Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers

By Robyn Bew and Richard Fields
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Executive Summary

The balance of power among shareholders, management, and boards of directors has been a subject of debate for many years. One area of intense focus has been how institutional shareholders exercise their proxy votes, which Mary Schapiro, Chairman of the US Securities and Exchange Commission (SEC), described as "often the principal means for shareholders and public companies to communicate with one another, and for shareholders to weigh in on issues of importance to the corporation."[1]

There is clear consensus on the importance and benefits of having institutions vote their shares in a responsible, well-informed way, but much less clarity on how the voting process works in practice. A particularly active area of the debate is over how investors use proxy advisers' research, recommendations, and other services – alone or in conjunction with other internal and external sources – in making decisions about tens of thousands of unique agenda items each year. Convictions are strong on both sides, with those in one camp charging that institutional investors vote "in a lock-step manner"[2] with proxy firm recommendations, and their opponents insisting that proxy advisers' research and recommendations are used "solely as a supplement to [most investors'] own evaluation of agenda items."[3]

Between November 2011 and March 2012, on behalf of the IRRC Institute, Tapestry Networks undertook an extensive inquiry into US asset managers' voting decision processes, as well as their views on the role proxy advisory firms play in those processes. In addition to reviewing major academic studies and current literature on the topic, we interviewed senior executives from 19 leading North American asset management firms and their affiliates, as well as academics, proxy advisory firms, proxy solicitors, and other stakeholders. In total, the investors we interviewed account for over $15.4 trillion in assets under management, or more than half of the assets under management in the United States.[4]

In addition to our interviews, Tapestry conducted a comprehensive survey of academic research and commentary on the relationship between proxy advisers and institutional investors. Studies

[1] Securities and Exchange Commission, "SEC Votes to Seek Public Comment on U.S. Proxy System," news release, July 14, 2010.

[2] Andrew Bonzani, vice president, assistant general counsel, and secretary, IBM, to Elizabeth Murphy, secretary of the US Securities and Exchange Commission, Comments on File Reference No. S7-14-10, Concept Release on the US Proxy System, Release No. 34-62495, October 15, 2010, 3.

[3] Glenn Davis, senior research associate, Council of Institutional Investors, to Elizabeth Murphy, secretary of the US Securities and Exchange Commission, Re: File No. S7-14-10 (Concept Release on the U.S. Proxy System), October 14, 2010, 6.

[4] Research participants included representatives from asset managers and their affiliates and subadvisors. Most research participants are based in the US, but we also spoke with some foreign-owned asset managers with significant holdings. Our calculation of assets under management is based on data from P&I/Towers Watson, *The World's 500 Largest Asset Managers*, (New York: Towers Watson, 2010). It includes assets under management for US-based managers at which we spoke with an employee, affiliate, or subadvisor; we did not include the assets of foreign-owned entities' US-based subadvisors or affiliates. See the Appendix for a list of research participants. This report also draws on conversations with board directors, executives, and other governance stakeholders conducted as part of Tapestry's normal course of business.

show recommendations from Institutional Shareholder Services (ISS), the largest proxy adviser, are associated with significant shifts in support for ballot proposals, but causal relationships are more difficult to identify. However, "influence" is about more than voting outcomes: proxy firms' perceived power may affect board and management decisions even outside the voting season. Studies of the first year of mandated advisory votes on executive compensation identified several effects of proxy firms' recommendations on issuer behavior, including changes to the terms of pay plans.

Report highlights include:

- **Proxy firms' role as data aggregators has become increasingly important to asset managers.** Across the board, participants in our research said they value proxy firms' ability to collect, organize, and present vast amounts of data, and they believe smaller asset managers are more reliant on those services. Nonetheless, participants emphasized that responsibility for voting outcomes lies with investors. They encouraged proxy advisers to fix problems such as data quality that contribute to negative perceptions of the proxy advisory industry and, by extension, those who use the industry's services.
- **Proxy advisers play a role in asset managers' formation of voting policy.** Most commentary focuses upon voting outcomes, but our research shows that asset managers' decision processes begin well in advance of vote execution, with a review and update of proxy voting policy. Research participants said changes in voting policy tend to be more evolutionary than revolutionary, but noted that proxy firms are one of the drivers of those changes. Depending on the asset manager, proxy firm policies may be adopted wholesale, used to identify issues and trends meriting closer attention, or incorporated as a source of input into voting guidelines, along with issuer dialogue and other sources.
- **Asset managers have a wide range of approaches to decision-making throughout the voting process.** A key point of differentiation is the level of involvement of investment professionals, which tends to parallel the level of internal discussion and debate that takes place between the initial application of voting guidelines and final vote execution. Since evidence of such deliberation is often difficult to identify, outside observers may conclude that asset managers are unduly influenced by proxy advisers.
- **Regardless of how wide a net they cast for inputs into voting decisions, most asset managers find proxy firm data particularly useful in say on pay and international votes.** Research participants' decision practices in both of these areas vary (and especially in the case of say on pay, are still in flux). However, most asset managers said they make active use of proxy firm data to help in some way with voting decisions in these categories.
- **The demand for investor-issuer engagement will continue to grow.** Participants believe the push for increased investor-issuer engagement will continue, but draw different conclusions about the resulting impact on proxy firms' influence. Some predicted that demands for more frequent investor dialogue will exacerbate asset managers' resource pressures, leading to greater reliance on proxy advisers. Others suggested that significant potential threats to the proxy firms' business models may lie on the horizon.

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Introduction

A succession of corporate scandals and economic shocks have kept corporate governance high on business and governmental leaders' agendas since the early 2000s. Much of the focus has been on the rights of corporate shareholders, particularly their voting rights at annual corporate meetings. Large asset managers have significant market power: according to one study, investment companies (including mutual funds and closed-end funds) owned 27% of all outstanding US corporate equity in 2010.[5] Some argue that these asset managers are too reliant on proxy advisers – the handful of firms, including Institutional Shareholder Services (ISS), Glass, Lewis & Co., and others which provide research, advice, and recommendations on the many ballot issues each year. In a 2005 speech, Leo Strine, at that time vice chancellor of the Delaware Court of Chancery, put it bluntly: "Some institutional investors will simply follow ISS's advice rather than do any thinking of their own."[6]

This report examines how a selection of leading North American mutual funds develop proxy voting guidelines and reach decisions regarding how to vote. These investors represent more than 50% of the assets under management in the United States. We set out to discover where asset managers actually fell on the continuum between blindly following proxy advisers' guidance at one end and making mere informational use of it at the other. We found a range of practices and approaches to deliberation of voting items that defied easy generalizations. We also found that proxy firms play an important role at numerous points in the decision process, including during review of voting guidelines and internal deliberation on voting matters, and especially in relation to international and say-on-pay votes, though that influence was more nuanced than the perceptions at either end of the continuum described above.

We begin with a brief review of trends in shareholder voting that helped drive the growth of the proxy advisory industry, which we follow with a review of recent academic studies assessing the influence of proxy firms. We then present findings from our interviews with senior executives from 19 North American asset management firms and other key stakeholders, including representatives from proxy advisers, proxy solicitors, and other governance experts. We conclude with suggested areas for further research.

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[5] Investment Company Institute, *2011 Investment Company Fact Book* (Washington, DC: Investment Company Institute, 2011), 12.

[6] Leo E. Strine, Jr. "The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face," *Delaware Journal of Corporate Law* 30, no. 3 (2005), 688.

Corporate voting and proxy firms in the spotlight

Public company shareowners have long had the right to vote on certain matters concerning corporate activity. They can vote in person at the company's annual meeting or by proxy – that is, through another whom they entrust with the authority to vote on their behalf. The vast majority of votes are cast by proxy, either on paper, by telephone, or, increasingly, via the Internet.

While asset managers control a sizable ownership stake in many US public companies, until the mid-1980s most did not devote significant time or attention to proxy voting. As one commentator noted, "If there was no problem with a portfolio company's management, it was [acceptable] to vote management's recommendations; if there was a problem, the solution was to sell the stock (the so-called 'Wall Street Walk')."[7] In the 1970s and 1980s, rapid expansions in computing power along with the rise to prominence of modern portfolio theory helped support the rise of index funds, which do not buy or sell (aside from portfolio rebalancing and changes to the components of the index). Some governance experts have argued that the growth in size and market power of the index fund industry has contributed to increased "investor voice"[8] in voting on governance matters, because as Vanguard founder John Bogle put it, "the only weapon [index funds] have, if we don't like the management, is to get a new management or to force the management to reform."[9]

A number of other developments have contributed to changing the landscape of institutional investor voting in the United States, including:

- **Regulations on fiduciary duty.** In the late 1980s, the SEC and Department of Labor formally attached fiduciary obligations to voting on corporate governance matters. These actions "demand that, instead of passive adherence to management's recommendations, each institutional investor vote all of its portfolio shares on every matter brought to shareholders in accordance with the standards of the proverbial prudent man."[10]
- **Vote disclosure requirements.** In 2003, the SEC began requiring mutual funds to disclose their proxy voting policies and voting records on Form N-PX.[11]
- **Increasing number of matters to be voted on.** To take just one example from a 2010 Investment Company Institute (ICI) report, there were more than 20,000 proxy proposals at Russell 3000 companies in 2009, and large registered investment funds cast more than 3.9 million individual votes on those proposals.[12] The large number of companies in which asset

[7] Charles M. Nathan and Parul Mehta, *The Parallel Universes of Institutional Investing and Institutional Voting* (Rochester, NY: Social Science Research Network, 2010), 1.

