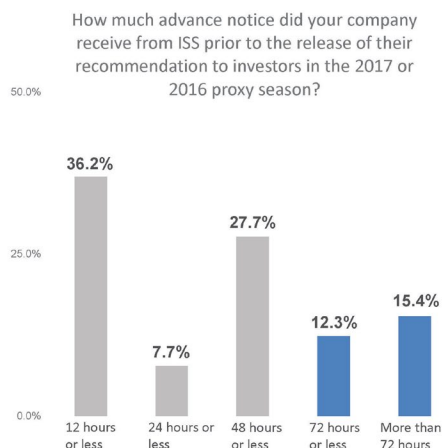
6 This robo-voting procedure was described in detail in the August 3, 2017 letter of the National Investor Relations Institute to SEC Chair Jay Clayton, available at: <https://www.niri.org/NIRI/media/NIRI-Resources/NIRI-SEC-Letter-PA-Firms-August-2017.pdf>

7 Testimony of Darla C. Stuckey, President & CEO, Society for Corporate Governance, Committee on Banking, Housing, and Urban Affairs Hearing on "Legislative Proposals to Examine Corporate Governance" (June 28, 2018), U.S. Senate, available at: <https://www.banking.senate.gov/imo/media/doc/Stuckey%20Testimony%206-28-18.pdf>

adverse recommendation, with roughly 36% of these companies indicating they received less than 12 hours-notice from ISS.

Advanced Notice of Recommendations

- **Current Response Time Much Shorter Than Needed**
- **Almost 37% Receive No Notice**
- **72% Receive Two Days or Less**
- **Only 16% Report Receiving Any Advanced Notice from Glass Lewis**

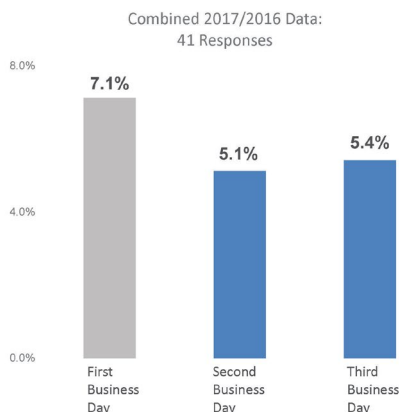


Companies were also asked to report the increase in shares voted within one, two and three business days of the publication of the advisors' adverse recommendation. Results varied depending on a variety of factors, including whether the recommendation in question was issued by ISS (which broadly employs electronic default voting) or Glass Lewis, or Glass Lewis (which seems to delay voting until much closer to the time of the annual meeting).

For the 2017 proxy season, the participating companies reported an average of 19.3% of the total vote is voted consistent with the adverse recommendations within three business days of an adverse ISS recommendation. For the 2016 proxy season, the companies reported an average 15.3% of the total vote being consistent with the adverse recommendations during the same three-day period.

Negative Votes After an ISS Adverse Recommendation

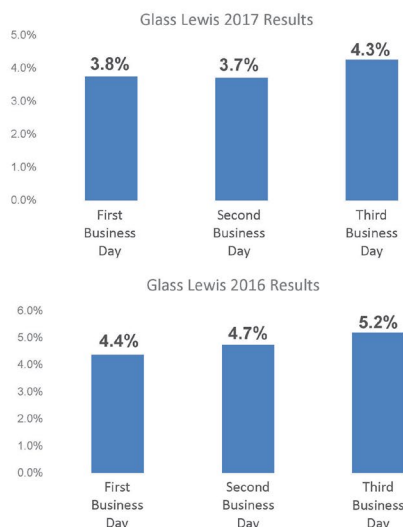
- **Combined Data Show Immediate Increase in Negative Vote**
- **On Average, 17.7% of Total Vote is Voted Negatively in the Three Days After Recommendation**
- **Immediate Impact of ISS Recommendation Before Companies Can Review Analysis**
- **Investors Likely Need Same Amount of Time to Review**
- **Votes Occurring Before Reasonable Investor Review**



Comparing the data for the voting spike for ISS and Glass Lewis recommendations provided an interesting contrast. Unlike ISS, Glass Lewis does not make extensive use of default electronic voting⁸ and reports that it often delays casting votes until much closer to the annual meeting at the instruction of its clients.⁹ While the average three-day spike for ISS was 17.7% for the 2017 proxy season, for Glass Lewis the comparable number was 11.8%.

