CIMA Research Executive Summary
Vol. 15 Issue 4

CIMA

Proxy Advisory Firms

Information intermediaries or standard setters?

PAMPLIN COLLEGE OF BUSINESS VIRGINIA TECH.

ILLINOIS Gies College of Business

Key conclusions

- Proxy Advisors (PAs), companies that advise and provide voting recommendations to shareholders, are viewed by compensation committees and other internal stakeholders as de facto standard setters.
- It is common for firms to deviate from their compensation policy under the influence of PAs. They influence compensation choices, such as the mix of short and long-term incentives, the use of stock options, which performance measures to use, and composition of peer groups.
- Internal stakeholders believe that PAs face conflicts of interest and rely too heavily on formulaic, one-size-fits-all processes. Despite these and several other criticisms, internal stakeholders feel that PAs have had an overall positive influence on compensation design.
- PAs hold substantial power and can directly influence compensation design, resulting in less differentiated compensation plans and boards that make fewer discretionary performance adjustments.
- The influence of PAs has also had beneficial effects such as increased transparency and accountability over executive compensation and shareholder engagement.

Contents

Abstract

Institutional investors may seek (and pay for) the advice of "proxy advisors" (PAs). These are companies that advise and provide voting recommendations on a range of issues, including board composition, takeovers and acquisitions, and executive compensation.

We examined how internal stakeholders, (i.e., board directors, HR executives and compensation consultants) who are responsible for executive compensation design, view PAs. More specifically, we wanted to understand how they perceive the role(s) of PAs, how they respond to PA influence, and how they perceive the quality of PA recommendations.

Interviews with these internal stakeholders showed that PAs are viewed as fulfilling their stated indirect role as information intermediaries who provide vote recommendations and identify "best" practices. However, PAs also appear to have more direct influence; interview participants indicated that they make changes to their compensation design to appease PAs or avoid scrutiny from PAs.

Though we found broad agreement regarding the various criticisms of PAs (e.g., that PAs face conflicts of interest, use one-size-fits-all models, and others), we also found that internal stakeholders' overall view of PAs is positive. They believe PAs have improved compensation practices, for example, by increasing transparency and accountability as well as shareholder engagement.

Introduction

Shareholders have the right to vote at company general meetings and, if they do not attend themselves, they can appoint a proxy to vote on their behalf. Institutional shareholders such as pension and investment funds can hold large numbers of shares and can affect the outcome of key votes on issues such as the composition of the board of directors and executive pay.

These institutional investors may seek (and pay for) the advice of "proxy advisors" (PAs) — companies that advise and provide voting recommendations to institutional investors.

PA firms, such as Institutional Shareholder Services (ISS) and Glass Lewis, provide research and voting recommendations on matters such as executive compensation and governance to institutional investors.

There is a growing concern among market participants that PAs have outsized influence on proxy voting outcomes. This potentially allows PAs to exert pressure on firms to adopt PAs' preferred practices, which may not actually be in the best interests of shareholders. Examining PAs' role(s) is important for understanding the design of executive compensation and has implications for whether PA influence is likely to enhance or harm firm value.

The nature of PAs' influence and whether PAs are helpful or harmful is the subject of debate among practitioners and academics alike. Regulators such as the Securities and Exchange Commission in the U.S. and the Financial Reporting Council in the UK have scrutinised PA influence. The role of PAs has come under increased scrutiny in the U.S. since the introduction of "Say on Pay" regulations in 2011. In ensuring that shareholders have more control over executive compensation schemes, the regulations increased the influence of PAs because if companies accept PA recommendations, then they are deemed to be acting in the interests of shareholders. This has become a contentious issue in the U.S. One of the major players, ISS, not only provides proxy voting advice but also consultancy services. Companies may feel that they have to pay ISS for consultancy advice to ensure that their compensation scheme will be approved (by ISS).

The influence of PAs has become a concern not only because of this potential conflict of interest but also because they act as de facto "standard setters" for executive compensation schemes. This has also been criticised because PAs, who review the affairs of many companies and without deep insight into particular company circumstances, may adopt a "checklist" approach in their scrutiny of company policies.

Concerns aired in the UK reflect those voiced in the U.S. Sir Winfried Bischoff, chair of the Financial Reporting Council, wrote to PAs informing them that the new Corporate Governance Code (Financial Reporting Council 2018), published in 2018, takes a broad view of governance and expects them to account for individual company circumstances in their recommendations. "A box-ticking approach does not serve the needs of your clients or promote high-standards of governance in the UK".

