Proxy Advisory Firms:
The Economics of Selling Information to Voters

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Motivation

- **Proxy voting**: M&A, director elections, governance changes, executive compensation
  - rise in shareholder activism, in the number and complexity of proposals to vote on.

- **Proxy advisory firms**
  - Provide research and vote recommendations to shareholders for a fee.

Motivation

1. Institutional ownership has increased a lot.

2. 2003 SEC rule about proxy voting

- Fiduciary duty to vote in investors' best interest.
- Required disclosure of votes.

Motivation

Key proxy advisors

- ISS: 61% of the market; 1,600 institutional clients.
- Glass Lewis (est. in 2003): 36%.

Empirical evidence: ISS has a strong effect on votes

- Alexander et al. 2010, Bethel and Gillan 2002, Ertimur et al. 2013, Iliev and Lowry 2015, Malenko and Shen 2016 (25pp causal effect)

SEC commissioner Michael Piwowar:

- *"I've become increasingly concerned that proxy advisory firms may exercise outsized influence on shareholder voting."*

This paper

Objective

- Develop a tractable framework for analyzing the economics of proxy advisory industry.
- Use it to study:
  - How do proxy advisors affect the quality of decision-making?
  - What are the effects of the suggested policy proposals?

What we do

- Model of shareholder voting with a seller of information.
  - Take a canonical model of strategic voting.
  - Introduce a seller of information (proxy advisor).
  - Shareholders can acquire information privately and/or from the advisor.

This paper: Economic forces

1. Proxy advisor provides an option to buy an informative signal.

2. The option to buy proxy advisor's information reduces shareholders' incentives to invest in private information acquisition.
   - Not a problem if a firm is owned by a single shareholder.

3. Collective action problem among shareholders leads to *inefficient* crowding out of private information acquisition.
   - A positive externality of information acquisition.
   - When others already follow PA, externality is higher for private information acquisition than for acquisition of PA's signal.
   - Collective action problem ⇒ inefficient overreliance on PA and too little private information acquisition.
   - All shareholders who follow PA make perfectly correlated errors ⇒ (sometimes) less informative voting.

Model setup

Players

- N shareholders (N is odd). Each has one share and one vote.
  - maximize value of its share minus info acquisition costs
  - extension: also care about litigation risk
- Monopolistic advisor
  - maximizes profits

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Proposal to be voted on

- Value is uncertain and depends on state $\theta \in \{0, 1\}$, which are equally likely
    - e.g., a proxy fight: 50% chance that the dissident adds value; 50% chance that the dissident destroys value

$$u\left(Accept, \theta\right) = \left\{ \begin{array}{ll} 1, & \text{if } \theta = 1 \\ -1, & \text{if } \theta = 0 \end{array} \right.$$
$$u\left(Reject, \theta\right) = 0$$

Model setup

Each shareholder has access to two signals:
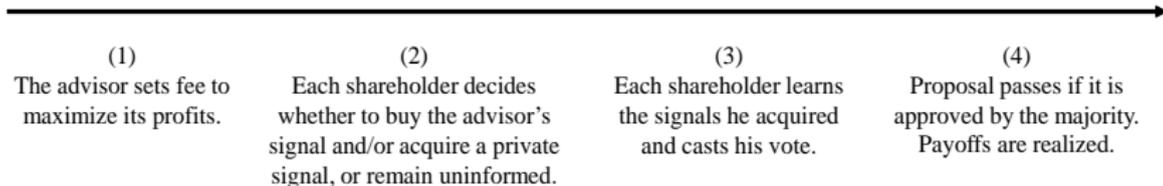
1. Can pay cost $c > 0$ and acquire a private signal s_i

$$\Pr\left(s_i = 1 | \theta = 1\right) = \Pr\left(s_i = 0 | \theta = 0\right) = p \in (0.5, 1].$$

2. Can pay fee $f > 0$ to the advisor and acquire signal r

$$\Pr\left(r = 1 | \theta = 1\right) = \Pr\left(r = 0 | \theta = 0\right) = \pi \in (0.5, 1].$$

- All signals are independent conditional on θ.

- Institution-level heterogeneity in correlation of votes with ISS recommendations (e.g., Iliev and Lowry 2015)

Timeline

| (1) | (2) | (3) | (4) |
| The advisor sets fee to maximize its profits. | Each shareholder decides whether to buy the advisor's signal and/or acquire a private signal, or remain uninformed. | Each shareholder learns the signals he acquired and casts his vote. | Proposal passes if it is approved by the majority. Payoffs are realized. |

- **Equilibrium concept**: Symmetric Bayes-Nash equilibrium

Benchmark case without the advisor

Voting stage

- Informed follow their signals, uninformed vote "for" with prob. $\frac{1}{2}$

Information acquisition stage: Acquire private info with prob. q^*

- **Assumption**: $c \in (\underline{c}, \bar{c})$, so that $q^* \in (0, 1)$

General model

Equilibrium at the voting stage:

- Shareholder with a private signal follows it.
- Shareholder with PA's recommendation follows it.
- No shareholder acquires both signals.

