**Toward a Theory of the Proxy Advisory Industry**

November 4, 2019

1. **Introduction**

Nearly a century ago, Berle and Means (1932) called attention to the separation of ownership and control in modern corporations, which they attributed to the inability and unwillingness of dispersed shareholders to exert control over management. The situation has become, if anything, more complicated today, as the preponderance of stock in major corporations is now held by often-passive institutional investors with little interest in monitoring corporate management, and no capacity to make judgements about management quality or management decisions.[[1]](#footnote-1) To fill the gap, proxy advisory firms have emerged that specialize in monitoring companies and providing information to shareholders to inform their votes. The hope is that these information intermediaries can plug the hole in the market and allow shareholders to exercise effective control.

Yet there are substantial doubts about the proxy advisory industry. In the last two decades, the industry has consolidated into effectively two companies that control 97 percent of the market, ISS and Glass Lewis, resulting in little diversity of opinion.[[2]](#footnote-2) It is well documented that the recommendations of proxy advisors have a significant effect on corporate elections,[[3]](#footnote-3) but the quality of their recommendations has been questioned.[[4]](#footnote-4) They maintain surprisingly small workforces for the number of securities and issues they track, leading some to conclude that their advice is largely based on simple formulas or checklists; and they often take positions on corporate governance issues about which the scholarly literature is divided, without an explanation of how they were able to arrive at definitive findings on issues that have eluded sustained academic investigation.[[5]](#footnote-5) Some evidence suggests that their recommendations may even reduce corporate value (Larcker et al., 2015)

The premise of this paper is that the quantity and quality of advice provided by the proxy advisory industry should be seen not as the search for some objective truth, but as the equilibrium outcome of competition between potential suppliers of advice who try to meet demands from funds with different preferences. We develop a model that embeds key institutional features of the demand side of proxy advice and the technology of producing proxy services (vote execution platforms), and study the equilibrium of the industry. We are particularly interested in understanding the equilibrium structure of the industry – how many firms survive in equilibrium – and the nature of advice that is provided. Our model shows that the industry tends toward monopoly provision of advice, and more important, that competitive pressure causes the advice to be slanted away from policies that are value-maximizing, even if most customers would like their votes to be cast in support of value-maximization.

The model is distinguished from the textbook model of a competitive market in two important ways, both of which reflect actual practices. First, all proxy advisory firms sell their advice bundled with vote execution services.[[6]](#footnote-6) Because a fund may cast tens of thousands of votes each year, and the process of submitting those votes company-by-company can be substantial, the value of vote execution services can exceed the value of proxy advice for some funds. Second, the funds that buy proxy advice have heterogeneous preferences over the type of advice they receive. Some care only about the returns generated by the company, while others care about nonfinancial consequences of a company’s behavior. For example, some investors care about “social” outcomes such as climate change, sustainability, and human rights; some care about specific issues such as animal rights and political contributions; and others may derive private benefits from corporate actions such as labor unions and public pensions that may seek to preserve jobs at the expense of corporate profits. As a result of heterogeneous demand for advice, the proxy advisor’s goal is not simply to provide advice that maximizes corporate value, but to provide advice that maximizes the financial and nonfinancial outcomes that matter to its customers.

The model consists of an issuer, a set of funds that hold the shares of the issuer and vote on its directors and policies, and an endogenously determined group of proxy advisory firms. Each proxy advisor adopts a production technology for executing trades that features economies of scale. Each proxy advisor also adopts a policy position, which is a point on a line, concerning the firm’s policy choices. One point represents profit maximization, while the other points involve lower profit but advancement of some other objective, that we call a “social policy.” Funds choose to buy services from the proxy advisor that offers the best combination of execution cost and policy position. That is, proxy advisors compete in terms of the price of execution services and the policy slant of their advice.