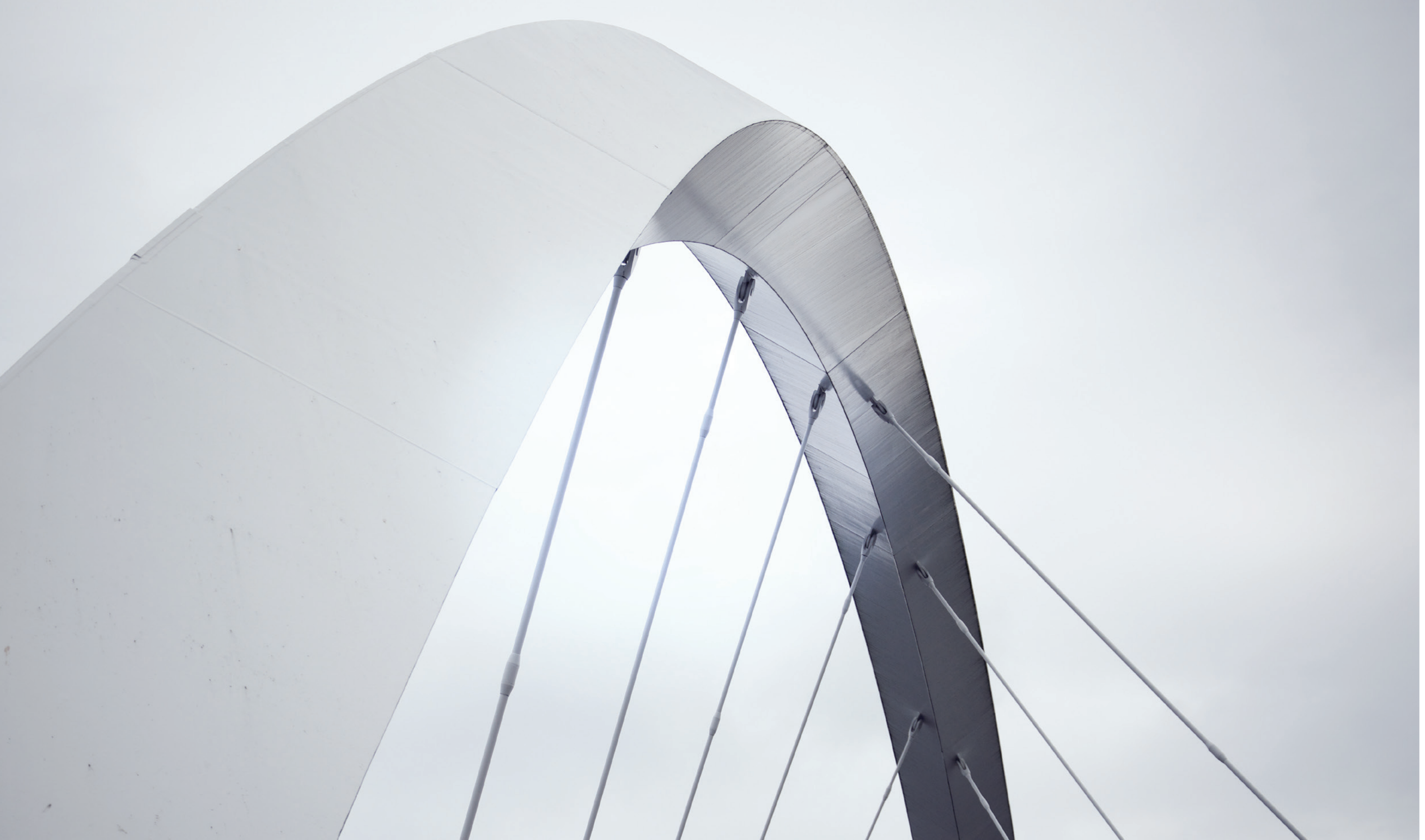
Prior research has examined the role of PAs primarily from the perspective of institutional investors. However, the impact of PAs on executive compensation practices ultimately depends on how the internal decision-makers within firms view the role of and respond to PAs. Boards of directors are elected by shareholders to represent the owners' best interests, including in setting compensation practices. However, if boards feel pressure to improve Say on Pay and director-related voting results, and, if PAs are viewed as influencing shareholder votes, then boards may view PAs' preferred practices as effectively "mandatory" standards for adoption, even if they do not fit the company's unique circumstances.