Negative Votes After an Glass Lewis Adverse Recommendation

- No Significant Trend in Glass Lewis Data
- No Underlying Trend in Responses (Peaks Equally Distributed)
- Consistent With Anecdotal Understanding of Glass Lewis Process
- Most Glass Lewis Proxy Shares Voted Immediately Prior to Meeting
- Lends Significance to ISS Results



3

Companies were also asked to state the time period they believed they would require to effectively communicate with shareholders to respond to an adverse recommendation. One hundred percent of companies stated they would need at least three business days while 68% stated they would need at least five business days to do so. This number must be viewed in the context that nearly 85% of respondents indicated that they received less than 3 days-notice of an adverse recommendation.

While the relatively small data set (and the non-random survey methodology) do not allow statistically significant conclusions to be drawn, the survey does provide empirical data to support the following conclusions:

- There is a discernible voting spike in the near aftermath of an adverse advisory recommendation that is consistent with the recommendation.
- The percentage of shares voted in the first three days represent a significant portion of the typical quorum for public company annual meetings.
- Companies need more time than they are being given to respond to adverse recommendations.

8 Glass Lewis Response To SEC Statement Regarding Staff Proxy Advisory Letters, (September 14, 2018), available at: <http://www.glasslewis.com/glass-lewis-response-to-sec-statement-regarding-staff-proxy-advisory-letters/>

9 Testimony of Katherine H. Rabin, CEO, Glass Lewis & Co, Subcommittee on Capital Markets and Government Sponsored Enterprises, U.S. House of Representatives, (May 17, 2016) available at: http://www.glasslewis.com/wp-content/uploads/2016/05/2016_0517_Glass-Lewis-HFSS-Testimony_FINAL.pdf.

Although this research makes clear that many institutional investors vote by default in a manner recommended by their proxy advisors, it is not true for all institutional investors. Several of the nation's largest funds like Vanguard, State Street, BlackRock and others have chosen to implement their own internal proxy voting analysis and increase the size of their internal corporate governance teams. The Financial Times has reported:

"New York-based BlackRock now has the largest corporate governance team of any global asset manager, after hiring 11 analysts for its stewardship division over the past three years, bringing total headcount to 31. Vanguard, the Pennsylvania-based fund company that has grown quickly on the back of its low-cost mantra, has nearly doubled the size of its corporate governance team over the same period to 20 employees. State Street, the US bank, has almost tripled the size of the governance team in its asset management division to 11. Both Vanguard and State Street said their governance teams will continue to grow this year."¹⁰

These efforts are to be applauded as they reflect a commitment of significant resources to making informed and independent voting decisions. Moreover, in the experience of most practitioners, those funds that employ their own internal resources tend to show a greater willingness to engage in dialogue with companies who feel the need to express disagreement with their initial voting decisions.

IS LACK OF RESPONSE TIME A PROBLEM?

Should we care that so many shares are being voted before companies can effectively communicate their disagreements with a proxy advisors' recommendations?

There are two immediate answers to that question.

First, as noted in the July 2018 BlackRock report, many institutional investors rely "heavily" on those recommendations before voting. These institutional investors have fiduciary duties to their beneficiaries or retail investors to have all relevant information, including a company's response to a proxy advisor's recommendation, before voting. To exercise that obligation, it is not unreasonable to ask that they hear "both sides of the story" before they cast their vote. While a company's original proxy statement performs a portion of that function, it cannot respond (in advance) to errors or flaws in a proxy advisor's recommendation.

That leads to the second reason we should care about the lack of time to respond. Proxy advisor recommendations are not always right. Indeed, in some cases, they are demonstrably wrong.

HOW PREVALENT ARE ERRORS IN PROXY ADVISOR REPORTS?

As far back as 2010, the Securities and Exchange Commission (SEC) highlighted concerns that "proxy advisory firms may...fail to conduct adequate research and base [their] recommendations on erroneous or incomplete facts."¹¹

In the years since that observation, public companies have continued to complain about errors in proxy advisor recommendations and have sometimes voiced those concerns in supplemental proxy filings with the SEC.