We establish several results concerning the equilibrium of this market. First, as the demand increases, the number of proxy advisors declines, tending toward a monopoly in the limit. This happens because as the demand grows, proxy advisors are able to employ vote execution technologies that exploit economics of scale, and offer lower execution prices. As prices fall, funds are increasingly attracted to the low-price proxy advisory firm, holding constant policy position. Less obviously, we show that a growth in demand from funds that care only about financial returns (versus social policy) causes proxy advisors in equilibrium to choose policy positions that cater more to funds that do value social policy. This counterintuitive result emerges because as the proxy advisor captures economies of scale and drops its price, the return-only funds are captured by the lower price, freeing the proxy advisor to attract business from social investing funds by catering to their policy preferences. Formally, the logic is similar to that of a Hotelling model in which firms compete on both price and location, but where a large subset of the demanders do not care about the location decision.

One of the most significant changes in the proxy advice market came in 2003 when the SEC began requiring mutual funds, which previously often abstained, to cast their votes in corporate elections. Our model implies that increased voting by these funds has two important consequences. First, it leads to consolidation of the proxy advisory industry by allowing a smaller number of firms to capture economies of scale. In this way, our model provides a partial explanation for the market dominance of ISS and Glass Lewis. Second, the model implies, counterintuitively, that voting by these passive funds causes proxy advisory firms to tilt their advice away from policies that maximize issuer value toward policies that give more weight to social issues. Because the passive funds follow this advice, the issuer is forced to adopt policy positions that are favored by the social investing funds. Thus, our model suggests that forcing passive investors to cast votes can have the perverse effect of worsening corporate governance – by causing proxy advisory firms to offer more slanted advice, and by concentrated voting power in their recommendations.

Analysis of the proxy advisory industry is at an early stage, both empirically and theoretically. Malenko and Malenko (2017) develop a strategic voting model in which a fund buys advice from a single proxy advisor, where the core economic problem is one of communication, and explores how proxy advice can crowd out the fund’s own information acquisition activity. The proxy advisor is assumed to provide unbiased advice. Ma and Xiaong (2018) also study a strategic voting model with a single advisor and a single fund, but in their context, the proxy advisor may offer biased advice in order to attract other business from the issuer. In both models, the fund prefers advice that maximizes the issuer’s value, and distortions emerge from inefficient monopoly prices. In our model, in contrast, the bias of proxy advice is the result of competitive pressures, and a response to non-value-maximizing goals among a subset of funds. A limitation of our model is that it abstracts away from strategic voting issues, but we hope the introduction of market competition considerations complements other approaches and helps move toward a more general theory of the proxy advisory industry.

Our model also offers perspective on the free-rider problem among shareholders. It is widely recognized that the small ownership stakes of most investors is a significant barrier to effective corporate governance (Berle and Means, 1932; Grossman and Hart, 1980). One might expect that introduction of a central provider of information in the form of a monopoly proxy advisor would mitigate free-rider problems and enhance governance. However, our analysis suggests that the dominance of a proxy advisor could make governance worse if it offers faulty advice in equilibrium that is followed by large numbers of investors.

Finally, the economic structure of our model is also related to recent work on media markets (e.g. Gentzkow and Shapiro (2006); Perego and Yuksel (2018)). In those models, as in ours, consumers have a preference for what type of news they receive. Unlike our model, in media models the market fragments into an array of firms, each serving a specific consumer niche. The reason our model has consolidation rather than fragmentation is that all of our consumers care about vote execution costs, in addition to the type of information they receive. Economies of scale in the provision of vote execution services overwhelm the consumer preferences for diversity of information in equilibrium.

Connect to Hart-Zingales (JLFA 2017). They argue that firms should maximize shareholder welfare, and that giving shareholders more decision rights can bring this about. Discuss how this works given information conditions. They also discuss shareholder configurations that would be effective, such as preference homogeneity. Discuss.

Connect to Lund (J Corp Law 2018; Stanford LR 2019) arguing that passive funds should be prohibited from voting. Discuss how this proposal would work out theoretically.

Connection/mention different problem that proxy advisory firms may be trying to sell bundled services. Cite MS paper.