In this study, we interviewed internal stakeholders (i.e., board directors, HR executives, and compensation consultants) responsible for setting executive compensation to understand how they perceive the role and influence of PAs. We also investigated how these internal stakeholders view the quality of PA guidelines and recommendations, and the resulting impact on executive compensation practices.

Objectives

The project aimed to understand how key decision-makers responsible for executive compensation design view PAs. In particular, we ask the following research questions:

- How do internal stakeholders perceive the role(s) of PAs?
- How do internal stakeholders respond to PA influence in terms of compensation design?
- How do internal stakeholders perceive the quality of PA recommendations and the resulting influence on compensation practices?



Research methodology

We employed field study methods by interviewing board directors, HR executives and compensation consultants to represent the perspective of "internal stakeholders." We also interviewed representatives from PA firms to complement our findings. See Table 1 for interview details. The goal of interview-based research is to "tap into the knowledge of those who have the requisite experience, first-hand knowledge, and understanding to provide meaningful insight into the substantive issue being investigated" (Malsch and Salterio 2016, p.17). Moreover, our research method enables us to provide rich narratives that enhance other research and direct evidence of PA influence on specific executive compensation practices, the latter of which is noted as a particular challenge in prior research.

Our interview script was pre-planned but we asked follow-up questions as needed and, otherwise, let the interview participants speak openly and at length. Each interview lasted an average of 65 minutes.

Each interview transcription was reviewed for accuracy and was formally analysed and coded by one of the two researchers as well as by a graduate-student research assistant. We developed a detailed codebook to guide our analysis and used specialised qualitative data analysis software.

Table 1: Interview details [1]

Role	Number of interviews	Additional information
Board directors	8	• Represent various industries, market caps (small through mega-cap), and levels of compensation risk • Some but not all had recently experienced or were currently experiencing a negative vote recommendation from at least one PA • All had compensation committee experience.
Human resources executives	18	• Representative job titles include head of global rewards, VP or SVP of rewards and director of executive compensation • Represent various industries, market caps (small- through mega-cap), and levels of compensation risk • Some but not all had recently experienced or were currently experiencing a negative vote recommendation from at least one PA • Sit in on board meetings and are more likely to interface directly with PAs.
Compensation consultants	11	• Represent dozens of firms across many industries • Represents 11 consulting firms, including 7 of the 15 largest compensation consulting firms.
Proxy advisory representatives	6	• Includes representatives from four of the five PA firms in the U.S. • Institutional Shareholder Services (ISS) and Glass Lewis & Co. hold more than 90% of the market share; Egan-Jones Proxy Services, Segal Marco Advisors, and ProxyVote Plus hold the balance.

[1] Note that respondents often specifically referred to ISS in their responses. Other than when respondents were describing the consulting role that relates only to ISS, respondents usually noted that their comments referred to PAs more generally. Similarly, when respondents referred to "ISS and Glass Lewis," they usually intended to speak of PAs in general.

Main findings and their implications for practice

1. How do internal stakeholders perceive the role(s) of PAs?

We found that internal stakeholders perceive that PAs indirectly influence compensation design through the following roles: information intermediary, "safe harbour" for fulfilling investors' fiduciary duty to vote shares, agenda setter for institutional investors, and agenda setter for internal stakeholders. We also found that internal stakeholders perceive that PAs directly influence compensation design by fulfilling a de facto standard setter role.

Although we organised our analyses of PAs' influence in terms of "indirect" versus "direct," in practice, these roles should be thought of as two ends on a continuum. We describe each role in turn and include quotations from interview participants for evidence.

Refer to Table 2 for the frequency with which interview participants identified the various roles held by PAs.

Table 2: The Role of proxy advisors

Relatively indirect influence

Role	Number of respondents (out of 37) who discussed the role	
Information intermediary	26	70.3%
Safe harbour	20	54.1%
Agenda setter for institutional investors	9	24.3%
Agenda setter for internal stakeholders	37	100%
De facto standard setter	37	100%

Relatively direct influence

Information intermediary

- Consistent with PAs' own stated objectives, we found that internal stakeholders view PAs as filling an information intermediary role. PAs aggregate and compile the details of an issuer's proxy statement and provide vote recommendations to institutional investors — their main customer. PAs also devise and disseminate guidelines and best practices through this intermediary role, which serves as a benchmark for their vote recommendations.
- "The role of proxy advisors is to support institutional investors and provide them with research that they ultimately may or may not use in their voting decisions. ... They're actually helping investors filter through their portfolio companies and know where to spend their time."

