PROXY ADVISORS: A CRITICAL ANALYSIS

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Abstract

The influence exerted by proxy advisors or proxy firms has become significantly more important over the last few years in pace with the increased activity of institutional investors. Recently, the adoption of a Swiss referendum has given fresh impetus to this development, concerning also international stockholders in the country. Spillover effects to the regulations of neighbor countries are not unlikely. Given this context, it is essential that the role of proxy advisory services and the associated stakeholders be critically appraised. Substantial problems may arouse with regard to the methodology that proxy advisors apply, the conflicts of interest that they confront, the transparency of their services or the lack thereof, and the competition in their market.

Keywords: Corporate Governance, Proxy Advisory, Institutional Investors, Ownership & Control

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1. Fundamental considerations

1.1 Shareholders, voting rights and the issue of incentives

Shareholders’ voting rights, which allow shareholders to influence important decisions at corporate general meetings, are the most valuable rights that shareholders possess, and therefore also present a core component of corporate governance. In the case of firms that are dominated by large shareholders (e.g., families), voting rights are most often observed to be exercised actively, which is often visible, for instance, in the composition of the members of the board of directors. A powerful position of this kind also gives the incumbent a vantage point for procuring better information (Buehler and Boeckli, 2005). Where the ownership structure is fragmented, as is mainly the case with large corporations, incentive issues exist which have the effect that the shareholders who possess relatively few voting rights are disempowered from performing supervisory duties and remain passive. Firstly, this is because the cost of acquiring and analyzing information is very high relative to the benefit that a small shareholder may gain (analysis of the underlying issues, evaluation of voting options and the exercise of voting rights) – particularly since the necessary activities are not the core competencies of many investors. Secondly, numerous (passive) shareholders can profit from the influence exercised by active shareholders without incurring costs (free-rider issues). Moreover, high transaction costs prevent the heterogeneous group of individual shareholders from coordinating their voting behavior and acting collectively (Olson, 1971).

This is also the reason why the managers of exchange-listed firms with a broad spectrum of shareholders are able to push agenda items through without much opposition. Shareholders, journalists, politicians and other stakeholders see effective corporate governance as being an important success factor not only for the development of the firm, but also for promoting the efficiency of capital markets. Shareholder activism becomes especially important when the corporate governance system fails, shareholders “vote with their feet”, and the stock price comes under pressure (Thompson and Edelmann, 2009).

The absence of actively exercised voting rights and an efficient shareholder democracy are accepted as being reasons for firms’ incorrect corporate strategies and excessive remunerations (authorized by the board of directors) resulting in bad press over the last few years. Shareholder control can be improved, on the one hand, by large individual shareholders who have sufficient incentive to do this due to the size of their investment share, or, on the other hand, by reduced transaction costs for smaller shareholders. It should be noted, however, that shareholders are in no way bound to carry out any fiduciary duties for other shareholders and that the interests of different shareholder groups do not always have to coincide with each other.
1.2 Institutional investors and proxy advisors

As institutional investors increasingly use investment funds as a vehicle for old-age provision (e.g., pension funds, investment funds, banks, insurances), their voting rights have become increasingly concentrated (Ferreira and Matos, 2008). However, since institutional investors’ shareholdings in individual firms remain rather small owing to their obligation to diversify, the incentive problem discussed above arises and often results in their renouncing of an active role (Li et al., 2006). Considerable time would have to be invested in the administration of such a large investment universe and institutional investors’ competencies are concentrated more in investments strategies than in corporate governance issues.  

Proxy advisors or proxy firms offer a solution to this problem. They will gather information on the exchange-listed corporations’ electoral issues and give investors advice on casting their votes at the respective general meetings. Issues of particular interest at the general meetings are, for example, the election of members of the board of directors and the remuneration of management. The increase in proxy advisory services is closely connected with the growth in the assets of institutional investors and their regulation. Institutional investors contract proxy advisors, in particular, because they are under pressure from policyholders to place the funds they manage in profitable investments. One should also note that a second opinion is also obtained in order to safeguard voting behavior.

