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The Controversy over Proxy Voting: The Role of Fund Managers and Proxy Advisors

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In this statement, we assess the role and power of proxy advisors and asset managers in corporate governance in a market that is characterized by a limited number of voting advisory firms (Institutional Shareholder Services and Glass Lewis) and a growing dominance of index investing concentrated in a few large asset managers, such as BlackRock, Vanguard, and State Street. We discuss the business model of proxy advisory firms and contrast its objectives with those of asset managers in the context of the informational screening/filtering role and voting analysis and conclude with a set of policy recommendations addressing transparency and regulatory oversight.

Keywords: asset manager; governance; proxy advice; proxy advisory market; securities regulation; shareholder activism; shareholder proposals

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Introduction

The growth of shareholder investment in both actively and passively managed mutual funds in the United States, and more recently also in the EU, puts the execution of voting rights by institutional investors in the spotlight. In the United States, investment advisors are fiduciaries whose duties extend to all functions undertaken on the fund's behalf, including the voting of proxies relating to the fund's portfolio securities. An investment advisor voting proxies on behalf of a fund, therefore, must do so in a manner consistent with the best interests of the fund and its shareholders.¹

The rise of institutional ownership is a global phenomenon, reaching 43% of the 2020 world stock market capitalization in the aggregate (OECD 2021). Passively managed funds, such as index funds and exchange-traded funds (ETFs), representing an important segment of these holdings, have induced the mutual fund industry to significantly reduce its fees. However, it is unclear how a fund manager trades off the competing objectives of low fund expenses with understanding and acquiring information on governance issues in order to meet the mandate to vote in the best interests of shareholders. Moreover, the industry comprises a number of large fund families whose concentrated participation in the proxy voting process has raised concerns that these asset managers, by voting large blocks of stock, may exert enormous power over corporate decision-making and governance.²

In order to economize on costs and to take advantage of scale economies, many funds rely upon specialized firms, proxy advisors, to guide their voting decisions. Proxy advisory firms develop recommendations on how to vote at shareholder meetings on a myriad of topics, such as mergers and acquisitions, board governance (director election; duality of board chair and CEO; auditor independence), say-on-pay and, more recently, environmental, social, and governance (ESG)-related issues. The market for proxy advisors is essentially a duopoly, with

Glass Lewis and Institutional Shareholder Services (ISS) dominating the global market.³ The reliance of mutual funds on proxy advisory firms potentially gives significant market power to them to influence proxy voting outcomes.

These issues have received attention in regulatory and legislative debates in the United States and in Europe.⁴ The issues associated with proxy voting are being further amplified with the inclusion of ESG-related issues in proxy voting reform. For example, the U.S. Department of Labor has proposed rulemaking intended to make clear “that fiduciaries may consider climate change and other environmental, social, and governance (ESG) factors when they make investment decisions and when they exercise shareholder rights, including voting on shareholder resolutions and board nominations.”⁵

In a meeting held in Annapolis, Maryland, on July 17 through 19, 2022, members of the Financial Economists Roundtable⁶ assessed the ongoing debate and policy initiatives surrounding proxy advisors and asset managers in corporate governance in a market that is characterized by a limited number of voting advisory firms and a growing dominance of index investing concentrated in a few large asset managers, such as BlackRock, Vanguard, and State Street. The aim of the discussion was to come up with a balanced assessment and policy recommendations. The discussion was robust, inclusive, and productive, and this statement is intended to capture the essential points raised during the meeting discourse.

The remainder of the statement focuses on the practice and potential improvements to proxy voting and the market for proxy advisory services in contemporary corporate governance. We start by discussing the rationale for proxy voting and why there is a demand for proxy advisory services. Next, we discuss the business model of proxy advisory firms and identify potential concerns. Finally, we conclude with policy recommendations for reforms and improvements in proxy voting and the provision of proxy advice.

The Proxy Voting Process

Shareholders of publicly traded companies express their governance rights through their votes at annual shareholder meetings. Votes are taken on a wide range of corporate strategies and governance features, including board composition, independence, pay structure, and incentives. Companies send proxy statements to shareholders ahead of the annual meetings, and these statements detail the resolutions

that are offered for shareholder vote, along with proxy cards with voting instructions. The proxy materials are typically available online and/or may be sent by mail to investors who are eligible to vote during the annual meeting. Proxy ballots include governance related resolutions, a list of directors to be voted upon, and the name of the external auditor firm selected (recommended) by the board. In addition, they may include proposals for strategic investments (e.g., vote on acquisition). Finally, a variety of shareholder proposals may be presented for vote; in this regard, “say on pay” and ESG-related proposals have received wide attention in recent years.