(Compensation consultant interviewee)

Safe harbour

- Internal stakeholders believe that some institutional investors "blindly follow" PA voting recommendations rather than perform their own due diligence, a strategy that allows them to nominally fulfil their fiduciary duty to vote. Most often, internal stakeholders noted that smaller institutional investors relied on PAs as a safe harbour due to their resource constraints, but, on occasion, larger institutional investors were also identified for their overreliance on PA recommendations.
- "There are some institutional investors that either are required by charter or just do it as a matter of rote that they actually vote whatever ISS says. So, they don't care really. ... Whatever [the PAs] put on the report, they vote it that way."

(Board director interviewee)

Agenda setter for institutional investors

- Internal stakeholders believed that PA voting recommendations as well as their "best" practices were used by institutional investors to screen and identify which issues to put on their agendas for review. For example, if PAs seem to be changing their opinion on a particular pay practice or altogether disapprove of one, these were the sorts of issues internal stakeholders believed that institutional investors were more likely to pay attention to and analyse.
- "[PAs] come up with what the appropriate proxy voting guideline should be around executive compensation. It's intended to give shareholders ... the baseline framework in terms of what should be looked at and what should be reviewed when shareholders have to approve compensation arrangements or equity shareholder proposals. It does help set the baseline."

(Compensation consultant interviewee)

Agenda setter for internal stakeholders

- Similar to the prior role, PAs also play a part in setting the agendas for board directors. Board directors (along with their supporting HR executives and compensation consultants) spend significant time reviewing and considering the "hot buttons" as determined by which issues the PAs are focusing on.
- "At compensation committee meetings, our compensation consultants do a whole presentation on the latest with ISS. We do that at almost every compensation committee meeting."

(Board director interviewee)

De facto standard setter

- We find that internal stakeholders perceive PAs as de facto standard setters. In interviews, they refer to PAs as "for-profit regulators" or "quasi-regulators." Moreover, internal stakeholders describe PA reports as identifying what PAs "like" or "do not like" (or even "hate") about a firm's pay practices and refer to "rules" that need to be followed or even "demands."
- "You wouldn't approve something that you thought the proxy advisors would disagree with. You might approve something that the consultants don't agree with because you hire consultants for advice, but you don't hire them to grade you. You might approve something that management doesn't like because that's too bad. It's hard for me to see that you would approve something that Glass Lewis or ISS trashed because of the reputation risk. In the end, the reputation of the company is the highest thing that you're responsible for."

(Board director Interviewee)

2. How do internal stakeholders respond to PA influence in terms of compensation design?

We find that many firms give in to PA influence by making changes to their preferred executive compensation design. Internal stakeholders readily admit that PA guidelines and recommendations have led them to compromise their compensation philosophy. Our interview participants provided examples such as:

- Changing the compensation mix (e.g., proportion of stock options versus restricted shared): "We wouldn't do that [compensation mix], even if it made strategic sense, simply because it would be too far out of what normal practice is and too far out of what ISS would like to see us doing." (HR executive interviewee)
- Decreasing the amount of equity issued to reduce the burn rate (i.e., speed at which firms use shares available for grant in their equity compensation plans): "In a perfect world, our CEO would do broad-based stock options," but due to pressure from ISS to reduce burn rate, the firm has been "put on a diet". (HR executive interviewee)
- Using certain performance measures (e.g., total shareholder return) over preferred ones: "Once [ISS] said total shareholder return was a good measure, the world seemed to just say, 'That passes the ISS test.' " (HR executive interviewee)

Some of these changes contradict what the board otherwise believes is optimal for the firm and its shareholders. Typically, these changes lead to increasingly undifferentiated executive compensation packages, and boards are less willing to make discretionary performance adjustments. Importantly, we find that PA influence was felt not only by firms with high-risk compensation design or that had faced PA scrutiny but also by firms with low risk compensation design or that had not suffered adverse PA scrutiny (i.e., the firm receives relatively high "Say on Pay" vote outcomes).

Giving in to PA influence was very common among interview participants, though some also noted times at which they were unwilling to compromise on compensation design. On such occasions, interview participants felt strongly that their chosen pay practice better aligned with the firm's strategy or shareholder preferences and were willing to defend their position against the PAs.

3. How do internal stakeholders perceive the quality of PA recommendations and the resulting influence on compensation practices?