Already in 1988, the US-Department of Labor obliged pension funds to vote in the interest of their policyholders. The proxy advisory service Institutional Shareholder Services (ISS) was established in the United States of America in 1985 and is today by far the most powerful player in this market worldwide (Fenn, 2011; Belinfanti, 2009). The power of proxy advisory services has continued to increase in recent years; and similarly, their recommendations regarding the election of members of the board of directors or remuneration models can influence voting at general meetings. On the basis of empirical investigations, the recommendation made by ISS that a member of the board of directors be rejected, led to 8 percentage points fewer ‘yes’-votes for this candidate (Cai et al., 2009). A recommendation that remuneration models be rejected reduced the votes in favor of the proposal by approximately 20 percentage points, from 93% to 73% ‘yes’-votes (Larcker et al., 2012).

1 Except some Anglo-Saxon institutional investors (e.g. Hermes, TIAA-CREF, CalPERS), who strike agreements directly (i.e. without voting), and except internal departments who work on the analysis and voting recommendations (Carleton et al., 1998; Downes et al., 1999).
**Figure 1.** European indices, total number of shareholders recorded² and their percentage shareholdings (as of March 2013)

<table>
<thead>
<tr>
<th>Country</th>
<th>Austria</th>
<th>France</th>
<th>Germany</th>
<th>Italy</th>
<th>Switzerland</th>
</tr>
</thead>
<tbody>
<tr>
<td>Index</td>
<td>ATX</td>
<td>CAC40</td>
<td>DAX</td>
<td>FTSE MIB</td>
<td>SMI</td>
</tr>
<tr>
<td>Name</td>
<td>Austrian Traded Index</td>
<td>Cotation Assistée en Continu</td>
<td>Deutscher Aktien Index</td>
<td>Financial Times Stock Exchange Index Milano Indice Borsa</td>
<td>Swiss Market Index</td>
</tr>
<tr>
<td>Number of firms</td>
<td>20</td>
<td>40</td>
<td>30</td>
<td>40</td>
<td>20</td>
</tr>
<tr>
<td>Number of shareholders recorded</td>
<td>190</td>
<td>500</td>
<td>552</td>
<td>268</td>
<td>558</td>
</tr>
<tr>
<td>Most frequent largest shareholder</td>
<td>Österreichische Industrieholding (3)</td>
<td>Government of France (5)</td>
<td>BlackRock (9)</td>
<td>Cassa Depositi e Prestiti (3)</td>
<td>BlackRock (2)</td>
</tr>
</tbody>
</table>

**Figure 2.** Shareholder structure by companies’ origin and type of major shareholder (as of March 2013)³

![Shareholder structure by companies’ origin and type of major shareholder (as of March 2013)](image)

**Figure 3.** Shareholder structure by companies’ origin and investors’ origin (as at March 2013)⁴

![Shareholder structure by companies’ origin and investors’ origin (as at March 2013)](image)

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¹ Data source: Thomson One Banker.
² Data source: Thomson One Banker.
³ Data source: Thomson One Banker.
⁴ Data source: Thomson One Banker.
The table shows that companies in France, Germany and Switzerland have twice as much shareholders recorded than companies in Austria and Italy suggesting that the firms’ size is larger as well. In addition, in Austria, France and Italy, the most frequent largest shareholders are investors associated with the government. State interests are thereby likely to play a role in these firms’ strategies. In Germany and Switzerland BlackRock, a US institutional investor, is the most frequent largest shareholder. Besides specific advisory firms themselves, large shareholders, especially institutional shareholders, often have their own proxy advisory departments. Generally, their activity is to be regarded analogous to “true” proxy advisory firms.

In the next step, we will investigate the prevalence of controlling shareholders in our sample. Controlling shareholders’ voting rights exceed 25%. Therefore, we will break down the shareholder structure of these indices into four ownership categories: (1) widely held (i.e. no controlling shareholder), (2) family-controlled firms, (3) state-controlled firms, and (4) firms controlled by other major shareholders (see Figure 2).

For Austria, we can observe a diversified shareholder structure with respect to the introduced categories: 30% of the ATX firms are widely held, 25% of the firms are controlled by families, also 25% are state-controlled, and 20% are controlled by other shareholders. A similar structure is given in Italy, but with a larger proportion of family ownership (40%). France’s, Germany’s and Switzerland’s indices, however, all show a clear dominance of widely held companies (above 70%). Here it comes to the point of integrating the potential influence of proxy advisory services to this analysis: they clearly have a higher influence on companies categorized as widely held because influence on firms controlled by families, states or others is very limited. Proxy advisors, therefore, can find a higher market potential in France, Germany and, above all, Switzerland, than they do in Austria or Italy.