The proxy ballots are received as part of a proxy statement which includes board recommendations for a “yes” or “no” vote. Thus, proxy voting is a mechanism that allows shareholders to influence company strategies and activities. More recently, they have become tools to challenge corporations on ESG issues. On shareholder proposals, such as “say on pay,” the votes are often advisory rather than binding. The advisory votes can be effective in generating public scrutiny of corporate practices and may influence corporate behavior and improve corporate governance.

The Advent of Proxy Advisors

Because corporate shareholder ownership is diffuse, there is a free-rider problem that may reduce the efficiency of the voting process. For example, the costs of private due diligence have to be borne by the individual investor, while the benefit of a better voting outcome is shared by all investors. The free-rider problem, therefore, may under-incentivize the production of information, possibly resulting in reduced price informativeness and poorly informed votes.

The free-rider problem extends to index and other passively managed funds that hold a large number of stocks, because they encounter significant information acquisitions costs in order to become informed about the governance issues of a particular firm. In this case, the fixed cost of becoming informed may outweigh the potential benefit they received by improved governance. Reducing managerial effort in acquiring information is generally not an option because the U.S. Securities and Exchange Commission (SEC) requires that mutual fund votes be publicly available. In addition, asset managers are expected to put into place well-designed policy and procedure guidelines for proxy voting and may face potential scrutiny from investors.

The market solution that arose to both improve the efficiency and quality of mutual fund votes and reduce information acquisition costs is the proxy voting advisor. Proxy advisory firms conduct research and provide their clients with recommendations for proxy voting. These recommendations are not binding, but they are widely used and may have impact on both corporate actions, such as board independence, executive pay, and acquisitions, and firm value.⁷ The market for proxy advice is highly concentrated with two firms dominating the industry: ISS and Glass Lewis.

The Business Model of Proxy Advisory Firms

Proxy advisory firms specialize in conducting due diligence related to voting on agenda items at annual shareholder meetings of publicly listed firms. They produce two types of recommendations: general voting recommendations on an issue-by-issue basis for each firm based on their “general guidelines,” updated annually prior to the proxy season, and a detailed subscription-based private background analysis (see Buechel, Mechtenberg, and Wagner 2022 for details). As pointed out by Malenko, Malenko, and Spatt 2021, the objective function of proxy advisors may relate to the demand for their services, rather than shareholder value maximization of the firms advised.

One of the economic roles played by proxy advisory firms is to provide recommendations to users on both contentious and ordinary issues. Contentious issues and the corresponding voting recommendations are identified based on the proxy advisors’ publicly available general guidelines that summarize the stance of the advisory firm on a list of such issues. These issues may include “say on pay,” CEO-chairperson duality, board classification, director nominations, strategic acquisitions, and ESG-related topics.

The information provided in the voting recommendations are, to some extent, only general. A highly informed vote, therefore, would benefit from the detailed analysis and firm-specific information contained in a private report to subscribers. The business model of proxy advisory firms, therefore, consists of a filtering service. For instance, by flagging a “No” recommendation for a particular item, the advisory firm signals its *general* concern with a specific proposal, allowing shareholders to focus on *contentious* issues appearing on the annual shareholder meeting agenda (Larcker, McCall, and Ormazabal 2015). In the context of asset management, the mutual fund manager can then allocate scarce

resources to contentious agenda items that will ensure that the asset manager can fulfill its fiduciary duty.

Concerns and Recommendations

There are a few general observations that help guide our recommendations. *First*, proxy advisory firms play a crucial role in corporate governance and the industry is characterized by low competition, effectively a duopoly. Given their central role in the proxy voting process, the accountability of these proxy advisory firms is crucial.

Second, the importance of the role of proxy advisory firms cannot be overstated. The rise of passively managed funds, such as index funds and ETFs, which must vote their shares but may allocate few resources to the process, has given outsized power to the proxy advisory firms. Effectively, they advise on (and judge) broad areas of corporate governance, as well as what other market participants should and could do. The advisory firms possess considerable power due to scale economies in information production and the reliance of institutional investors on their information and advice. Consequently, many asset managers, especially those of passively managed as well as smaller funds, will rely heavily on the information produced by the proxy advisory firm. We suggest that the dependence on (a few) proxy advisory firms should be lessened rather than reinforced.

Third, the difficulties in measuring and agreeing on the “right” corporate governance decisions make it important to have diversity in perspectives. There is no absolute right or wrong on these issues, and hence we should be concerned about imposing a *one-size-fits-all* perspective that may occur from reliance on proxy advice.⁸ Reliance on proxy advisory services for voting recommendations raises the question of how investor preferences, and their heterogeneity, across the whole market can be heard and aggregated.