We found that internal stakeholders were nearly unanimous in recognising the criticism that PAs face a conflict of interest and suffer from a formulaic "one-size-fits-all" approach to their analyses and recommendations. We have described and included quotations for only these criticisms and refer to the other criticisms more generally. Table 3 summarises the frequency with which interview participants identified each criticism.

Table 3: The criticisms of proxy advisors

Criticism	Number of respondents (out of 37) who discussed the criticism	
Conflict of interest	32	86.5%
One-size-fits-all	32	86.5%
Shareholder misalignment	21	56.8%
Errors and inaccuracies	16	43.2%
Lack of transparency	15	40.5%
Unresponsive	10	27.0%
Inexperienced staff	7	18.9%
Wastes time/energy	5	13.5%

Conflict of interest

- The criticism concerning conflicts of interest pertains specifically to ISS since it is the only PA firm that provides both proxy voting recommendations to institutional investors as well as consulting services to public issuers on how to improve their voting outcomes.
- Participants described the practice of consulting to and providing voting recommendations for the same issuer with terms such as "blood money," "extortion fees," "bribes," and "racketeering."
- "You guys are a walking contradiction! On one hand, you provide this insight. On the other hand, you want to charge me for consulting to make sure that we are validating what we do against the guidelines that the other side of the house possessed. ... They literally are talking out of both sides of their mouth, and, unfortunately, you can get caught in the middle. One of the ways to get out of jail with them is to get in bed with the consulting arm. So, it is a conflict; it's a huge conflict."

  (Board director interviewee)
- Interestingly, though interview participants nearly all identified and spoke of this criticism at length, none were able to identify whether and how this conflict had negatively affected the quality of PA recommendations.

One-size-fits-all

- This criticism, also held widely among interview participants, blames PAs for using formulaic, one-size-fits-all models in their analyses, resulting in recommendations that are too standardised and ignore important firm-specific details.
- "ISS, in many ways, occupies an ivory tower. They're not on the ground. It's not a criticism, merely an observation. They're not in the bowels of these companies—they can't be; it's a physical impossibility—and yet they're judging these companies."

  (Compensation consultant interviewee)

- Unlike the conflict of interest criticism, interview participants did feel that the quality of PA recommendations suffered as did compensation design. For example, participants noted that PA guidance often did not account for firm size, firm age, product lifecycles, or, more generally, unique details of the firm's strategy.

Other criticisms

Though not as common as the conflict of interest and one-size-fits-all criticisms, interview participants also voiced several other criticisms of PAs and the PA industry:

- PA guidance has led to compensation practices that misalign shareholder and executive decision-making.
- PA guidance often contains errors and inaccuracies.
- The policies and procedures underlying PA research and recommendations are not transparent and often introduce policy changes too late for firms to adjust their pay practices.
- PAs rely on inexperienced staff (e.g., recent graduates) for analysis of the proxy statements.
- Dealing with PA-related issues distracts executives from important and value-added tasks and, instead, results in lost time and energy.

Refer to Hayne and Vance (2019) for additional details and evidence concerning these other criticisms.

4. Implications for practice

- PAs fill various roles, which can be depicted on a continuum ranging from having relatively indirect influence through helping institutional investors monitor their portfolio firms, to having much more direct influence, effectively allowing PAs to set executive compensation "standards." It is important to understand the overt role of PAs — to provide nonbinding vote recommendations and compensation "best" practices that are not mandated for adoption — but also to recognise their perceived role. As described in this report, many key decision-makers responsible for executive compensation design either believe that PAs have a more significant role or feel pressured to allow PAs a more significant role.
- Executive compensation plans should be designed to motivate, reward and retain the best talent. Compromising the firm's compensation philosophy to avoid PA scrutiny, align with PA recommendations, or win a proxy vote may result in short-term gains at the cost of long-term consequences.
- As an alternative to succumbing to PA influence, firms can stand their ground as it relates to their compensation philosophy, increase outreach and engagement efforts to learn what shareholders prefer, and improve reporting disclosure and transparency in proxy statements by fully and clearly detailing their executive compensation design choices (especially ones that might appear to go against PA recommendations).
- From interviews with PA representatives, we learned that they see their influence on executive compensation as mainly indirect. Further, PA representatives are aware of the criticisms against the services they provided. Importantly, the PA representatives we interviewed expressed a general willingness to engage with issuers to discuss their issues and concerns, particularly any errors and inaccuracies in their reporting.
- While many PA criticisms are widely known and there is currently a push to introduce regulation to restrain PA influence, PAs are, in fact, viewed as having a positive influence on some areas of compensation design.