[8] Bernard S. Black, "Agents Watching Agents: The Promise of Institutional Investor Voice," *UCLA Law Review* Vol. 39 (1992).

[9] Christine Benz, "Bogle: Index Funds the Great Hope for Corporate Governance," *Morningstar*, October 15, 2010.

[10] Ibid.

[11] Securities and Exchange Commission, "Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies," April 14, 2003.

[12] Investment Company Institute, "Trends in Proxy Voting by Registered Investment Companies, 2007–2009," *Research Perspective* 16, no. 1 (November 2010), 4, 11.

managers are invested and the large number of votes called for at each meeting mean that proxy-related expenses can be substantial.

Beginning in 1972, with the founding of the not-for-profit Investor Responsibility Research Center[13] and then in 1985 with the incorporation of ISS, proxy advisory firms began offering their services to help investors deal with these increasing responsibilities. Proxy advisers provide research and advice on governance issues, guidelines and recommendations on specific ballot issues, and voting platform services. The investment community appreciates these services: one institutional investor, TIAA-CREF, noted, "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 utilizing [proxy firm] research."[14]

Since the 1980s, companies have entered, merged, and exited the industry.[15] Currently, the market is dominated by two providers. ISS, a subsidiary of New York Stock Exchange listed company MSCI, is by far the largest. In 2009, the last year for which market share data is readily available, ISS had more than 61% of the market for proxy advisory services;[16] another report listed ISS as having 1,700 clients in 2010.[17] According to a third study, institutions managing a combined $26 trillion in assets subscribe to ISS's proxy research.[18] The second-largest proxy advisory company is Glass, Lewis & Co. Glass Lewis, a subsidiary of the Ontario Teachers' Pension Plan Board, is reported to serve more than 500 institutional clients collectively managing assets of over $15 trillion.[19] Several other firms in the United States and Europe also provide proxy services, but on a smaller scale.

Critics of the proxy advisory industry say the industry is a "classic oligopoly."[20] ISS' practices such as providing voting recommendations while also offering issuers services designed to suggest whether a particular management proposal will meet with investors' approval have resulted in conflict-of-interest charges, despite the existence of firewalls and disclosure policies designed to mitigate such conflicts. Critics also say proxy advisers' process for developing voting recommendations lacks transparency and that the recommendations do not always represent the

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[13] ISS bought the Investor Responsibility Research Center in 2005. The IRRC Institute, which sponsored this research paper, was formed with the proceeds of that sale. It is not affiliated with ISS or with any proxy advisory service.

[14] Jonathan Feigelson, senior vice president, general counsel, and head of corporate governance, TIAA-CREF, to Elizabeth Murphy, secretary, US Securities and Exchange Commission, Re: Concept Release on the U.S. Proxy System, File No. S7-14-10, November 8, 2010, 5.

[15] For a brief review, see Stephen Choi, Jill Fisch, and Marcel Kahan, "Director Elections and the Influence of Proxy Advisors" (NYU Law and Economics Research Paper No. 08–22, 3rd Annual Conference on Empirical Legal Studies Papers, Fordham Law Legal Studies Research Paper No. 1127282, May 2008).

[16] Tamara Bellinfanti, "The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control," *Stanford Journal of Law, Business & Finance* 14, no. 2 (Spring 2009), 14.

[17] Society for Corporate Governance Secretaries and Professionals, "Proxy Advisory Services: The Need for More Regulatory Oversight and Transparency," March 4, 2010, 2.

[18] European Securities and Markets Authority, *An Overview of the Proxy Advisory Industry: Considerations on Possible Policy Options* (Paris: European Securities and Markets Authority, 2012), 11.

[19] Ibid.

[20] David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "Proxy Advisory Firms and Stock Option Exchanges: The Case of Institutional Shareholder Services" (Stanford GSB Research Paper No. 2077, Rock Center for Corporate Governance Working Paper no.100, April 24, 2011), 2.

best interests of the company. There are opportunities, these critics say, "for the vote to become skewed, biased, or misdirected."[21]

Explicitly and implicitly, these concerns are heightened by the widely-held perception that proxy advisers have substantial influence on voting decisions. Indeed, that influence was one reason that Chairman Schapiro cited for the SEC's investigation into proxy voting mechanics.[22]

In their comments in response to the SEC's concept release on the proxy industry review, corporate issuers called out specific instances in which proxy adviser recommendations seemed to dramatically affect voting. UnitedHealth Group noted that in two years, shortly after a proxy adviser issued its recommendations, 14% and 16% of shares voted with those recommendations.[23] Johnson & Johnson noted a similar impact of between 13.4% and 17.9% over three years.[24] IBM wrote that it was concerned because one voting bloc "essentially controlled by ISS has more influence on the voting results than IBM's largest shareholder."[25]

For their part, proxy firms and certain other stakeholders and commentators dismiss the accusations of undue influence.[26] In an interview for a recent study on institutional voting, a proxy firm executive said, "[We] do not influence a single share or control a person; [we are] only influential if clients agree with us."[27] Several large institutional investors have called the accusations of undue influence "an affront to investors."[28] BlackRock emphasized in an SEC comment letter, "We do not blindly follow any proxy advisory firm's advice;"[29] similarly, TIAA-CREF said, "We [use] proxy advisory firm research solely as an informational tool to supplement our internally produced research."[30]

A survey of recent academic literature and commentary, detailed in the next section, indicates there is support for both positions, as well as a range of more nuanced views.

[21] Tom Quaadman, executive director, financial reporting and investor opportunity, Center For Capital Markets Competitiveness, to Mary Schapiro, chairman, Securities and Exchange Commission, Re: Concept Release on the U.S. Proxy System, File No. S7-14-10, RIN 3235-AK43, August 5, 2010, 3.

[22] Mary Schapiro, Address to the Practicing Law Institute's 41st Annual Institute on Securities Regulation, New York, November 4, 2009.

[23] Dannette L. Smith, secretary to the board of UnitedHealth Group, to Elizabeth Murphy, secretary of the US Securities and Exchange Commission, Comments on Concept Release on U.S. Proxy System File No. S7-14-10, RIN 3235-AK43, October 22, 2010, 8.

[24] Douglas K. Chia, assistant general counsel, Johnson & Johnson, to Elizabeth Murphy, secretary of the US Securities and Exchange Commission, Comments on Concept Release on the U.S. Proxy System, File No. S7-14-10, Proxy Advisory Firms, October 19, 2010, 2.

[25] Andrew Bonzani, vice president, assistant general counsel, and secretary, IBM, to Elizabeth Murphy, secretary of the US Securities and Exchange Commission, Comments on File Reference No. S7-14-10, Concept Release on the US Proxy System, Release No. 34-62495, October 15, 2010, 3.

[26] For a review of the commentary surrounding the SEC's proxy plumbing investigation, see Kenneth L. Altman and James F. Burke, *Proxy Advisory Firms: The Debate over Changing the Regulatory Framework* (New York: Altman Group, 2011).

[27] Richard Fuller and Helga Birgden, *Institutional Share Voting and Engagement: Exploring the Links between Directors, Institutional Shareholders and Proxy Advisers*, (Sydney: Australian Institute of Corporate Directors, 2011), 63.

[28] Abe M. Friedman, managing director, global head of corporate governance and responsible investment, BlackRock, to Elizabeth M. Murphy, secretary, Securities and Exchange Commission, Re: Concept Release on the U.S. Proxy System (Release Nos. 34-62495; IA-3052; IC-29340; File No. S7-14-10), October 29, 2010, 9.

[29] Ibid., 9.

[30] Jonathan Feigelson to Elizabeth Murphy, Re: Concept Release on the U.S. Proxy System, File No. S7-14-10, 5.

Literature review

A number of governance researchers have identified correlations between proxy firms' recommendations and investors' voting outcomes, but causation is more difficult to prove conclusively. However, influence is not limited to voting outcomes, and recent studies also indicate that companies make choices about important issues such as compensation with proxy advisers' reactions in mind. In some instances this could be seen as a form of self-censorship so as to meet with the approval of the proxy firms.