1. **Model**

The model features a single company (“issuer”) that is owned by investors and is the subject of proxy votes. The issuer ultimately adopts a policy position , in part as a result of a proxy election. The consequence of the policy choice depends on the state , distributed according to . The realization of the state can be observed only by paying a cost . The issuer’s value is maximized with if ; and if . Some funds are assumed to derive private benefits from the issuer’s action that causes them to prefer a non-value-maximizing policy in some states of the world. Specifically, a fund with bias prefers policy A if . The policy is determined by the votes of all shareholders through a reduced-form mechanism described below. We adopt the convention that . The managers of the issuer have a preference over the policy as well indicated by cutoff parameter . If , then the managers prefer to maximize value; if then the issuer has a managerial agency problem.

The market for proxy advice consists of an exogenous number of funds (demanders) and an endogenous number of proxy advisors (suppliers). We will refer to the business that is the subject of advice as the “issuer”, the businesses that provide advice as “firms”, and the businesses that purchase advice and hold the company’s stock as “funds.”

1. *Suppliers: Proxy Advisors*

The supply side of the market consists of proxy advisory firms. Each firm publicly announces its policy position , which represents the rule it will use when recommending issuer policies.[[7]](#footnote-7) Specifically, an advisory firm recommends if , and otherwise. We assume that a proxy advisor must choose a single policy for all its advice rather than offer advice customized to each fund’s preferences.[[8]](#footnote-8) When the meaning is clear, we use to index proxy advice firms.

In addition to providing voting advice, the firm executes votes for its customers. The sequence is first that each firm chooses whether to enter and a vote execution technology. There are economies of scale in executing votes, largely due to fixed costs associated with operation of an automated vote processing platform. Each firm charges a per-share execution cost of .[[9]](#footnote-9) Firms choose sequentially. Second, each firm that chose to enter simultaneously chooses a bias and a technology . A proxy advice firm is thus characterized by the triplet . <There are two possible ways to model this, as follows:>

**Technology Assumption T1.** The firm chooses a technology with fixed cost and constant marginal cost where and .

**Technology Assumption T2.** The firm chooses a technology with associated fixed and marginal cost functions and . We assume that , and where is the number of shares voted.

1. *Demanders: Funds*

There is a measure 1 of funds, each of which holds 1 share, divided into two broad types. A fraction are “return-only” (RO) funds that care only about the financial performance of the company, while are “socially responsible investment” (SRI) funds that care about financial returns but also non-financial (“social”) consequences of the company’s policy. The SRI funds have a bias that is distributed uniformly over . NOTE: I believe we may be able to simply assume a single that is common for all SRI funds. Funds are atomistic in the sense that they do not believe their proxy votes will swing the election.

A return-only fund’s payoff is . Because the fund is atomistic and voting is costly, the fund will abstain if given the choice. We assume that if the fund is forced to vote and it has the choice of buying proxy advice from two firms charging the same price, the fund will choose the advisor with the smallest bias, that is, with closest to zero.

An SRI fund’s payoff is

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where a “correct” votes means the fund supports when , and otherwise . The last term represents a social payoff to the fund from casting its vote consistent with its values, a payoff that is distinct from financial returns. The parameter is the “ideal” policy for the fund in terms of private benefits, and the parameter indicates the importance of social benefits compared to financial returns. Note that this benefit is independent of the number of shares held and whether the policy is ultimately adopted or not. For example, the benefit a fund receives from the company taking an action to reduce global warming or disinvest in a human-rights-abusing country is independent of the number of shares it owns.[[10]](#footnote-10) We have in mind the idea that part of the fund’s business model is to commit to potential investors that it will vote according to certain values or principles, and fidelity to this goal matters to the fund, regardless of how the other shareholders votes, or whether it brings about a change in corporate policy in the end.

The probability of a correct vote depends on the alignment of the proxy advisor’s policy rule and the fund’s bias. If the advisor and fund are perfectly aligned, the fund will always cast a correct vote; otherwise, the probability is decreasing in the distance between their biases. Specifically, it follows from the information technology that

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Note that , and if , and (and the opposite signs if ).

Each fund must make two decisions: to vote or abstain, and if voting, how to acquire information. A fund can acquire information and execute votes on its own at cost . Alternatively, the fund can purchase advice and vote execution services from a proxy advisor at a price of .