In all nations’ indices except the Swiss one, most of the owners of the companies originate from the country itself (Austria: 70%, France: 49%, Germany: 52%, Italy: 68%). For the Swiss SMI we conclude another picture: only 32% of the stockholdings belong to Swiss-based investors, whereas 36% are owned by US investors and 7% by UK investors. Moreover, the analysis shows a US ownership of above 20% in France and Germany, whereas the figures are relatively low in Austria and Italy (8 to 9%). In view of this, the influence of US investors (e.g., pension funds) either directly or indirectly via proxy advisory services can be significant in France, Germany and Switzerland.

Another point to note is that (smaller) foreign investors in all single countries are likely to consult the two ‘big players’ of the United States, “ISS” (whose clients’ portfolios amount to about USD 26 billion; ESMA, 2012) and “Glass, Lewis & Co.” (USD 15 billion; ESMA, 2012)—proxy advisory services that do not adequately consider the specific features of national corporate governance. This strongly is the case in Switzerland with its large foreign ownership. But also for the other non-Anglo-Saxon countries Austria, Germany, France and Italy, ISS and Glass Lewis’ concepts of US-style corporate governance are unlikely to be able to challenge the countries’ institutional framework conditions and its culture and political landscape or be able to formulate solid voting recommendations for pension funds. A capacity to perform these functions, however, is extremely important for achieving optimal corporate governance (Doig et al., 2007).

2. Critical appraisal of proxy advisory services

The increased opportunity for shareholders to exert influence and the associated importance of proxy advisors has recently also enabled uncomfortable opinions to be voiced.

This concerns, specifically, (2.1.) the methodology that proxy advisors apply, (2.2.) the conflicts of interest that they confront, (2.3) the transparency of their services or the lack thereof, and (2.4.) the competition in their market. The following analysis critically appraises these four points.

2.1 Methodology

Proxy advisors can have a substantial influence on the decisions made at general meetings. It is therefore important their recommendations on exercising voting rights are solidly based. The problem is once again, however, that many experts, regulators and academics assume that one ‘true form’ of corporate governance exists. Unfortunately, no ‘best form’ of corporate governance exists, in the same way that no ‘single value’ can express such a concept. The absence of an analytical basis is often heavily criticized (Ertugrul et al., 2009; Bhagat et al., 2008). An optimal corporate governance structure depends on numerous complex internal and external corporate factors, such as local circumstances, shareholder structure and the sector, all of which have to be taken into considered. Research has shown that it is fundamentally important to take the corporate environment into consideration when evaluating the form of corporate governance and, particularly, when selecting board members (Boone et al., 2007; Coles et al., 2008; Lehn et al., 2009; Linck et al., 2008). Moreover, some corporate governance mechanisms are complements or substitutes for other mechanisms. For this reason, voting recommendations that are based on ratings and indices (the one-size-fits-all principle) should be used with caution. Research has shown that such indexes offer misleading rather than reliable information on the corporate governance of the investigated
companies, that the recommendations offered are not even correctly based on the indices, and that shareholders do not even vote in accordance with the recommendations. Equally, good ratings are not related to better performance (Daines et al., 2010; Epps and Cereol, 2008). Governance indices are therefore a poor reflection of the reality (Bhagat et al., 2008).

An investigation of the economic consequences of “say on pay” shows that an adaptation of the remuneration model to the (anticipated) recommendations of proxy advisors has a negative effect on the share price (Larcker et al., 2012). The authors therefore question the benefit of using proxy advisory services. This also impinges on task and duty of diligence of institutional investors to take decisions in the interests of the policyholders.

In this context, the inadequate training of the staff employed by proxy advisory services and the resulting lack of expertise (or the outsourcing of work to low-wage economies) are often criticized. Often voting recommendations have to be delivered for countless firms on complex matters within a short period of time.

### 2.2 Conflicts of interest

Proxy advisors often award ratings and thereby become opinion-leaders on matters of corporate governance. Companies are guided by so-called “best practices” and are often advised by consultancy services that not only award the companies ratings but also advise investors at the same time, and, in some cases, even offer investment funds. These proxy advisory services also issue ratings similar to those of the ratings agencies, and offer advisory services at the same time. Business linkages or long-term friendships between proxy advisors and board members harbour potential dangers. This casts doubt on the independence of proxy advisors.