There is significant correlation between proxy adviser recommendations and voting outcomes

Academics have attempted to quantify proxy adviser influence in voting decisions: one academic quoted a commentator who said that "[w]hen institutional investors follow ISS [vote recommendations] en masse, directors of public corporations can expect to see 20%, 30%, even 50% of their company's shares being voted not as the directors recommend, but as ISS recommends."[31] In general, researchers agree that there are voting outcomes that correlate closely with the positions proxy advisers – particularly ISS – recommend, but they disagree over the extent to which proxy adviser recommendations shift voting. For more on this distinction, see "Moving the vote versus changing the outcome: an important distinction," on page 11.

Among the research that identifies a correlation between proxy adviser recommendations and voting outcomes is that of Jennifer Bethel and Stuart Gillan, who found that in 1998, a negative ISS recommendation was associated with 13.6% to 20.6% fewer votes in favor of management proposals.[32] Similarly, Jie Cai, Jacqueline Garner, and Ralph Walking concluded that when ISS recommended voting against a director candidate between 2003 and 2005, the director received 19% fewer votes.[33] Stephen Choi, Jill Fisch, and Marcel Kahan found that in uncontested director elections in 2005 and 2006, "withhold" recommendations of four proxy advisers were correlated with a 3.5%–20.3% drop in the "for" vote, depending upon the proxy adviser.[34]

Another way in which academics analyze proxy voting is by type of voter. James Cotter, Alan Palmiter, and Randall Thomas studied the 2003–2008 proxy seasons and found that mutual funds, the largest shareholder voting bloc, were more likely to vote in accordance with ISS than with management.[35] Their study noted some very strong correlations: in the 2006–2007 proxy season, a negative ISS recommendation on a management proposal was associated with a 28.7% reduction in "for" votes across all shareholders, but a 63.8% drop in the support of mutual funds.[36] When

[31] Tamara C. Belinfanti, "The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control," 4.

[32] Jennifer Bethel and Stuart Gillan, "The Impact of the Institutional and Regulatory Environment on Shareholder Voting," *Financial Management* 31 no. 4 (Winter 2002), 25.

[33] Jie Cai, Jacqueline L. Garner, and Ralph A. Walking, "Electing Directors," *Journal of Finance* 64, no. 5 (October 2009), 2404.

[34] Stephen Choi, Jill Fisch, and Marcel Kahan, "The Power of Proxy Advisors: Myth or Reality?" *Emory Law Journal* 59 (2010), 886.

[35] James Cotter, Alan Palmiter, and Randall Thomas, "ISS Recommendations and Mutual Fund Voting on Proxy Proposals," *Villanova Law Review* 55, no. 1 (2010), 3. .

[36] Ibid., 63.

both management and ISS opposed a shareholder proposal, shareholder support dropped by 33.3% across all shareholders and by 53.1% for mutual funds.[37]

However, correlation is not the same as causation

Those who believe that asset managers blindly follow proxy adviser recommendations point to the correlation statistics as proof for their argument. These correlations are interesting, but correlations alone "do not allow us to clearly map out the causal relationships."[38]

Choi, Fisch, and Kahan noted that although they found significant correlation between proxy advisory recommendations and how asset managers voted, there was also "a substantial correlation between proxy advisor recommendations and the factors that academics, policy makers, and the media have identified as important."[39] According to this view, the proxy firms' positions essentially mirror the current consensus on good governance. If this is the case, then the proxy advisory firms' influence on voting outcomes is much smaller than correlation might indicate: the researchers concluded that an ISS "recommendation shifts 6% to 10% of shareholder votes – a material percentage but far less than commonly attributed to ISS."[40]

In a later paper, the same authors evaluated the relationship between mutual fund voting and proxy advice and concluded that although there is some correlation between mutual fund voting and proxy advice – less correlation at the biggest mutual funds, more at the smaller ones – "the influence of ISS is … mostly due to funds' measured evaluation of the ISS recommendations, with significant thinking on their own, rather than to funds' blindly following these recommendations."[41] In their sample, Choi, Fisch, and Kahan found "excessive deference to ISS recommendation appears less of a concern than excessive deference to management recommendations."[42]

Another academic study of the first year of say-on-pay voting came to a similar conclusion. Despite raw data demonstrating high correlation between proxy adviser recommendations and vote results, Thomas, Palmiter, and Cotter concluded that ISS has "less impact" than meets the eye. They wrote, "For management-sponsored 'say-on-pay' proposals, what is striking is that shareholders are more than twice as likely to follow management's recommendation than they are ISS's recommendation when the two recommendations differ."[43]

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[37] Ibid., 61.

[38] Ibid., 3.

[39] Stephen Choi, Jill Fisch, and Marcel Kahan, "The Power of Proxy Advisors: Myth or Reality?" 881.

[40] Ibid., 906.

[41] Stephen J. Choi, Jill E. Fisch, and Marcel Kahan, "Voting Through Agents: How Mutual Funds Vote on Director Elections," (University of Pennsylvania, Institute for Law and Economics Research Paper No. 11-28, NYU Law and Economics Research Paper No. 11-29), August 17, 2011, 9.

[42] Ibid., 20.

[43] Randall S. Thomas, Alan R. Palmiter, and James F. Cotter, "Dodd-Frank's Say on Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance?" *Cornell Law Review*, vol. 97 (2012, forthcoming), 33. For more on correlations between investor votes and management recommendations, see Investment Company Institute, "Trends in Proxy Voting by Registered Investment Companies, 2007-2009," *Research Perspective* 16, no. 1 (November 2010), 12.

Moving the vote versus changing the outcome: an important distinction

It is important to note that a correlation between proxy adviser recommendations and a percentage shift in voting support says nothing about whether the proxy adviser recommendation affects the passage or failure of a proposal.

This distinction can be observed in 2011's say-on-pay votes. ISS recommended in favor of 88.7% of all say-on-pay proposals.[44] Within the S&P 500, average support for say-on-pay proposals was 89%. When ISS recommended against, support was 65%.[45] While a 24% reduction in support is meaningful, 65% is nonetheless a majority.[46] Thomas, Palmiter, and Cotter noted, "Despite predictions that shareholders (especially institutional shareholders) would reflexively follow ISS recommendations on 'say-on-pay' proposals, failed 'say-on-pay' votes were far fewer than had been recommended by ISS."[47]

Indeed, 98% of Russell 3000 companies' say-on-pay proposals received approval in 2011. In other words, while critics of the proxy firms point out that all of the companies whose say-on-pay proposals failed received a "no" recommendation from ISS, investors ultimately disregarded 90% of ISS' "no" recommendations.[48]

The 2012 proxy season was still underway when this report went to press, but by early May, voting results appeared comparable to last year. According to one study, "So far in this second year of mandatory SOP, overall support levels remain strong, averaging 91.0% compared with 91.5% in 2011 and with only 13 SOP proposals receiving less than 50% support compared to 18 for the same period last year."[49]

Other factors may increase correlation without being causative

Choi, Fisch, and Kahan, who, as noted earlier, found ISS responsible for only a 6%–10% vote shift, attempted to identify why the correlation between recommendations and voting outcomes was so much higher. They identified four conceptually distinct reasons why proxy adviser recommendations correlate with shareholder voting:

> First, the same director nominee and company characteristics may independently influence both the proxy advisors' recommendation and the shareholder vote. Second, proxy advisors may gather information that investors use to make their voting decisions. Third, investors may select a proxy advisor based on their *ex ante* agreement with the bases upon which the

[44] Ted Allen, Jolene Dugan, Erik Mell, Carolyn Mathiasen, Edward Kamonjoh, Roel Delgado, and Oguz Tolon, *2011 U.S. Postseason Report* (Rockville, MD: Institutional Shareholder Services), 29.

[45] Ibid., 5.

[46] Note, however, that companies receiving less than 70% say-on-pay support face additional scrutiny from ISS.

[47] Randall S. Thomas, Alan R. Palmiter, and James F. Cotter, "Dodd-Frank's Say on Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance?" *Cornell Law Review*, no. 97 (2012), 39.

[48] At Russell 3000 companies, ISS recommended against 340 say on pay proposals and 27 failed. See Ted Allen, Jolene Dugan, Erik Mell, Carolyn Mathiasen, Edward Kamonjoh, Roel Delgado, and Oguz Tolon, "2011 U.S. Postseason Report," *Institutional Shareholder Services*, 5, and "Say-on-Pay: 2011 Proxy Season De-Brief," *Frederick W. Cook & Co., Inc.*, (2011).

[49] Ernst & Young, "Proxy Season 2012: Early Voting Results," *Proxy Perspectives*, May 2012, 1.

> advisor formulates its recommendations. Finally, investors may view the advisor's recommendation alone as a basis for deciding how to vote, independent of the underlying factors upon which that recommendation is based. It is only this last reason that can truly be characterized as causality.[50]

While the ends of the continuum – pure causation and pure correlation – are relatively easy to define, what falls between is harder to categorize and is sometimes counterintuitive. For example, when an investor uses its own proxy guidelines and applies its own judgment, but relies on that adviser for information, the proxy firm's selection of information could have influential effects because of the way in which information is presented, or the facts the adviser chooses to include or exclude. On the other hand, if an investor selects a proxy adviser due to prior agreement with the adviser's governance philosophy, any similarities between its own policy and that of the adviser are not necessarily a result of improper influence, but might simply indicate parallel beliefs about what constitutes good corporate governance.