1. *Policy Choice/Voting*

The issuer’s policy depends on the manager’s preferences and the votes cast. Let represent the manager’s bias over actions; if then the manager seeks to maximize value. To capture the influence of votes on decisions, let . Then we assume that if , the manager chooses A with probability , where ; and if , the manager chooses A with probability , where . This reduced form mapping of votes into policy decisions abstracts away from strategic voting issues, but captures the core idea that the issuer is increasingly likely to follow the wishes of shareholders as the number recommending a particular policy increases. A natural assumption is that and , meaning that only a majority vote influences the manager. If the vote is binding, then and are step functions, and the manager’s bias is irrelevant. The purpose of this setup is to allow for the possibility that shareholder voting can improve firm value.[[11]](#footnote-11)

1. *Timing*

The sequence is as follows. First, each proxy advisor chooses a production technology . In order to avoid problems with existence of equilibria, and to reflect the realistic fact that some firms have a history, we assume that proxy advisors enter sequentially. That is, they commit to a technology one by one. Second, each chooses a bias and a price . Third, each fund chooses whether to self-inform, acquire advice and vote execution services from a proxy advisory firm, or abstain. The state of the world is revealed, voting occurs, and the issuer chooses a policy.

1. **Sketch of Results Assuming T2 and SRI Funds Have a Common**

For the purposes of discussing the intuition below, let be the number of shares voted in the entire market. Assume the market to has demand such that is such that .

1. *Benchmark case with no proxy advisors*

Note that RO funds don’t vote. SRI funds vote if .

1. *Proxy advisors*

Equilibrium with T1. In this case, proxy advisors will choose if only SRI funds vote, and if both RO and SRI funds vote. If more than one proxy advisor is in the market with a given bias, price competition drives the price down to marginal cost. The no-entry condition further drives the price to the minimum of the average cost curve. This is the traditional competition equilibrium, possibly with multiple firms at and . As the market grows, proxy advisors enter at the efficient T1 scale.

Equilibrium with T2. Assume sufficient economies of scale so that the marginal cost is below the average cost curve when the entire market is served. Then only one T2 firm can survive in equilibrium. This is because if two T2 firms were to enter, they would compete price down to marginal cost, yielding a negative profit for each. This one firm, a monopolist, will charge the highest price possible to prevent the funds from executing their own votes. If only SRI funds are in the market, this will be , meaning it is optimal to choose . If both RO and SRI funds are in the market, the price is again constrained by the SRI funds, so again it is optimal to choose . This equilibrium will prevail whenever is large enough that a monopolist can earn a positive profit because the first entrant will adopt T2 and deter further entry.

1. *Effect on Corporate Value*

If managers are value maximizers, then voting cannot increase firm value. At best, it is neutral. On the other hand, if managers suffer an agency problem (), then voting can improve value. For example, if the mass of RO funds were to receive value-maximizing advice, their voting would counteract the agency problem. If even biased funds can increase value correcting for a managerial bias in the opposite direction. We can analyze these cases, and identify the value consequences of different voting regimes.

1. **Extensions and Implications**

What if some funds are not atomistic?

What if funds are allowed to delegate their votes to management, and have that meet fiduciary requirements? That is, allow funds to receive voting advice from management at no cost.

What if regulators were to force a separation between advisory and execution services?

Come up with policy suggestions.

1. **Discussion**

The purpose of this paper is to develop an economic model of the proxy advice industry to shed light on the economic forces that determine its structure, and to understand what sort of advice will be supplied and demanded in equilibrium.

The demand for proxy advice has been growing over time as a result of (i) Department of Labor’s ruling in 1988 that pensions had a fiduciary duty to vote under ERISA; (ii) SEC’s no-action letter in 2003 giving its opinion that mutual funds had a fiduciary duty to vote, and the followup comments that granted safe-harbor status to proxy advice; (iii) increasing number of issues that require votes: Dodd-Frank and say-on-pay; more frequent director elections due to decline of staggered boards; growth of shareholder proposals.

NOTES

* Europe has a wider array of proxy advisory firms. They seem to focus specifically on one country.