Finally, we acknowledge the possibility of unintended consequences if there is increased regulation. For example, a benefit provided by proxy advisory firms is that they facilitate governance decisions by smaller asset managers. Indeed, the empirical evidence is that smaller asset managers vote in a manner much closer to the proxy advisory firms’ recommendations as compared to larger asset managers, who devote considerable resources to information production.⁹ This means that if proxy advisory firms would cease to exist, there might be even more concentration in the asset management industry if smaller players cannot afford to effectively discharge their fiduciary duty to vote their

shares in their investors' best interest. We caution that regulators should be mindful that their actions do not impose undue costs that could increase barriers to entry and reduce potential competition.

Concern 1: Accountability and Conflicts of Interest of Proxy Advisory Firms. The influence of proxy advisory firms in corporate governance raises issues of accountability and conflicts of interest. Proxy advisory firms may follow different practices with respect to selling services to public companies.

At least in principle, proxy advisory firms have an incentive to provide more favorable advice for the management of public companies that are their clients than for others that are not. Such incentives can emerge if, for example, there is a side relationship between the proxy advisory firm and those firms that they are analyzing, such as consulting. In fact, corporations may have incentives or feel obligated to engage proxy advisory firms for these services. For instance, they may buy services from proxy advisory firms that seem unrelated to the basic proxy advisory business, such as governance training courses, or even ESG rating services. The value proxy advisory firms may derive from such business relations could threaten the independence of their analysis and judgment leading to potential bias in their recommendations. Analogously, in the wake of the Enron scandal, the 2002 Sarbanes-Oxley Act sought to address the independence of consulting and auditing functions for auditing firms for similar reasons as those noted above.

Recommendation 1: At a minimum, proxy advisory firms should be required to disclose publicly any side business they have with the firms that they are covering and the asset managers that they are serving. By providing this information, asset managers, regulators, and independent analysts can evaluate conflicts of interest that could lead to potential bias in the recommendations.

Concern 2: Transparent Guidelines. The filtering function of proxy advisory firms described in the prior section is valuable if and only if asset managers (and ultimately investors/shareholders) can understand the factors that proxy advisory firms use to identify relevant contentious agenda topics prior to the proxy season. Proxy advisory firms disclose "general guidelines," and investors rely upon them to understand how they formulate their recommendations.

Recommendation 2: Given the importance of the "general guidelines" for investors' understanding of how proxy advisory firms assess the proxy item and their subsequent recommendation, it is important that there is accountability in adhering to the guidelines. In order for investors to understand the positions that proxy advisory firms take, both the process of generating these positions and their inputs should be transparent and the basis of the guidelines clearly articulated.

Whenever possible, the guidelines should reflect a strong and informed empirical foundation. If this is not possible because the basis appears to be philosophical rather than evidence-based, the underlying rationale for the recommendation should be transparent. It may be helpful for the proxy advisory firms to seek more explicitly a public consultation for changes in their guidelines in order to give asset managers (or even corporate managers) a fair chance of being heard. This process is analogous to regulatory rulemaking whereby regulators routinely employ a public comment process, as required by the Administrative Procedure Act. One might even consider a more fundamental process of investor involvement in generating the guidelines.

Concern 3: Proxy Advisory Market Power and Industry Competition. The current market structure of proxy advisory firms is highly concentrated, with just two firms (ISS and Glass Lewis) capturing more than 90% of the market. There is a plausible economic rationale for this, namely, economies of scale in both information production and the mechanics of delivery of proxy information and voting.

However, the concentration in the proxy advisory industry gives them considerable influence in the corporate governance of public firms and, therefore, regulators should assess whether there exist significant barriers to entry. We acknowledge that there are large asset managers, such as BlackRock, Fidelity, State Street, and Vanguard, that have the capacity to replicate the services of proxy advisory firms. These asset managers have the resources to build their own analyst teams to advise on proxy voting. This makes them much less reliant upon the advice of the proxy advisory firms than smaller mutual funds, whose votes, as mentioned previously, tend to be closely aligned with the recommendations of the proxy advisory firms. The ability of large asset managers to produce proxy information in-house provides a countervailing power that limits monopoly-like pricing and/or insider-type informational

advantages of proxy advisory firms. We also note that there does not appear to be serious concern, at present, with respect to the pricing of proxy advisory services.