A review of supplemental proxy filings during 2016, 2017 and a partial 2018 proxy seasons (through September 30, 2018) provides some insight on the nature of this problem.

10 Marriage, Madison. "BlackRock, Vanguard and State Street bulk up governance staff," *Financial Times*, 28 Jan. 2017.

11 SEC Request for Comments, July 14, 2010, available at: <https://www.sec.gov/news/press/2010/2010-122.htm>

In conducting that review, we established four categories of filings in which companies challenged a proxy advisor's recommendation:

- 1. No Serious Defects.** Filings specifying no serious defect in the report, but simply expressing a disagreement. Often, these filings sought to justify poor company performance by reference to external market or economic forces. (These filings were not further tabulated.)
- 2. Factual Errors.** Filings claiming that the advisor's reports contained identified factual errors.
- 3. Analytical Errors.** Filings claiming that the advisor's reports contained identified analytical errors, such as the use of incongruent compensation peer group data or the use of peer groups that inexplicably varied from year to year.
- 4. Serious Disputes.** Filings that identified specific problems with the advisors' reports often stemming from the "one-size-fits-all" application of the proxy advisors' general policies. These included support for shareholder proposals seeking to implement bylaw changes that would be illegal under the issuer's state law of incorporation, inconsistent recommendations with respect to the same compensation plan in multiple years, and other serious disputes.

We contend that supplemental proxy filings should be regarded as a reliable source of data because, like all proxy filings, they are subject to potential liability under SEC Rule 14a-9 if they contain statements that are false or misleading, or if they omit a material fact. In short, if a company claims that an advisor's recommendation is factually or analytically wrong, it must be prepared to substantiate that claim.¹²

Moreover, it is probably fair to say that the number of supplemental proxy filings contesting proxy advisor recommendations represents the "tip of the iceberg" since many companies with objections to an advisor's recommendations decide not to make supplemental filings either because default electronic voting or other timing issues limit their impact on voting, or because they know they have to face the recommendations of the proxy advisor in future years.¹³

During the period examined, there were 107 filings from 94 different companies citing 139 significant problems including 90 factual or analytical errors in the three categories that we analyzed. There were 39 supplemental filings claiming that the advisors' reports contained factual errors, while 51 filings cite analytical errors of varying kinds. Serious disputes were expressed in 49 filings. Some filings expressed concerns in more than one category, with several expressing objections in all three categories. A hyperlink to the tabulated results is [available here](#).

Perhaps the most ironic filing was made on June 1, 2017 by Willis Towers Watson.¹⁴ The company took issue with an ISS report challenging the design of its executive compensation program. In short, Willis Towers Watson objected when ISS sought to substitute its judgment about compensation plan design for that of a company widely regarded as a leading expert on that very topic. The filing cited a litany of factual errors and laid bare the lack of depth in the ISS analysis perhaps suggesting that ISS had unwisely brought a knife to a gun fight.

Other filings were less entertaining but often no less troubling. Standing back and looking at the body of these supplemental filings leads to the conclusion that a meaningful number of public companies have been willing to go on the record identifying real problems in their proxy advisory reports.

¹² This accountability stands in stark contrast to the fact that ISS and GL have experienced no regulatory consequences for issuing incorrect reports.

¹³ Picker, L & Lasky, A. "A congressman calls these Wall Street proxy advisory firms 'Vinny down the street' for their power to pressure companies," CNBC, 28 June 2018.

¹⁴ Willis Towers Watson Public Limited Company, Proxy Statement to the SEC, June 1, 2017.
<https://www.sec.gov/Archives/edgar/data/1140536/000119312517189751/d380806ddefa14a.htm>

CONCLUSION

The two surveys discussed in this article strongly suggest that the concerns expressed by public companies and industry groups about proxy advisors should not be dismissed. Policy makers should explore and implement legislative or regulatory measures to assure that:

- Funds with fiduciary duties to their beneficiaries are not placing undue reliance on the recommendations of third parties;
- Institutional investors are making fully-informed voting decisions;
- Investors have more transparency into how their votes are to be cast on a default basis; and
- Public companies are allowed a reasonable opportunity to identify and respond to defects in the analysis of third-party proxy advisors.