A focus on voting outcomes may obscure other indicators of proxy firms' impact

Setting aside the correlation-causation question, another avenue of proxy advisers' influence is the degree to which they affect the actions of public company boards and management well before voting season begins. As two commentators put it, "If most directors believe that ISS has power – as their actions indicate – boards may do what they believe ISS wants them to in order to keep their seats, whether or not their belief is justified."[51] Before becoming chancellor of the Delaware Court of Chancery, Leo Strine came to a similar conclusion about the belief in the power of ISS: "Powerful CEOs come on bended knee to Rockville, Maryland, where ISS resides, to persuade the managers of ISS of the merits of their views about issues [facing their companies]."[52]

A number of recent studies support these views. In a 2010 survey, the Center on Executive Compensation found that 54% of companies had changed or adopted a compensation plan or policy in the previous three years primarily to meet the standards of a proxy advisory firm.[53] Negative say-on-pay recommendations, for example, did cause corporations to change their approach even if they did not completely reject their original say-on-pay proposal. Before the vote, many companies modified pay practices "in response to preliminary 'against' recommendations of proxy advisers."[54]

Similarly, a recent Conference Board-NASDAQ-Stanford survey of 110 companies found that 72% of respondents reviewed proxy adviser policies or engaged with a proxy adviser to receive feedback on their executive compensation plan, while 70.4% said that their programs were

[50] Stephen Choi, Jill Fisch, and Marcel Kahan, "The Power of Proxy Advisors: Myth or Reality?" 879.

[51] Scott Fenn, *A Call for Change in the Proxy Advisory Industry Status Quo: The Case for Greater Accountability and Oversight* (New York: Center on Executive Compensation, 2011), 21.

[52] Leo E. Strine, Jr. "The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face," 688.

[53] Scott Fenn, *A Call for Change in the Proxy Advisory Industry Status Quo: The Case for Greater Accountability and Oversight*, 4.

[54] Robin Ferracone and Dayna Harris, *Say on Pay: Identifying Investor Concerns* (Washington, DC: Council of Institutional Investors, September 2011), 17.

influenced by the proxy advisers or the advisers' policies.[55] In response to proxy firm policies, companies in the sample reported making changes to their compensation plans, including enhancing proxy disclosure (32% of respondents), reducing or eliminating certain severance practices (24%) and perks (16%), adopting stock ownership guidelines (13%), and introducing performance-based equity awards (9%).[56] The study concluded, "The majority of companies determine in advance whether their executive compensation programs are likely to receive a favorable recommendation from ISS or Glass Lewis; and companies are likely to make changes to a program in anticipation of a negative recommendation from these firms."[57]

Another group of researchers looked at companies' reactions to negative recommendations from proxy firms and found that "some companies filed supplemental proxy disclosures … including slideshow presentations, letters to proxy advisory firms taking issue with the information or analysis in their reports, and letters to shareholders defending their pay-for-performance orientation."[58]

Our review of the literature suggests that contrary to business leaders' impression of the perceived power of proxy advisers, the number of votes moved by proxy firm recommendations is smaller than commonly believed. However, the research also indicates that proxy advisers carry a great deal of influence at earlier stages in the process, affecting the governance debate in general and often leading companies to adjust (and, in some cases, rethink) their positions on significant matters such as executive compensation.

To explore patterns of proxy firm influence beyond the correlation-causation question, we engaged practitioners at leading North American mutual funds in conversations about how they approach the proxy voting process, including the way they use proxy adviser research and recommendations. Findings from those conversations are detailed in the following section: we hope they make a substantive contribution to the ongoing debate on investor engagement in the governance process.

[55] David F. Larcker, Allan L. McCall, and Brian Tayan, "The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions," *Director Notes,* March 2012, 4.

[56] Ibid., 5.

[57] Ibid., 6.

[58] Randall S. Thomas, Alan R. Palmiter, and James F. Cotter, "Dodd-Frank's Say on Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance?" 43.

Interview findings

> The debate over potential regulatory changes impacting proxy advisory firms has … highlighted what some institutional investors and proxy advisory firms noted in their [SEC comment] letters is a significant gap in understanding about exactly how proxy voting decisions are arrived at by institutional investors.[59]

Nearly two years after the SEC concept release, the future regulatory landscape for proxy firms is still uncertain, and considerable knowledge gaps remain regarding how proxy voting decisions are made. To help fill these gaps, we set out to explore whether North American asset managers' use of proxy firms for voting policy development and application goes beyond the two extremes of "blindly following" on the one hand and "for informational purposes only" on the other. See the Appendix for a list of research participants.

The following themes emerged from our work:

- Proxy firms' role as data aggregators has become increasingly important to asset managers
- The voting decision process begins with a review and updating of voting guidelines, and proxy firm policies are a key input
- Three questions about the level of internal deliberation on voting matters can help outside observers evaluate the independence of an asset manager's voting decisions
- Regardless of how wide a net they cast for informational inputs into voting decision making, most asset managers find proxy firm data particularly useful for say-on-pay and international votes
- Participants believe the push for increased investor-issuer engagement will continue, but disagree over its impact on the proxy advisory industry

Proxy firms' role as data aggregators has become increasingly important to asset managers

Virtually unanimously, research participants highlighted the value they derive from the role proxy advisers play in *"digest[ing] and normaliz[ing] the vast quantities of data present in proxy statements in a short period of time."*[60] One asset manager said, *"Proxy firms play a critical role in presenting the data: it's concise, consistent, and you always know where things are. It's an important starting point for our analysis, so we can manage the volume during proxy season."* Another asset manager described proxy firms as essentially *"data aggregators. [They say,] 'Here's the company's performance over the year: X director didn't show up to committee meetings, Y company didn't adopt a declassified board.'"* Indeed, according to some participants, the value of proxy firm voting recommendations is distinctly secondary: *"We don't necessarily agree with*

[59] Kenneth L. Altman and James F. Burke, *Proxy Advisory Firms: The Debate Over Changing the Regulatory Framework*, 37.

[60] This document reflects Tapestry Networks' use of a modified version of the Chatham House Rule in which the names and institutional affiliations of participants are a matter of public record, but comments (shown in italics) are made anonymously.

everything they say, but they do a tremendous amount of work pulling information together and packaging it, so we can take what we want."

None of the participants in our research expressed explicit dissatisfaction with their own resources for researching voting matters. However, several investors noted the focus on maximizing returns to clients in tough economic times has certainly had an impact on resource allocation choices – which in turn has affected their use of proxy advisory firms. One participant framed the trade-off this way: *"If [institutional investors] have an incremental dollar to invest, would [we] prefer to invest it in deeper, better analysis into emerging markets or specific companies, or in proxy voting?"* Another observed, *"[Researching proxy voting issues] doesn't add a lot of value in terms of making [clients] money, frankly, but it's our fiduciary [responsibility], and it has to be done right."* A group of US and European public company directors acknowledged the challenge even while expressing concerns about leaving decision making to proxy firms: "Being active sounds like a good thing, but of course it requires knowledge and resources [institutional investors] might not have. It may detract from returns."[61]

About the research participants

- **Assets under management (AUM):** When excluding advisors for foreign parents, participants managed over $15.4 trillion in assets under management, which accounted for more than 50% of AUM in the United States in P&I/Towers Watson's most recent ranking.[62] AUM for individual participants ranged from $31.3 billion to $3.6 trillion with a mean of roughly $1 trillion.
- **Meetings voted per year:** Participants cast votes at anywhere from several hundred meetings to over 15,000. For approximately half the participants, annual meeting volume is between 4,500 and 10,000.
- **Staffing levels:** The number of full-time employees (FTEs) devoted to proxy voting oversight and execution responsibilities at participating asset managers ranged from less than two to more than 20. The most common staffing level was the 3–5 FTE range, followed by the 10–13 FTE range. These numbers do not include investment professionals with voting input.
- **Reporting structure:** There is no uniformity in the reporting structure for proxy voting professionals at participating firms. The majority of participants' corporate governance teams report to their corporate operations or investment services departments. Others report to their corporate compliance, legal, or portfolio management groups.

[61] Audit Committee Leadership Summit, "Shareholder Engagement: The Influence of Proxy Advisory Firms and the Role of the Board," *ViewPoints*, July 28, 2010, 5.

[62] Our calculation of assets under management is based on data from P&I/Towers Watson, *The World's 500 Largest Asset Managers*, 2010. It includes assets under management for US-based managers at which we spoke with an employee, affiliate, or subadvisor; we did not include the assets of foreign-owned entities' US-based subadvisors or affiliates. See the Appendix for a list of research participants.