Conclusions

- PAs' stated role is to process information and provide voting recommendations to investors to help monitor boards of directors. However, PAs appear to have gained influence so much so that key decision-makers view them as de facto standard setters. In fact, firms make changes to their executive compensation design — even ones that go against their compensation philosophy, do not align with shareholder interests, and may potentially hurt firm value — to avoid or reduce scrutiny from PAs.
- Direct influence by PAs reflects a structural problem that undermines the ability of the proxy voting system to fulfil its intended corporate governance role. Our evidence demonstrates the extent of PAs' power to influence corporate practices, lending validity to this concern. At the same time, our findings also demonstrate the positive influence of PAs, notwithstanding public comments and criticisms to the contrary. As investors and regulators continue to evaluate the appropriate role and influence of PAs, they should consider both the negative and positive effects PAs may have on governance and executive compensation outcomes, as described in our study.
- Internal stakeholders believe that PAs face conflicts of interest (particularly ISS) and rely too heavily on formulaic, one-size-fits-all processes among several other criticisms. Despite these criticisms, internal stakeholders do feel that PAs have an overall positive influence on compensation design.
- The negative consequences of PAs' ability to directly influence compensation design are that executive compensation contracts have become increasingly homogenous and that boards make fewer discretionary performance adjustments. Moreover, compromising the firm's compensation philosophy to avoid PA scrutiny, align with PA recommendations, or win a proxy vote may result in short-term gains at the cost of long-term consequences (e.g., the ability to motivate, reward, and retain the best talent).
- The positive effects of PAs' influence include increased transparency and accountability regarding executive compensation as well as more frequent engagement between internal stakeholders and shareholders.
- Ultimately, the impact of PAs on executive compensation practices for a given firm depends on how the internal stakeholders respond to pressure to conform to PA-preferred practices. Our study highlights the tension that internal stakeholders — particularly boards of directors — may face between using their internal information and expertise to implement policies they believe are in shareholders' best interests and maintaining legitimacy with external monitors.

References and further reading

1. Ertimur, Y., F. Ferri, and D. Oesch. 2013. Shareholder votes and proxy advisors: Evidence from say on pay. Journal of Accounting Research 51 (5): 951-996.
2. Financial Reporting Council. 2018. The UK Corporate Governance Code. [online] London: Financial Reporting Council. Available at: frc.org.uk [Accessed 4/15/2019].
3. Government Accountability Office (GAO). 2016. Corporate shareholder meetings: Proxy advisory firms' role in voting and corporate governance practices. Report 17-47. Washington, DC: Government Printing Office.
4. Hayne, C., and M. Vance. Forthcoming. Information Intermediary or De Facto Standard Setter? Field Evidence on the Indirect and Direct Influence of Proxy Advisors. Journal of Accounting Research. DOI 10.1111/1475-679X.12261
5. Larcker, D., A. L. McCall, and G. Ormazabal. 2013. Proxy advisory firms and stock option exchanges. Journal of Accounting and Economics 56 (2-3): 149-169.
6. Malsch, B., and S. E. Salterio. 2016. "Doing good field research": Assessing the quality of audit field research. Auditing: A Journal of Practice & Theory 35 (1): 1-22.
7. McCahery, J., Z. Sautner, and L. Starks. 2016. Behind the scenes: The corporate governance preferences of institutional investors. Journal of Finance 71 (6): 2905-2932.

Researchers' names and contact details

Christie Hayne

Assistant Professor
Gies College of Business
University of Illinois at Urbana-Champaign
Wohlers Hall, Suite 211
Champaign, IL 61820

T: 217.300.4577
E: hayne@illinois.edu

Marshall Vance

Assistant Professor
Pamplin College of Business
Virginia Tech
Pamplin Hall, Suite 3007
880 West Campus Drive
Blacksburg, VA 24061

T: 540.231.2527
E: mdvance@vt.edu

Acknowledgements

Christie Hayne and Marshall Vance would like to thank CIMA's General Charitable Trust for funding this project. We would like to sincerely thank the compensation professionals who agreed to participate in this research. We are also grateful for the research assistance provided by Ying Gao, Julianna Lyle, Rachel Lyle, and Sarah Zieve.

aicpa.org
aicpa-cima.com
cgma.org
cimaglobal.com

July 2019
ISBN 978-1-85971-877-3