HOW TO FIX OUR BROKEN PROXY ADVISORY SYSTEM

JAMES K. GLASSMAN AND J. W. VERRET

The system for proxy voting by mutual funds and other institutions that own shares in publicly traded companies in America is badly broken. The source of the disrepair is regulation. Among the unintended consequences of rules enacted with the best of intentions is the harm inflicted on retirees and other investors. The good news is that, with small changes, the system can be fixed.

A rule enacted by the Securities and Exchange Commission in 2003, which followed actions by the US Department of Labor 15 years earlier, required institutions to adopt and disclose policies for proxy voting that were intended to minimize conflicts between the institutions’ interests and those of their shareholders.

An SEC staff interpretation led to a result almost the opposite of what many of the rule’s supporters intended. Institutions could easily protect themselves from legal liability by shifting responsibility to proxy advisory firms, which acquired increasing power over corporate governance, to the detriment of shareholders. The rule resulted in outsourcing decision making to advisors with little particularized knowledge and no incentive to maximize value. The proxy advisory firms themselves face the same conflicts of interest that the rule was intended to minimize. The problem is compounded by a market for proxy advice that is dominated by two firms. To fix this broken system, it is necessary to return the responsibility to determine the need for a vote to shareholders and directors.

OUTSOURCING PROXY ADVICE

Now that mutual fund shareholders are required to vote on all proxies, the simple solution is to hire an advisor and enjoy virtual immunity from liability if they follow these advisors’ recommendations. Meanwhile, the SEC has given the proxy advisors protective treatment that has not been granted to similar financial gatekeepers.

- Two small organizations that most investors have never heard of, Institutional Shareholder Services (ISS) and Glass Lewis & Co., LLC, have come to dominate not just the field of proxy advice but the landscape of corporate governance in America.
- ISS, which controls more than three-fifths of the market, renders millions of decisions for more than 1,000 institutions that vote on proxies, affecting their holdings in 5,000 US companies.

THE INFLUENCE OF PROXY ADVISORS ON BUSINESSES

Proxy voting by institutions has become increasingly important in determining how American businesses are run, both because those institutions now hold three-quarters of the equity assets of the 1,000...
largest public corporations and because shareholder activism has increased, with the encouragement of government.

- For example, the Dodd-Frank law requires public companies to hold “Say-on-Pay” shareholder votes on executive compensation plans. While these votes are nonbinding, corporate directors risk lawsuits if they ignore shareholder opposition. ISS has been especially active in recommending “no” votes on many pay plans.

- Between them, ISS and Glass Lewis influence the votes of one-fourth to one-half of the shares of the typical mid- or large-cap company. A Stanford University study found that opposition by a proxy advisor results in a “20% increase in negative votes cast.” That figure underestimates the power of ISS and Glass Lewis since corporations trying to avoid a negative recommendation from a proxy advisory firm will shape their policies accordingly.

IMPACT OF PROXY ADVISORS ON SHAREHOLDER VALUE

It is essential to evaluate whether the policies these powerful proxy advisory firms advocate actually enhance shareholder value—the aim of good corporate governance.

- A lack of transparency makes research difficult, but studies of Say-on-Pay and exchange offers (also called options repricing) show that ISS’s recommendations deplete shareholder value to a significant degree.

- ISS also backs other governance policies—such as independent chairs and golden parachutes— for which support in the academic literature is mixed, at best.

The ultimate result is lower returns for investors, including retirees.

REASONS FOR POOR-QUALITY ADVICE BY PROXY ADVISORY FIRMS

Lack of resources to examine proxy questions in depth and with regard for the nuances inherent in the management of specific corporations, misaligned incentives, and the very conflicts of interest that the SEC tried to avoid yield suspect recommendations by the advisory firms.

- Their use of “one-size-fits-all” guidelines has produced such absurdities as recommending a vote against Warren Buffett as a director of Coca-Cola.

The proxy advisors are not shareholders and do not bear the cost of bad decisions. Their incentives are therefore not aligned with those of investors, who are directly affected by loss in value of their investment from bad decisions, or corporate directors, who themselves own shares and risk lawsuits and diminished reputations for poor decisions.

- In addition, proxy advisors suffer from the conflicts of interest that the SEC tried to avoid. Some of their largest clients are giant pension plans run by unions and politically motivated individuals, with strong social, labor, and environmental agendas. Other clients are public corporations—“issuers”—themselves. ISS, for instance, advises issuers on governance policy (including how to get proxy questions approved) and at the same time advises institutions on how to vote.
THE THREE STEPS NEEDED TO FIX THE CURRENT SYSTEM:

- Limit proxy voting requirements of mutual funds and pension funds so that those institutions will be the sole arbiters of when it makes sense to vote using active analysis of the question at hand. The test should be whether the vote enhances the value of their investment to a substantial degree and whether the benefits of the voting process exceed the costs.

- End the preferential regulatory treatment that proxy advisors currently enjoy in the law. Institutional investors would remain free to purchase proxy advisory services if those services are valuable on their own merit.

- End extraneous proxy requirements such as Say-on-Pay votes. Let shareholders and directors decide the matters that should be put to votes, if any, beyond those already required under state corporate law.

CONTACT

Chad Reese, Outreach Associate  
703-993-8921, creese@mercatus.gmu.edu  
Mercatus Center  
3351 Fairfax Drive, 4th Floor, Arlington, VA 22201  
www.mercatus.org

ABOUT THE AUTHOR

JAMES K. GLASSMAN served between 2007 and 2009 as US undersecretary of state for public diplomacy and affairs and as chairman of the Broadcasting Board of Governors. In April 2012, he was appointed to the Investor Advisory Committee of the US Securities and Exchange Commission. He was the principal financial columnist for the Washington Post from 1993 to 2004, has written three books on investing, and is currently investing columnist for Kiplinger’s Personal Finance.

J. W. VERRET is a senior scholar at the Mercatus Center at George Mason University and an assistant professor of law at George Mason University School of Law. As a member of Mercatus’s Financial Markets Working Group, he regularly briefs congressional staff, members of Congress, SEC commissioners, and other financial regulatory agencies on financial regulation topics.

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