Industry observers have long pointed to firm size as a determinant of resources: the ICI noted in a comment letter to the SEC that certain "funds – such as those that are part of smaller fund families with more limited resources – may rely more heavily on proxy advisory firms to guide their votes."[63] One research participant told us, *"Small investors – where it's one person who oversees governance and voting – have no resources to engage with companies even if they knew what questions to ask a specific issuer."* Others observed that some smaller asset managers have deep expertise in their sectors and companies: *"They've been in some of our sectors for a long time, so their understanding of the issues and ability to get into the details is very good."*[64]

Another frequently noted distinction when looking at asset managers' resource levels is that between index- or exchange-traded funds (ETFs) and actively managed funds. Many observers believe that "index funds vote with ISS because they can't justify to shareholders why they invest in their own analysis."[65] One participant said, *"[T]he passive side is probably more reliant on proxy firms because they don't have the resources to look at every indexed stock to the same degree. That would be [my] biggest area of concern regarding undue influence of the proxy firms."* A 2009 IRRC Institute-Proxy Governance study of what were then the top seven ETFs identified "significant variation in the voting philosophies and patterns" of large ETFs, including evidence that some do rely on proxy firms: "[T]wo of the smaller ETFs we examined vote primarily based on the guidelines and recommendations of their proxy advisors."[66]

However, other participants pointed out that there is considerable variation among firms in each category: *"Within each segment, there are firms that are relatively more active on corporate governance issues, and those that are less active. Some index fund shops have the staff and devote the time to examining the issues, and for some managed funds it's not a high priority."* Indeed, several of the largest US index fund managers report active engagement with hundreds to thousands of issuers each year. As one governance observer put it, "[t]hey think they can accomplish more in improving corporate governance through private discussions with company management and boards than through high-profile proxy-voting activity."[67]

Several research participants also cited improved records management and voting logistics as benefits of engaging a proxy adviser's services, which could be an indirect reference to the resource constraint issue. For about half the participants, the usability of proxy firms' voting platforms was an important driver of service selection. One participant said, *"We used to do everything ourselves, and as volume increased, it became much more complex logistically, especially internationally."* Another acknowledged, *"When we began working with the proxy*

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[63] Karrie McMillan, general counsel, Investment Company Institute, to Elizabeth Murphy, secretary of the US Securities and Exchange Commission, Re: Concept Release on the U.S. Proxy System (File No. S7-14-10), October 20, 2010, 14.

[64] We invited 10 asset managers ranked by P&I/Towers Watson as below the US top 25 in size (according to P&I/Towers Watson, "The World's 500 Largest Asset Managers," 2010) to participate in this research, and two agreed.

[65] Audit Committee Leadership Summit, "Shareholder Engagement: The Influence of Proxy Advisory Firms and the Role of the Board," 5.

[66] Scott Fenn and Bradley Robinson, *Proxy Voting by Exchange-Traded Funds: An Analysis of ETF Voting Policies, Practices, and Patterns* (New York, NY, and McLean, VA: IRRC Institute for Corporate Responsibility and Proxy Governance, 2009), 27.

[67] Barry B. Burr, "Money managers increasing activism on governance - but quietly," *Pensions and Investments*, March 19, 2012. See also the corporate governance policies of BlackRock, State Street Global Advisors, and Vanguard, ranked by P&I/Towers Watson as the top three passive fund managers by assets under management (P&I/Towers Watson, "The World's 500 Largest Asset Managers," 2010).

firm, our reporting and records management significantly improved. It's easier to know where things are."

Participants in governance leadership roles at asset management firms emphasized that regardless of staff size, ultimate accountability for proxy voting lies with them and not with any third-party service provider. The asset managers we interviewed generally take a two-step approach to oversight:

- **Active monitoring during proxy voting season.** One participant said, *"We reconcile every ballot, every vote. We're able to do a lot with technology."* Another said, *"I get reports weekly on votes and can monitor any deviations from our policy and track potential errors."* Several participants also specified that they document the rationale for any override of policy.
- **Postseason reviews.** At one participant's firm, *"the [governance team] does its own tracking to see if our decisions are correct; we also get our results formally audited. We expect our voting to be error-free."*

Virtually all the asset managers with whom we spoke also do some form of benchmarking of voting results – against management's recommendations as well as those of proxy firms – to gather insight into voting trends and help inform potential changes to voting guidelines. Several participants noted that they benchmark results against peer company votes as well: *"Our board will ask us, 'Are we out in left field?' It's always valuable to know what others are thinking."*

While generally satisfied with proxy firms' services, a significant number of participants said there is room for improvement. One participant noted, *"They can be a bit sloppy – they don't always double-check their data points, and votes get lost sometimes. This just fuels more criticism."* Another asset manager was more critical: *"On occasion, the research we receive from them is wrong. It's prepared by relatively junior people. We're not going to substitute work from someone who's been at this for six months for [work by] our analysts, who've been following a company for years."*

Research participants believe proxy firms have an obligation to continuously improve data management and to address some of the criticisms identified in the SEC's concept release on proxy plumbing.[68] As one participant said, *"I've told ISS they need to ensure better quality of the analysis they provide. It's a terrific service, as long as it's accurate and unbiased. If the data is wrong, or there are biases in their evidence, people won't trust them or the companies who use them."*

The voting decision process begins with a review and updating of voting guidelines, and proxy firm's policies are a key input

The first section of this report discussed a range of research studies focused on voting tallies of proxy ballots. But as one participant put it, voting decision-making is *"a dynamic, ongoing*

[68] Concerns raised in the SEC concept release include the potential for inaccurate or incomplete recommendations and analysis, lack of transparency in methodology, and a one-size-fits-all governance approach. The concept release also discusses concerns about proxy advisers' potential conflicts of interest, an issue not explored in this report. See US Securities and Exchange Commission, "Concept Release on the US Proxy System," *Federal Register* 75, no. 140 (July 22, 2010), 43012–13.

process, not a snapshot," which requires substantial work in advance of the end vote. Proxy ballot outcomes are influenced by decisions made months earlier, beginning with those related to voting policy. According to participants in our research, proxy advisers play an important role at this stage, though for most, they are not the sole source of policy input.

Describing their development of voting policy, several asset managers made comments similar to one who said, *"I prefer [the word] 'guidelines' to 'policy,' because we want to create a framework for making decisions, not a rigid, rules-based system."* This participant continued, *"Director independence is central to our guidelines. So if a company has a strong, independent board, we'll generally go with management if we believe in their business model. If the board is not deemed independent, it's a trigger for us to go deeper on a number of issues."*

Another participant described this phase of the voting process in the following way:

> *We think of our guidelines as foundational principles. They've always been the basis for our thinking, even before we published them. They're aspirational standards for governance – including independent directors, sensible compensation, and so on – and we expect them to be relatively static over time. Then we track issues and proposals we see coming up. Year on year, most of these tend to be the same. Uncontested director elections and auditor ratification are relatively stable. When there is a spike in new proposals, or a sea change in thinking, for example with say on pay, we then evaluate how those things align with our principles.*

The asset managers we interviewed said that changes to voting policy are more evolutionary than revolutionary. Virtually all research participants said they formally revisit voting policy at least once a year, while staying close to developments on an ongoing basis: *"We do an annual detailed review, and three updates: before, during, and just after proxy season."* However, significant year-on-year changes to voting policy were not common among the asset managers we interviewed; instead, as one participant said, *"If we saw a trend over time [on our votes on one issue], we'd change our guidelines."*

As for the proxy advisers' formulation of voting policy, in a December 2011 webcast on 2012 benchmark voting policy changes, ISS said it implements "400+ client-specific custom [voting] policies," which in aggregate account for more than "50 percent of ballots that flow through ISS' voting system."[69] It has also acknowledged that "many of our clients can have voting guidelines that closely follow our recommendations."[70] Asset managers make use of policy statements by proxy advisory firms in different ways:

- **As a point of reference.** Most research participants reported that they use custom voting guidelines. However, even those in this camp said they make active use of proxy firms' policy statements to help flag issues and trends of importance: *"We look at the proxy firms, as well as our peers and competitors, to help identify what issues are current each year. We'll develop*

[69] Patrick McGurn, Martha Carter, Carol Bowie, and Debra Sisti, "Twelve for 2012: Notable Changes to the ISS Benchmark Voting Policy for the Upcoming Proxy Season," December 7, 2011, 3.