Recommendation 3: The regulation of proxy advisory firms should take the industrial organization of the market into account. Any new regulatory measures should be proportional, while encouraging new entrants and more specialized proxy advisory firms in the market. For example, we envision the entry of more specialized proxy advisory firms tailored to specific voting items, such as ESG, that could provide diversity of views in recommendations and potentially allow for better aggregation of heterogeneous investor preferences in stock prices as we discuss next.

Concern 4: Recognizing the Importance of Heterogeneity in Investor Voting Preferences Is Important for Governance.

Our system of governance relies heavily upon the *diverse perspectives* of different investors and the proxy voting process. The concern, however, is that blind reliance on proxy advisory recommendations may increase the homogeneity of voting choices, reducing the potential for firm value maximization that takes into account a wide variety of viewpoints. Shareholder investment is increasingly concentrated in passively managed index funds, ETFs, and large mutual fund families, including those noted above, further removing individual shareholder preferences in corporate governance from the proxy process.

Recent initiatives, such as the proposed Index Act, may help facilitate the ability of fund investors to vote their own proportional share interests. Perhaps in response to this initiative, BlackRock announced that it would expand the proxy voting options available to its institutional clients that are invested in index funds. Its press release states that approximately 47% of the \$3.8 trillion index equity assets will be eligible for the new voting options.¹⁰ In a similar way, Charles Schwab, another large asset manager, has started to involve investors more directly in proxy voting.¹¹

While there are differences in crucial details (such as the handling of abstaining shares), allowing the ultimate buy-side investors to vote their shares is an interesting concept. It reflects an underlying desire to diffuse corporate voting power and allow heterogeneous perspectives to obtain a voice. Allowing shareholders of large index and other passively managed funds (based upon BlackRock's model or the Index

Act, for example) to vote their own shares may lessen the power of the largest asset managers, but it also could reduce the countervailing power regarding proxy advisory firms.¹² This suggests having an appropriate balance of power between proxy advisors and asset management firms.

Recommendation 4: Securities regulators should encourage the asset management industry to provide their investors with a mechanism to make their voting preferences known to the fund manager, and regulators should oversee the transparency and *integrity* of the voting processes, including the supply of information to asset managers, much like it oversees the integrity of price formation in securities markets.

We note that there have been some recent developments that are in line with our recommendations. Specifically, the repeal of the 2004 "Egan-Jones" and "ISS" letters by the SEC's Division of Investment Management,¹³ which provided special status to the conflicts of interest of proxy advisory firms, was a helpful development. These letters from the SEC staff allowed asset managers to delegate to a proxy advisory firm their voting decisions and not be held responsible for any conflicts of interest, so the repeal promotes diversity in shareholder perspectives.¹⁴

Conclusion

Voting on corporate affairs at the annual shareholders meetings should be aligned with investor preferences, because shareholder voting is regarded as the basis for legitimate decision making at the level of the firm. We believe that votes should be cast in accordance with shareholder preferences, with accountability and a diversity of opinion.

However, as was discussed in earlier sections of this statement, free-riding issues and the fixed cost of becoming informed render voting by shareholders difficult. Proxy advisory services have emerged as a possible solution to these problems and they are now an integral part of the corporate governance system in the U.S. and EU capital markets. Since there are economies of scale in information production as well as in facilitating vote transmission, a natural monopoly emerges. Although the duopoly market structure with two dominant firms is in line with this interpretation, we note that this gives rise to significant market power for proxy advisory firms to influence corporate governance.

The rise of institutional asset management, in general, and passive index funds and ETFs, in particular,

further complicate the ability of individual shareholders to have a say in corporate affairs. The current market structure of asset management is characterized by a few large fund families that concentrate shareholder voice. This raises the question of what can be done to align investor preferences with the decisions taken at the annual shareholder meetings.

The emerging common theme in the United States and Europe in responding to these issues is to enhance the regulatory and corporate governance oversight of proxy advisors and to encourage the role of investor preferences in corporate decision-making. Thus, we conclude this statement by highlighting the key recommendations stemming from the discussion in the previous section.¹⁵

First, we recommend that proxy advisory firms should be transparent about any conflicts of interest by disclosing any *other business* they have with the firms that they are covering and the asset managers that they are serving. The objective is to facilitate an assessment of potential biases in the construction of general guidelines, recommendations, and reports produced by these firms.

Second, the services provided by proxy advisors are of fundamental importance for good corporate governance of firms and the reasoning behind such recommendations may be complex and opaque. Therefore,

given the importance of the “general guidelines” for the proxy advisory voting recommendations, it is important that there is accountability and transparency regarding the underlying basis and the process by which they are generated. Whenever possible, the *guidelines* should reflect a strong and informed empirical foundation. The empirical evidence should be explained, and where guidelines appear to be philosophical rather than empirically grounded, that should be made transparent.

