MARKETS

How Financial Institutions Disenfranchise Everyday Investors

By PAUL ROSE | May 12, 2021 6:30 AM

Traders work on the floor of the New York Stock Exchange in New York City, March 9, 2020. (File photo: Bryan R Smith/Reuters)

Corporations are increasingly beholden to proxy-advisory firms that often ignore the interests of everyday investors.

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CORPORATE America's proxy season is upon us, with most public companies preparing to hold their annual meetings. This year, an array of social activists and labor unions have called on asset managers to vote in favor of various socially oriented shareholder proposals, among other ideas buried in proxy statements that outline matters up for shareholder votes.

We don't yet know how these votes will turn out, but if history is any guide, we can predict how most institutional investors will cast their ballots. Among the largest shareholders in most public companies, large asset managers tend not to consider ballot items individually. Instead, they outsource their votes to one of two major proxy-advisory firms, Institutional Shareholder Services (ISS) and Glass, Lewis & Co., which — despite generating relatively modest revenue — wield outsized influence over shareholder voting. ISS and Glass Lewis are each owned by private-equity firms and together control more than 90 percent of the proxy advisory market. Last year, 114 institutional investors voted in lockstep with one of these two major proxy advisers. These "robovoting" institutional investors collectively managed more than $5 trillion in assets.

Regulators have taken notice. Last summer, the Securities and Exchange Commission enacted new rules for the proxy-advisory industry, which take effect next year. Although the SEC's final rule did not directly address robovoting, the commission did suggest in supplemental guidance that an institutional investor relying on proxy advisers should consider "whether its policies and procedures, including any policies and procedures with respect to automated voting of proxies, are reasonably designed to ensure that it exercises voting authority in its client's best interest." Further, investment advisers using proxy-advisory services may need to provide "sufficiently specific" disclosure so that "a client is able to understand the role of automated voting in the investment adviser's exercise of voting authority."

The SEC is taking renewed interest in shareholder voting because the shareholder franchise is a critical tool for protecting the interests of business owners, who — unlike employees, customers, suppliers, and lenders — lack contractual protection of their interests. For most of the past century, shareholders were dispersed and relatively powerless to act as a check on management. But with public markets increasingly controlled by institutional investors, a single shareholder can tilt the balance in a proxy vote. Today, powerful institutional investors are better able to monitor and influence corporate managers. In addition, investors often hold diverse views on environmental, social, and governance issues, and some are willing to sacrifice substantial profits in response to these issues.

The increase in institutional investors' power may have the potential to reduce managerial opportunism. But new tensions have emerged in the relationships between institutional investors and the individuals whose money they manage, as well as between proxy advisers and the institutions they advise. Individual investors who hold shares in mutual or pension funds have always faced the risk that the interests of management would not align with their own. Now, they must contend not only with corporate executives but also with the institutions that invest their savings.

Proxy advisers, of course, must respond to the demands of their customers. But not all institutional investors utilize these firms in the same way, or with the same interests. The largest fund families have in-house teams dedicated to shareholder-voting issues and utilize proxy advisers mainly to gather information. Many other institutional investors, however, do not perceive that informed shareholder-voting offers a competitive advantage — especially index funds, which operate on a low-cost business model owing to fierce price competition. These are our robovoters. Conversely, some institutional investors pay particular attention to shareholder-voting matters but are focused on issues beyond share value — notably, specialized "social investing" funds and pension funds with captive capital, especially public pension funds controlled by partisan elected officials. Empirical evidence suggests that socially oriented investors have successfully captured proxy-advisory firms' voting recommendations; in a study last fall, University of Southern California professor John G. Matsusaka and researcher Chong Shu found that proxy-advisory firms have tended to "tilt their advice away from policies that maximize issuer value toward policies that give more weight to social issues."

The apparent capture of proxy-advisory firms' voting recommendations highlights the risks inherent in institutional investor robovoting. The most influential shareholders in shaping proxy advisers' views may be those institutional investors who are least concerned with maximizing shareholder returns. But as proxy advisers adopt these views, the robovotes follow. Individual investors, many of whom are principally worried about building a nest egg for retirement, are left holding the bag. And the costs may be real: Another recent study by Chong Shu found that stock prices drop when ISS changes a voting recommendation to match the preferences of investors it is trying to retain as clients.

So as some activists monitor proxy votes to see whether institutional investors support their social agendas, I'll be watching to see how many funds continue to outsource their votes to proxy advisers. I'll also see how they change their disclosures, if at all, in light of the SEC rule that will be in force next year. Hopefully, the commission's new rule will reorient voting behavior to the benefit of "Main Street" individual investors.

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REVIEW OF INSTITUTIONAL INVESTOR ROBOVOTING, published by the Manhattan Institute on April 22.

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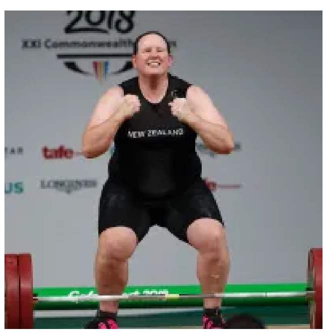

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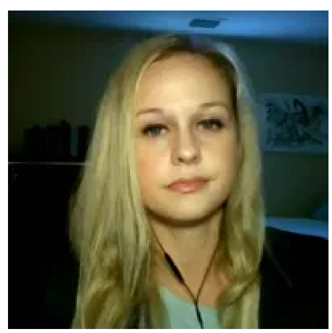

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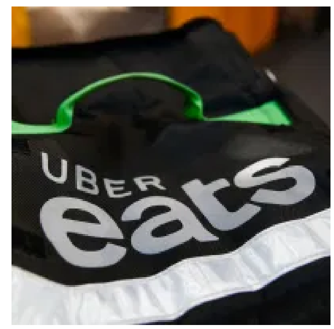

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