[70] Audit Committee Leadership Summit, "Shareholder Engagement: The Influence of Proxy Advisory Firms and the Role of the Board,"6.

our own view on those. For example, we did a deep dive on guidelines last year, identifying where we were aligned or different with proxy firms and others." Another participant explained, *"If ISS or Glass Lewis change a position, that's often a trigger for us to review our own policy in that area."* A third asset manager said, *"We view Glass Lewis and ISS like sector-specific analysts, where the 'sector' they focus on is governance."*

- **As voting policy.** Of the asset managers with whom we spoke, a few said they have adopted the voting policies developed by one or another of the proxy firms. One participant in this group said, *"We used to have custom guidelines. But over time, we realized they were very close to [the proxy adviser we use], so much so that our guidelines resulted in very few different votes, so we converged. We consider it a cleaner baseline than the accumulation of custom guidelines. We still retain the right and the responsibility to go in a different direction when we need to."* Another asset manager said, *"We had the option to create a custom policy, but after we reviewed the [proxy firms' policies], the portfolio managers felt their guidelines were reasonable, as long as [the portfolio managers] had the opportunity to disagree."*

Research participants observed that influence flows the other way, too: from investors to the proxy firms. ISS reported it received more than 335 investor responses to its annual policy survey in 2011, and that it conducted six policy roundtable discussions.[71] One participant said, *"We participate when we have specific views we want to express. We also have dialogue with the ISS team on a regular basis outside the survey."* Some asset managers we interviewed choose not to take part in ISS's solicitations of investor input: *"At the end of the day, I'm not sure how much sway [the policy surveys have]. We'd rather see what they come up with."* One expressed broader doubts about the independence of the process: *"They say [their policy represents] their clients' views, but we think they're driving it."*

Participants called attention to two additional sources of input into voting policy:

- **Investment professionals.** Several asset managers reported that the views of investment professionals, both at home and overseas, are important during reviews of voting policy. One participant said, *"Our voting policy is really driven by the portfolio managers; we survey them every year for their views. Governance is baked into their models."* Another asset manager observed, *"[Our] staff in India, Brazil, Europe, and elsewhere could be thinking differently about governance issues than we do here in the US, so we ask for their input."*

- **Issuers.** Information from ongoing engagement with issuers is also a key input. One asset manager reported, *"The volume of conversations with companies has gone up, and the duration of the conversations has increased even more. We probably spend more time here than we do on voting [execution]."* Another said, *"We talked to about 400 issuers last year about compensation."*

Other sources of input cited by participants are listed in the box on the following page.

[71] Ibid, 2.

Sources of information US asset managers use in developing voting policy

- Other investors' policies, including peers, industry leaders, and major players in other categories (e.g., pension funds)
- Academic research
- Governance think tanks and associations
- Outside counsel

Additional sources mentioned by participants from publically-traded firms:

- Asset manager's own corporate secretary
- Asset manager's corporate investor relations and government affairs groups

Three questions about the level of internal deliberation on voting matters can help outside observers evaluate the independence of an asset manager's voting decisions

The majority of research participants reported that they use automated platforms provided by one of the proxy firms to manage annual voting logistics. These services include the initial application of asset managers' voting guidelines. One investor described the process: *"Their team takes our guidelines and applies them. In other words, where we have a policy stated, they'll code it in and send it to us, and the case-by-case items stay open. Then we take it from there."* Only a small minority of the firms we interviewed perform the initial voting policy application completely in-house.

The widespread use of proxy firms' automated voting platform services likely contributes to the perception that proxy advisers exert a high degree of influence on final voting decisions, but as one participant said, *"The first [application of voting guidelines] is only the beginning."* No voting policy, however customized or comprehensive, can cover every instance of every governance issue for every company, every year. It became clear from our conversations that voting decision-making is a complex and dynamic process that defies easy generalizations.[72]

To help get past those generalizations, the following questions are useful for evaluating the independence of an asset manager's voting decisions:

1. How much internal deliberation takes place?
2. Who is involved?
3. For which issues is proxy firm data of greatest importance?

[72] A study by Mercer for the Australian Institute of Company Directors mapped decision-making models for institutional share voting, and identified similar dimensions of variation to those we describe on the following pages. See Richard Fuller and Helga Birgden, *Institutional Share Voting and Engagement: Exploring the Links between Directors, Institutional Shareholders and Proxy Advisers*, 60.

How much internal deliberation takes place?

At several participating asset management firms, relatively little discussion of ballot items takes place once the initial application of voting policy is completed: *"In cases where our custom policy calls for case-by-case decisions, those items are referred to the proxy committee. But the vast majority of our votes are cast by ISS according to our policy."* At another participant's institution, *"We have our own policy, but within that about 90% of [ballot] items are routine and 10% case-by-case. Those 10% come to [the governance team] and we get them in front of the portfolio managers."*

This approach to handling so-called routine ballot items is another driver of perceptions about the influence of proxy firms, helping to fuel comments about investors voting in "lockstep." However, most participants agree with one who said, *"So much happens before the actual vote. There are conversations involving all sorts of parties – internally and externally. It can sometimes be ambiguous where views originate."*

Who is involved?

Representatives from the majority of the asset management firms with whom we spoke reported some level of active deliberation over proxy vote decisions, especially for non-routine items, but they differed over the level of portfolio manager (or other investment professional) involvement, fund board involvement, and the allocation of final voting decision rights.

Portfolio manager involvement

In a 2010 survey, the Shareholder Forum found evidence that at least at some institutional investors, investment professionals play an active role in proxy vote decision making:

> Significant proportions of investors will spend time – either "a few minutes," "up to an hour" or "more than an hour if needed" – to consider voting issues, as distinguished from applying standard policies or recommendations, according to the importance of the decision … Professionals with buy-sell responsibilities were significantly more likely to allocate time to voting decisions, with at least 70% of them reporting that under conditions of controversy they would spend up to an hour or more considering information about each of the listed issues other than auditor selection and change in voting support requirements.[73]

At over half the asset managers participating in our research, portfolio managers (PMs) are moderately to actively engaged in discussions about proxy vote decisions. In these instances, the governance team typically prepares relevant information to *"enable the fund managers to make a decision."* One participant described how this happens: *"We compile a package with the proxy statement, a summary of ISS and Glass Lewis recommendations, and our proxy-voting policy guidelines. The analysts then review and confirm their vote decision."* Another participant explained, *"[Investment professionals] are the ones who've followed the company closely, often for a long time, and really know the details. They know when the policy might indicate to vote X, but given the company's situation, we should vote Y instead. For example, we might normally*

[73] Gary Lutin, *Survey of Investor Communication Priorities for Voting Decisions* (New York: Shareholder Forum, 2010), 2–3.

vote in favor of a particular M&A proposal, but in a given instance, the analyst feels it would be too dilutive. Often, multiple [PMs] will weigh in." See the box below for an example of one asset manager's approach to managing internal vote discussions across investment teams.

Several participants said that portfolio manager input was important in determining company performance, which in turn influenced votes on items such as executive compensation: *"Company performance can be a red flag, but you really need to understand the specifics of that industry and sector. So we draw heavily on the portfolio managers' expertise to understand 'good' or 'bad' performance."* Another asset manager said, *"We're value investors, so we often buy into companies at a contrary time. We want to be able to ensure management can continue to motivate staff and turn around the company, so our shareholders benefit. Based on recent performance, a formula might say, 'The CEO doesn't deserve this pay level', but based on our philosophy, that might be a simplistic view."*

At a number of the other asset managers with whom we spoke, portfolio managers are involved only occasionally in proxy voting deliberations. According to governance leaders at these firms, investment professionals *"may weigh in on an unsolicited basis to give us input. When they do, we usually will defer to their judgment, but we don't actively solicit their view in most cases."* Asset managers taking this approach tend to focus portfolio manager involvement on areas with clear economic impact, as one participant described: *"Our portfolio managers are directly involved [in decision making] 10% of the time or less … On any ballot, some items are routine. Ratification of auditors won't really move the needle in terms of returns. The PMs won't really have insight there, but on share issuances, recapitalizations, M&A decisions – those will have material economic impact, and it's where we want them involved. We want to focus their expertise on votes that affect value creation at the firm."*

Voting deliberation via message thread

At one research participant's firm, the governance team engages the investment team in an online debate about items on proxy ballots:

> *Say a company has two referred items. I'll identify which PMs own the security and will send an email with specifics on the proposals and summaries of the company position, our views, research from proxy firms, and the meeting deadline. It becomes an open discussion thread. We get a dialogue going: one PM could argue in favor of voting for the proposal, another argues against, and others weigh in. It's a very helpful way to tap into our own expertise across the company. We want to encourage thoughtful decision making.*

Several research participants view the level of portfolio manager involvement in decisions on proxy votes as a function of the firm's overall philosophy about governance: *"Our focus is on helping our clients achieve their financial goals, not necessarily trying to buy into companies to change their governance structure. So we need to ensure our proxies get voted reliably and* *consistently, according to our clients' interests."* Another participant observed, *"For some investors, governance is a greater priority, especially since the financial crisis … For others, it's more of a compliance exercise, which could lead to more of a hands-off approach."*