Furthermore, there is the opinion that proxy advisors’ recommendations do not correspond to opinions that would result from individual substantiated discussions between institutional investors and the executive board. Often greater attention is given to supposed “moral” and “sustainable” issues than to the interests of the shareholders. The fact that shareholders often do not subscribe to these recommendations leads to the conclusion that proxy advisors follow their own agendas and do not necessarily act in the interest of the shareholders. It is therefore also questionable whether the recommendations that proxy advisors give to pension funds support the interests of their policyholders.

### 2.3 Transparency

Proxy advisors are not subject to regulation, which may be one reason why the sector lacks transparency. Often the voting guidelines on countless individual proposals are unclear, and the recommendations, which are drawn from a “black box”, are wrong, sketchy and contain mistakes (Daines et al., 2010). This is possibly linked to the weak foundation that the recommendations are based on (see 2.1 Methodology). Because the decision-making premises are unclear and mostly over-generalized, the results cannot be monitored or checked for consistency. It can also be observed that recommendations focus on well-worn issues such as “sustainability” or “social responsibility”, which, though important, are principally aimed at catching attention. This form of activism is not shared by the majority of shareholders (Copland, 2012). In contrast to institutional investors or board members/directors, proxy advisors are not obliged to “act in the interest of the policyholders” or the company. The criteria that proxy advisors use when making decisions have to be transparent, as this allows institutional investors to select advisors who will make recommendations aligned to their specific preferences. This is the only way to ensure that a shareholder democracy is effective and that proxy advisors are aware of their responsibilities (Choi et al., 2009).

### 2.4 Competition

The indicated lack of transparency is not intended to advocate regulation, but rather to indicate the lack of competition. The market is principally dominated by the US-proxy advisory service “ISS”, as its “first mover”: it is one of the few globally active proxy advisory firms and covers about 45,000 general meetings in 110 countries (Fenn, 2011). The products of proxy advisors, that is, the analysis and recommendations that are prepared on the general meeting agenda issues, can be produced with large economies of scale. This, naturally, enables the “first mover” to gain a competitive advantage. The two biggest players, “ISS” (market share circa 60%; Belinfanti, 2009) and “Glass, Lewis & Co.” (market share circa 37%; Belinfanti, 2009), influence general opinion on what is considered “good corporate governance” and, consequently, have an impressive influence on votes and on the (strategic) advisors of large corporations. Large corporations are also inclined to adopt the views of proxy advisors – views which are not always economically viable – in order keep a low profile. Researchers estimate that “ISS” can influence up to 20% of all the votes at a general meeting (Choi et al., 2010). Furthermore, numerous proxy advisors join national and international co-operations and adopt their recommendations. This makes the advisory market, which is already small enough, is even smaller.
3. Conclusion

Passive shareholders profit free of charge from individual shareholders’ efforts to establish an effective shareholder democracy. The effectiveness of a voting right, however, can be limited by certain factors. The shareholder structure is often very fragmented so that individual shareholders are unable to muster enough motivation to influence corporate issues. It is simply not worth the incurring costs of this kind with a small shareholding. Moreover, the transaction costs are so high that it is not possible to coordinate a large heterogeneous group for the purpose of analyzing common issues and making joint decisions. Where the shareholder composition is widely dispersed, these factors also usually discourage shareholders from exercising a controlling role, leaving them to adopt a passive role.

In Austria and Italy over half of all firms are controlled either by families or the state. These investors are likely to affect firm decisions and accordingly, the influence of proxy advisory firms is reduced. In contrast, in Germany, France and Switzerland most of the largest firms are widely held and US investors play an important role. In these cases, proxy advisory firms possibly have a substantial impact at general meetings. Our analysis shows the potential influence of proxy advisors on voting outcomes, but it also presents an overview on their dangers. Because of the strength of their potential influence, it is essential that advisors’ recommendations are guided by certain fundamental principles: a scientific methodology, no conflicts of interest, and transparency. Moreover, these principles can only be truly effective on the condition that proxy advisors operate in a competitive market.

It will only be possible to counteract or prevent potential consequences of problematic decisions from impacting the economy as a whole if shareholders are able to soundly subscribe to the decisions made at the general meetings. To promote this, conflicts of interest between proxy advisors and the corporations being analyzed or their shareholders must be eliminated or at least declared. Any slackness in this ruling would diametrically oppose the principle of acting “in the interest of the policyholder”.

References

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