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NOTES

Intuition from Hotelling model with differentiated prices. Consumers near a producer are captured and subject to market power. This works against one firm capturing the entire market.

Economides 1993 shows nonexistence problems in Hotelling game with and endogenous locations. The price game has a well defined equilibrium, but the location game may not have an equilibrium if firms anticipate the impact of their location on equilibrium prices. Shows tendency to move toward the middle. Is that the main force driving our results, in the end? Economides stresses the role of reservation prices – this seems relevant for our analysis because some funds may choose not to buy or to self-serve.

EDELMANN p 141 notes that ISS develops its policies in conjunction with its institutional clients. Good institutional overview.

Current industry: ISS, Glass Lewis, Egan-Jones Proxy Services, Marco Consulting, ProxyVote Plus. All provide vote execution services.

GAO 2016 basic info on industry. “To compete, proxy advisory firms must offer comprehensive coverage of corporate proxies and use sophisticated systems to provide research and proxy vote execution services.” P8 “the initial investment to develop and implement the necessary technology is a significant expense for firms” GAO mentions policies developed in consultation with institutional investors, corporate issuers, industry practices, and discussions with other stakeholders. P19. “One market participant we interviewed said that a relatively small number of institutional investors drive ISS’s policy formation process.” P23. Gives examples of specific policy positions taken that are at variance with other market participants.

ISS

Gain unmatched control and visibility over your proxy voting activities.

Research & Vote Recommendations

ISS produces more than 42,000 proxy analyses each year in 115 global capital markets.

High-touch Support

A dedicated and experienced global account management team.

Worldwide Operations Network

Beyond processing votes: works with hundreds of custodian banks to ensure accounts are properly set up for proxy voting, reconciles client holdings to incoming ballots, and continuously audits ballot and account environments.

Leo Strine quote that ISS got business because of regulatory mandate of ERISA (Col LR)

McCahery et al JF survey of investors have descriptive info on use of proxy advisors.

U.S. Congress. Chairman’s statement: Questions have been raised regarding potential conflicts of inter- est that proxy advisory firms may face when making voting rec- ommendations, for example, as I alluded to a moment ago, activist shareholders—now some of ISS’ and Glass Lewis’ biggest clients— which increases the risk that these two firms will favor special in-

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terest proposals over those that actually increase or enhance the shareholder values.

Cost examples: see statement by Lynne E. Turner

Edelaman et al Also p 1401 without proxy advisors, many pension plans would have difficulty managing their highly seasonal proxy voting responsibilities for the thousands of companies in their portfolios

(GAO 2007 p5 on importance of vote execution svcs to ISS.)

On policy, note that proxy advice industry is largely unregulated at this time.

NACD (2013) viewpoint:

“Nonetheless, most are not heavily regulated and, therefore, lack the proper oversight that governs other players in the statutory proxy system. As a result, with no recourse, the data used in their reports are not always accurate. . . . Proxy advisory firms have been successful in driving change in company policies and practices, even in instances when there is no clear governance or `pay-for-performance’ benefit.

July 14, 2012, SEC issued 151-page concept release highlighting responsibilities of SEC in regard to proxy process. Received more than 300 comment letters, many of which pertained to regulating proxy advisory firms on executive compensation. Issues raised” lack of transparency, review time by issuers, potential conflicts of interest, and faculty errors in reports.

Free rider problem a la Grossman and Hart (1980). However, the largest institutional investors are not atomistic. Still, they are not 100 percent residual claimants. Index funds invest minimal resources on stewardship (Vanguard, Blackrock, State Street Global Advisors). See Bebchuk Cohen Hirst, “The Undersupply of Shareholder Engagement,” 2017.

STRINE SUGGESTS FIDUCIARY DUTY AS WAY TO CHANGE OBJ FUNCTION

Iliev and Lowry RFS 2014 show economies of scale: large funds and funds in families more likely to vote based on own info.

Choi Fisch Kahan Emory LJ give examples that boards follow ISS advice even if they don’t agree with it.