Fund board involvement

The level of fund board engagement in the voting decision-making process varies considerably. At the majority of research participants' firms, the policy for board-level involvement is exception-based and extremely rare. One participant said, *"We have a general escalation policy, but it's rarely used. When we have situations where we're voting outside or contrary to our guidelines, we first review it with Legal, and if they still feel it needs to go to the trustees, they'd escalate at that point. It hardly ever happens."* Another said, *"If we're not on the same page with the portfolio managers on an issue, we prefer to talk it through to come to a view on what's the best [decision]. There's still an option to override if someone feels strongly about going in a different direction, so the need to escalate up the chain hasn't really come up."*

According to the small number of participants whose boards are more actively engaged in proxy voting discussions, involvement seems to result from the interest of individual board members rather than an explicit policy choice. One investor said, *"Our board members are very interested in corporate governance issues. Many of them take part in thought leadership on different topics."* At another research participant's firm, *"the fund board of trustees delegates all proxy voting to [the governance team], but many of them do have strong opinions about certain governance issues, based on their own backgrounds and expertise. Some get heavily involved in the annual discussions on our voting policy and guidelines, though rarely in an individual voting decision."*

Allocation of final voting decision rights

Final voting authority varies by firm. At some asset managers, the corporate governance team drives the final decision: *"The PMs have input, but the final decision is made by our team. We seek to speak with a single voice."* At others, the investment professionals take the lead: *"If [the portfolio managers] make a recommendation, we usually default to that view."*

Some firms permit split votes, whereas others do not:

- Some participating asset managers believe that, in the words of one participant, *"as one votes, we all vote. We aim to make the same decision across all our funds."*
- Taking the opposite view, another participant said, *"Our overarching mind-set is that our clients have hired PMs to execute their individual strategies. Large-cap versus aggressive-growth views on an issue could be different takes on what's beneficial from a fiduciary perspective. That's why we feel it sometimes makes sense to not have all votes the same."*
- A third investor described how a split-vote approach might play out:

  In a transaction vote, two funds might not be equally situated. For example, in a merger situation between A and B, we might conclude that the transaction was economically better for Company A. So if the fund only held Company A, it would be a straightforward yes *vote; if only Company B, a straightforward no vote. Funds holding both would look at their portfolio and the relative weighting of A versus B. Their individual voting decision would depend on the weighting.*

For which issues is proxy firm data of greatest importance?

The research and recommendations provided by proxy firms are clearly an important source of information for asset managers. However, other sources are significant as well. The variation in research participants' approaches to information seeking for voting decisions is similar to the variation in their approaches to the development of voting guidelines, discussed earlier:

- A small number of participants use proxy adviser research and recommendations as their primary source of input.
- Most firms draw on proxy firm information in conjunction with a variety of other sources, including issuers' proxy statements, other company data, publicly available information, academic research, and more.

These findings are consistent with those of a Shareholder Forum survey, which found that respondents' top preference as a means of obtaining information was direct questioning of management. Direct questioning received a rating of "top priority" from 26.8% of respondents, while proxy adviser reports were cited as a top priority by only 17.1% of respondents – though more than half did rate proxy adviser reports as "highly valuable." [74] The views of dissidents, SEC filings, management's public statements, and other investors' opinions were also rated as highly valuable practices.[75]

Regardless of how wide a net they cast for informational inputs into voting decision making, most asset managers find proxy firm data particularly useful for say-on-pay and international votes.

In the case of say on pay, we heard a range of approaches:

- **Adopt proxy firm recommendations:** *"We generally concur with our proxy adviser's recommendation on pay the vast majority of the time."*
- **Use proxy adviser recommendations to flag a company for further review:** *"We used Glass Lewis's pay-for-performance methodology last year as a guideline. If they give a company an F three years in a row, we'll take a closer look."*
- **Use proxy firms' underlying methodologies as a baseline for customization:** *"We do look at what the proxy advisers are saying. This allows us to select the flags of concern to us and add or delete as necessary. For example, our proxy firm has four indicators for excessive compensation, and we add a fifth."* Another investor said, *"We don't agree entirely with the proxy firms' methodology for defining peer groups. We probably end up in most cases with a*

[74] Gary Lutin, *Survey of Investor Communication Priorities for Voting Decisions*, 3. The Shareholder Forum kindly provided additional detailed survey data, not included in the publication, for this report.

[75] Ibid.

combination, [using] some of Glass Lewis and ISS's companies, some of management's. We go to our analysts and get their view on what they think is most accurate."

However, participants emphasized that compensation is more dynamic than virtually any other voting issue, and they expect the practices of investors, issuers, and proxy firms alike will continue to evolve for some time.[76] Said one, *"Everyone I know is reevaluating how to deal with say on pay on an almost constant basis."*

The challenges of proxy voting in overseas markets are well known; they include short voting seasons, narrow disclosure windows, and market-specific restrictions such as share blocking or re-registration.[77] Even BlackRock, an investor with considerable global presence and resources, has described cross-border voting as "a nightmare."[78]

Several participants described situations similar to one who said, *"We feel certain we have good coverage of US issuers, but we had votes in nearly 70 countries last year, and we don't have the ability to be experts in all of them."* Another asset manager agreed that many investors lean more heavily on proxy adviser recommendations for foreign votes and explained why: *"Some markets are much less transparent; there are disclosure issues, not to mention the need for translation. Proxy firms may be better able to gather and summarize the data in those markets than many investors."*

A small number of asset managers reported a relatively lower level of reliance on proxy advisers for international voting recommendations than other participants. One explained, *"We're fortunate in that our portfolio teams are globally dispersed. We do look at proxy firm data too, but we have an active view on whether we agree or not."* Another investor said, *"We expect our analysts in overseas locations to maintain an understanding of what's going on in emerging markets, so even though we have one [voting] policy globally, we aren't looking with a US-centric view."*

One participant observed that more investors may join this camp over time as firm investment patterns change: *"Certainly, we're relatively more reliant on the advisory services' reports to frame the issues in outlying markets – countries where we may have only a small exposure. That's today, but as we get deeper into some of the emerging markets, we'll inevitably develop our own guidelines."*

[76] Indeed, a study of 2011 say-on-pay votes found that ISS and Glass Lewis were in agreement on "Against" recommendations less than 18% of the time. See Yonca Ertimur, Fabrizio Ferri, and David Oesch, "Shareholder Votes and Proxy Advisors: Evidence from Say on Pay," March 7, 2012.

[77] For a detailed discussion of issues and challenges US investors face in voting international shares, see Lisa Schneider and John Wilcox, *Everything You Ever Wanted to Know about International Proxy Voting but Were Afraid to Ask* (Washington, DC: Council of Institutional Investors, 2011).

[78] Ruth Sullivan, "Michelle Edkins Takes Low-key Route to Engagement," *Financial Times*, May 15, 2011.

The rise of environmental and social issues

Environmental and social issues are steadily gaining in significance in the US corporate and investor communities, as evidenced by the growing list of signatories to the UN Global Compact's Principles for Responsible Investment (UNPRI) and participation in the Global Reporting Initiative. Shareholder proposals in this area focus on a wide range of issues, including greenhouse gas emissions, diversity practices, philanthropic activities, employee safety, corporate political spending, and more. In one recent survey, about 30% of asset manager respondents said they made requests for dialogue with issuers on an environmental or social topic in the last year.[79]

Most of our research participants indicated that they treat environmental and social proposals on a case-by-case basis, drawing on a variety of sources of input. A minority say they are less active on such matters. One of these asset managers said that on environmental and social matters, *"we've tended to stay on the sidelines. We believe these issues fall under the purview of management and the board, so our general stance is abstention."* However, participants say they expect this to change in the future: *"In the past few years awareness has continued to increase on differences between the ways companies handle [social and environmental] issues and how they organize to handle them, including the roles of the C-suite and the board. This is a good thing, and more investors should pay attention."*

If these participants are correct, then investors will need to develop policy guidelines that will help them form opinions on the relevant practices and data reported by thousands of issuers. As with say on pay, the complexity of the issues and the time involved may push many asset managers to rely on proxy firms' data and recommendations on social and environmental matters.