Third, the regulation of proxy advisory firms should take the *competitive landscape of the market* into account. Regulatory measures should not be so burdensome that they close the door for new entrants and more specialized proxy advisory firms. Furthermore, the entry of new players should be encouraged.

Finally, fourth, we recommend that regulators encourage asset managers to find a way to incorporate investor preferences into their proxy voting and provide oversight to the voting process, ensuring transparency and integrity.

We close by pointing out that with the trends in financial markets and the increasing dominance of index investing, concentration in both asset management and proxy advisory firms offers a rich area for further research.

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Editor's Note

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Notes

1. <https://www.sec.gov/rules/final/33-8188.htm>. See also EU (2017).
2. Concerns about the role of large asset managers in separating management from shareholders date back at least to Peter Drucker's book "The unseen revolution: How pension fund socialism came to America," New York: Harper & Row, 1976.
3. Together they control 90% of the proxy-advisory market (see Rose 2021). The SEC proxy advisory amendments (SEC 2022) indicate that ISS covers annually 48,000 shareholder meetings in 115 countries; Glass Lewis covers 30,000 shareholder meetings across about 100 global markets annually.
4. See SEC (2021) and EU (2017), also known as "the SRD2 directive."
5. <https://www.dol.gov/agencies/ebsa/laws-and-regulations/rules-and-regulations/public-comments/1210-AC03>.
6. The Financial Economist Roundtable (FER, <https://www.financialeconomistsroundtable.com/>) is a group of senior financial economists who have made significant contributions to the finance literature and seek to apply their knowledge to current policy debates. The FER focuses on financial economic issues of contemporary policy interest in the United States and globally through a forum for intellectual dialogue to promote informed private and public policy decisions.
7. See Buechel et al. (2022). In related work, Aggarwal et al. (2015) examine how public opinion on corporate governance is associated with proxy advisors' recommendations and voting by mutual funds.
8. The importance of credit rating agencies comes to mind. In that context there is a clear objective measure: default risk. That clarity has made them indispensable for the functioning of debt markets. Nevertheless, a key lesson from the Global Financial Crisis was that dependence on them should be limited (and indeed, the Dodd-Frank Act pushed back on reliance on credit ratings for federal regulation). However, the centrality of ratings in debt markets, together with the natural monopoly aspects, make that aim difficult to accomplish.
9. See Brav et al. (2021), Iliev and Lowry (2015), and Buechel et al. (2022), p.5.
10. <https://www.blackrock.com/corporate/about-us/investment-stewardship/blackrock-voting-choice>.
11. https://www.investmentnews.com/schwab-responds-to-investor-activism-by-giving-fund-shareholders-more-say-in-proxy-voting-227783?NLID=2022_Daily-Pulse-1-column&NL_issueDate=20221013&utm_source=2022_Daily-Pulse-1-column-20221013&utm_medium=email&utm_campaign=investmentnews&utm_visit=734333&msdynttrid=7ZXD1SFDsL9wKtjHYH5vwEbnpFB1Hd4Dg0hfA7IzU40.

12. Greater participation of the underlying investors rather than asset managers may enhance the power of the proxy advisory firms.
13. <https://www.sec.gov/news/public-statement/statement-regarding-staff-proxy-advisory-letters>.
14. Another concern is that *common ownership* in asset management due to the rise of passively managed funds and increased concentration in the asset management industry may lead to distortions in proxy voting. In the literature, the common ownership problem refers to the objective function of asset managers holding an index portfolio (Schmalz 2022). The task of a fund manager is to maximize the combined shareholder value of all firms in the portfolio. However, this objective may not be the same as maximizing individual firm shareholder values. The difference between these two objective functions is related to the competitive structure of the industry. For example, if two firms are competing with each other, such as Pepsi and Coca-Cola, a common shareholder (holding shares in both companies simultaneously) may favor a lower degree of competition between these two firms than individual shareholders would. Thus, common ownership in the equity of firms competing in the same market, as is often the case in index investing, changes the objective function of investors. The growing importance of a small number of very large asset managers may well increase the risks attributed to common ownership.
15. The relevance of this statement and its recommendations is broader than the United States and Europe. Getting corporate governance right is a global agenda, including development circles. In particular, the G20/OECD Principles have become global reference points for best practices governance involving diverse stakeholders: private corporations, state-owned enterprises, institutional investors, and related intermediaries (includes proxy advisors): <https://www.oecd.org/corporate/principles-corporate-governance/>.

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