ONE CAN THINK OF OUR PAPER AS PROVIDING A THEORY OF ENDOGENOUS OBJ FUNCTIONS OF PROXY ADVISORS.

The important question: do proxy advisory firms have an incentive to choose policies that maximize firm value? (Seems to be taken as given. We want to explore this – what exactly would they maximize in equilibrium?) Objective functions are not endowed; rather, they emerge from an equilibrium selection process. Note that our bias does not emerge because of related consulting business.

\*The challenge for neutral voters is whether to believe management or activist since both have private interests. This paper assumes that ISS is neutral. What is missing is a reason why ISS would be neutral. What economic forces would lead a neutral proxy advisor monopolist to emerge in equilibrium? We should that a neutral advisor does not emerge. There is a presumption that ISS will try to maximize value if majority of its customers want that. By way of analogy: no one thinks that newspapers provide unbiased information on efficient policies.

Strine Harvard Law Review 2006 1765 “Those institutions most inclined to be activist investors are associated with state governments and labor unions, and often appear to be driven by concerns other than a desire to increase the economic performance of the companies in which they invest. By contrast, those institutional investors one might think are best situated to make wise voting decisions – the money managers who operate mutual funds, particularly index funds – have little desire to spend money on stockholder activism or offend corporate management. For that reason, many rely heavily on the advice of yet another level of agency, firms like Institutional Investor Services (ISS) that provide advice on how to vote on corporate ballot issues, to satisfy their legal obligation to vote in an informed manner on behalf of their investors. The influence of ISS and its competitors over institutional investor voting behavior is so considerable that the traditionalist will be concerned that any initiative to increase shareholder power will simply shift more clout to firms of this kind – firms even more unaccountable than their institutional investor clients. . . . Unlike corporate managers, neither institutional investors as stockholders nor ISS as a voting advisor owe fiduciary duties to the corporations whose policies they seek to influence.” NOTE that problem is not unaccountability – ISS is accountable to the market (its customers) – the problem is that his accountability will create problems.

Check Proxy Advisory Firm Reform Act of 2016, or its successor.

1. Institutional investors now hold 70 percent of corporate equity, according to a 2017 *ProxyPulse* report produced by Broadridge + PwC (2017). [↑](#footnote-ref-1)
2. Market shares are approximately 61 percent for ISS and 37 percent for Glass Lewis according to Center on Executive Compensation (2011). [↑](#footnote-ref-2)
3. For recent evidence on the effects of proxy advisor recommendations, see Larcker et al. (2015) and Malenko and Shen (2016). [↑](#footnote-ref-3)
4. For an overview of institutions, laws, and issues, see Gallagher (2014) and Edelman et al. (2014). [↑](#footnote-ref-4)
5. For criticisms of proxy advisor recommendations, see Larcker et al. (2013) and U. S. House of Representatives (2013). Another common criticism is that proxy advisory firms have a conflict of interest because they sell consulting services as well as proxy advice; see Li (forthcoming) for discussion and evidence. [↑](#footnote-ref-5)
6. For a description of the services sold by proxy advisory firms, see General Accounting Office (2017). For testimony on the importance of vote execution services, see Edelman et al. (2014), for example, citing a statement by TIAA-CREF (page 1398): “Though we dedicate a significant amount of resources to corporate governance research and the voting of proxies, we still would have difficulty processing the 80,000 plus unique agenda items voted by our staff annually without using [vote execution services].” [↑](#footnote-ref-6)
7. Proxy advisory firms take positions on a wide variety of issues. For example, Glass Lewis has policy guideline reports for 34 separate countries/regions: <http://www.glasslewis.com/guidelines/>. [↑](#footnote-ref-7)
8. In practice, proxy advisory firms do offer some customizability of vote execution services, but their advice appears to be common across all customers. [↑](#footnote-ref-8)
9. We assume that a proxy advisory firm sells advice and vote execution services as a bundle. [↑](#footnote-ref-9)
10. Is this specification consistent with the microfoundations of the information problem? [↑](#footnote-ref-10)
11. This is a cumbersome formulation. There is a probably a better way to do it. [↑](#footnote-ref-11)