The wide variance in approaches to deliberation on voting matters shows that many different roads can lead to the same vote outcome. One asset manager observed, *"So many people overstate the importance of ISS. Just because we reached the same conclusion, it doesn't mean we didn't do our own thinking."* Another wondered where critics draw the line in their suspicion about investors' information sources: *"Are we not supposed to read the* Wall Street Journal *and the* New York Times *either?"*

However, participants also recognize that given the lack of transparency in investors' voting decision making, it is easy for outside observers to conclude that asset managers are unduly influenced by external forces such as proxy firms. While this report was focused on the US mutual fund community, the concern is universal. A recent study by the Australian Institute of Company Directors summed up the problem in the following way: "If it is accepted that proxy advice is simply an input, then influence is considered acceptable … If, however, the proxy advisory firm is regarded as the decision maker, then its influence is considered not to be

[79] Marc Goldstein, *The State of Engagement between U.S. Corporations and Shareholders* (New York: IRRC Institute, 2011), 16.

acceptable, but an abrogation of a fundamental duty."[80] A research participant expressed it another way: *"If an institutional investor can't provide a thoughtful, independent response to a question about why they voted a certain way, to many people that implies they defer to [the proxy advisers]."*

Participants believe the push for increased investor-issuer engagement will continue, but disagree over its impact on the proxy advisory industry

Many commentators believe the increased focus on corporate governance that emerged in the wake of the financial crisis is here to stay. More and more, investors are expected to interact with issuers, spurred in some cases by mandates such as say-on-pay votes, a general move towards "stewardship", social and environmental concerns, or public pronouncements by influential investors.[81] Some fear these expectations will exacerbate demands on investors' resources and push them to increase their reliance on proxy firms for the "mechanics" of executing votes. One participant predicted, *"The role of proxy voting teams will evolve. In the past, it may have been more about 'get the vote done, and get it right.' Going forward, it will be more about how we can engage and encourage better governance. But that takes time and resources."*

Another research participant observed that as issuers' governance practices advance, their demands on investors' time and resources may actually increase rather than decrease: *"Beyond just identifying how to vote, there's so much more we do with talking to issuers before, during, and after the votes. It's not just the companies who are dealing with 'no' votes. In some cases, the best companies [in terms of governance practices] are the ones who want the most feedback."* The issue is further complicated by the fact that there is no clear definition of high-quality engagement between companies and investors, nor is there a universally accepted standard for a successful outcome from such engagement.[82]

Given that *"few investors are looking to spend increasing amounts of money on activities that are not directly revenue generating,"* it is not difficult to envision a scenario in which proxy advisers become further entrenched as a resource for asset managers and thus expand their influence – both direct and indirect – over proxy vote decision making.

On the other hand, the proxy advisory industry landscape could change dramatically in the next few years. The SEC's proxy plumbing investigation could result in a wave of new regulations on proxy firms. One commentator cites recent interpretations by both the Department of Labor and the SEC of ERISA fiduciary standards which "would liberate the institutional investor community from the tyranny of the current model of having to vote all portfolio shares on all matters," and ultimately could "undermine the necessity for institutional investor dependence on proxy

[80] Richard Fuller and Helga Birgden, *Institutional Share Voting and Engagement: Exploring the Links between Directors, Institutional Shareholders and Proxy Advisers*, 65.

[81] See, for example, Laurence Fink, chairman and CEO, BlackRock, open letter encouraging engagement, January 17, 2012.

[82] For a detailed discussion, see Marc Goldstein, *The State of Engagement between U.S. Corporations and Shareholders*.

advisors."[83] Alternatively, specialty firms focused on investor-issuer engagement might ultimately prove a threat to the proxy voting agencies' dominance.[84]

While it is difficult to predict the direction in which the proxy advisory industry will evolve, research participants are encouraged by what they see as an increasingly open dialogue: *"As companies talk with investors more frequently, and with the proxy firms too, there'll be fewer and fewer surprises. Nobody loses with better communication."* Our conversations with asset managers and other stakeholders lead us to conclude that not only is investors' communication with issuers and other external players important, so too are their internal communication patterns, and especially their patterns of deliberation on specific voting matters.

[83] Latham & Watkins, "Proxy Advisory Business: Apotheosis or Apogee?" *Corporate Governance Commentary*, March 2011. "ERISA" stands for the Employee Retirement Income Security Act of 1974.

[84] Two London-based firms have established themselves as engagement and stewardship specialists. These two firms, Governance for Owners (GO) and Hermes Equity Ownership Services (EOS) provide proxy voting services, and also engage with companies on behalf of investors.

Conclusion

Both the academic literature and our conversations with research participants reveal the complexity of investor voting decision making, which we view not as a linear process, but as a dynamic system, with multiple information flows and feedback loops. While causal relationships between proxy firm recommendations and voting results are not as easy to identify as correlations, proxy advisers clearly impact the governance dialogue in general and say-on-pay and international voting in particular. They also affect the behavior of issuers and investors outside the annual proxy voting cycle.

By themselves, voting outcomes do not fully explain the level of outside influence on an investor's decision making. In addition, it is essential to understand the level of internal deliberation involved in reaching those outcomes. In other words, those seeking to understand the nature of proxy firms' influence (or, for that matter, the influence of management) on asset managers' voting decisions should look not only at the ends, but also at the means used to get there. Reassuring signs include the application of informed judgment, decision-making processes that are appropriately tailored to each firm's investment philosophy and resource levels, and a commitment to continuous improvement. As one research participant put it, *"We think we can influence behavior that will maximize shareholder value at the companies we invest in. So we want to constantly keep evaluating, is this [proxy voting] approach the best way? Is there a better or more effective way to serve our clients?"*

Areas for further research

During the development of this report, we identified several areas for additional research:

- **Deeper exploration of voting processes in small and midsize asset managers.** We are grateful for the active and thoughtful participation of so many leading asset managers in this research. While our participants collectively account for over 50% of US assets under management, most are on the larger end of the size spectrum. A deeper dive into the voting practices of the midsize and smaller segments of asset managers would be worthwhile.
- **Longitudinal studies of changes in individual investor voting activity.** One participant described proxy voting as *"a dynamic, ongoing process, not a snapshot."* Future research might study a single firm (or small set of firms) over time to chart the evolution of policy guidelines as well as voting patterns on key proxy matters.
- **Monitoring the evolution of say on pay.** Issuers, investors, and the proxy firms themselves all changed their approaches to executive compensation in 2011, after the first season of mandatory advisory say-on-pay votes. This topic deserves continued attention to see how the decisions and practices of major stakeholders impact each other.
- **Exploration of emerging trends, such as environmental and social proposals, and their impact on voting decisions.** According to one recent survey, shareholder resolutions on environmental and social issues are expected to "dominate other major proposal categories for a third consecutive year" in 2012 and will receive increasing levels of support.[85] Several participants recommended further investigation of the role of proxy advisers' input in this area.

[85] Ernst & Young, "Leading Corporate Sustainability Issues in the 2012 Proxy Season: Is Your Board Prepared?" *Ernst & Young Global Limited* (2012), 1.

Appendix: Research participants

AllianceBernstein

Stephen Grillo – Vice President and Proxy Manager

John Phillips – Senior Portfolio Manager, Bernstein Global Value Equities, and Chairman, Proxy Voting Committee

Ameriprise Financial

Columbia Management:

Lee Faria – Vice President, Compliance

Malcolm A. (Mac) Ryserse – Corporate Governance Analyst

BlackRock

Zach Oleksiuk – Vice President, Corporate Governance and Responsible Investment

Rob Zivnuska – Director, Corporate Governance and Responsible Investment, Americas

Broadridge

Maryellen F. Andersen – Corporate Governance Officer, SVP Corporate and Institutional Relations

Capital Group

Capital Research and Management Company:

Anne Chapman – Vice President, Fund Business Management Group

Chad Norton – Vice President, Fund Business Management Group

Dodge & Cox

Thomas M. Mistele – Chief Operating Officer and Senior Counsel

Fidelity Investments

Mark Lundvall – Vice President, Investment Proxy Research

Georgeson

Rhonda L. Brauer – Senior Managing Director, Corporate Governance

Glass, Lewis & Co.

Bob McCormick – Chief Policy Officer

Goldman Sachs

Heather Keough – Proxy Voting Coordinator and ESG Investment Analyst

Patricia Meyer – Vice President and Associate General Counsel

Institutional Shareholder Services

Sean Quinn – Vice President and Head of ISS Governance Institute

Legg Mason

ClearBridge Advisors:

Mary Jane McQuillen – Managing Director, Portfolio Manager, and Proxy Committee Member

Eric Thomson – Vice President, Business Analyst, and Proxy Committee Member

Manulife Financial
Tara Gormel – Senior Legal Specialist

MFS Investment Management
Matt Filosa – Assistant Vice President and Corporate Governance & Proxy Voting Manager

Morgan Stanley
Drew Hambly – Head of Corporate Governance

New York University School of Law
Stephen Choi – Murray and Kathleen Bring Professor of Law

Prudential Financial
Quantitative Management Associates:
Clark Pellington – Chief Compliance Officer

The Putnam Funds
Nancy Florek – Vice President and Proxy Manager

State Street Global Advisors
Andrew Letts – Vice President, Corporate Governance

TIAA-CREF
Peter G. Reali – Senior Analyst, Corporate Governance

T. Rowe Price
Donna Anderson – Vice President and Corporate Governance Specialist

University of Pennsylvania Law School
Jill E. Fisch – Perry Golkin Professor of Law

Van Eck Global
Greg Krenzer – Trading & Risk Manager

Vanguard
Glenn Booraem – Principal and Fund Controller
Christopher Wightman – Senior Manager

Wake Forest University
Alan Palmiter – Howard L. Oleck Professor of Business Law

Wells Fargo
Wells Fargo Wealth Management:
Kevin Ario – National Manager PSG/MDS
Wells Fargo Funds Management:
Thomas C. Biwer – Manager, Asset Allocation Investments