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**Information acquisition stage.** Each shareholder:

- acquires a private signal with probability q_s
- acquires PA's recommendation with probability q_r
- remains uninformed with probability $1 - q_r - q_s$

Information acquisition stage

1. If $f \geq \bar{f}$, only private information acquisition.
2. If $f \in [\underline{f}, \bar{f})$, **incomplete crowding out** of private information acquisition.
3. If $f < \underline{f}$, **complete crowding out** of private info acquisition.
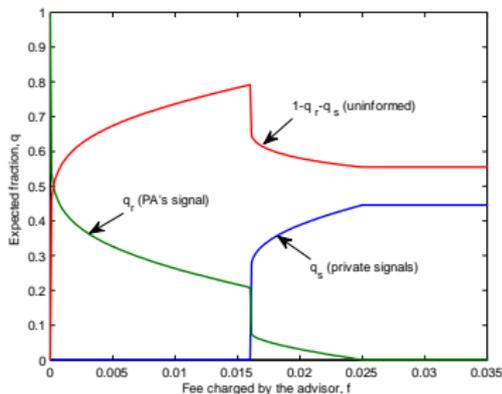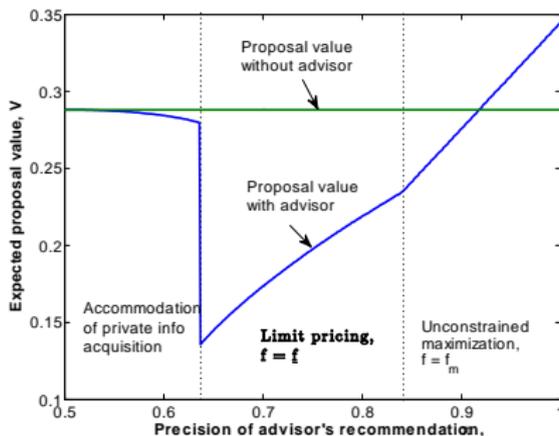
Pricing of information by the advisor
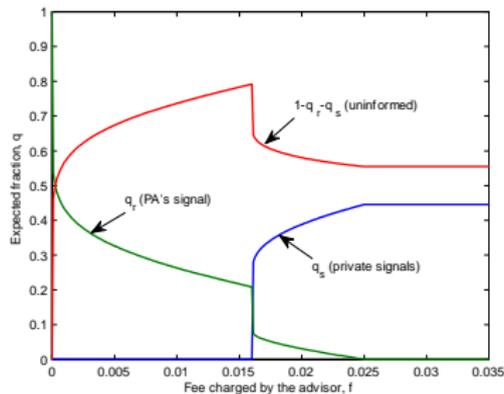
- Advisor solves $\max_f f q_r(f)$
  - "competes" with private info acquisition technology

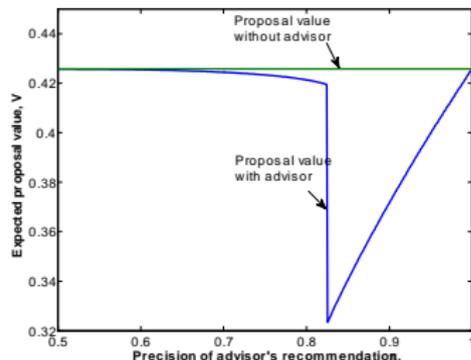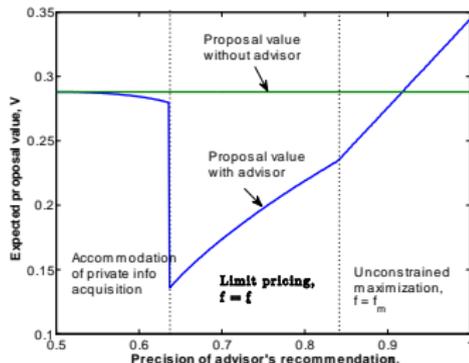# Quality of decision-making

Result

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Additional inefficiency due to strategic fee setting by PA:

- If PA's information is imprecise, there is over-reliance on its recommendations.
- If PA's information is precise, there is under-reliance on its recommendations.

Analysis of regulation

1. Litigation pressure
2. Reducing the advisor's market power
3. Disclosing the quality of recommendations

Litigation pressure

Motivation: Institutions can subscribe to and vote with ISS to avoid lawsuits, i.e., not only for information reasons.

- "...could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party" (2003 SEC rule)

- "relying on the advice from the proxy advisory firm became a cheap litigation insurance policy" (Daniel M. Gallagher, former SEC commissioner)

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Setup: Shareholder gets an additional payoff $\Delta > 0$ from buying the advisor's recommendation and following it.

- Δ is the PV of litigation costs that get saved by following advisor.

Litigation pressure

Implication: Litigation pressure increases firm value iff the advisor's recommendation is sufficiently precise.

- encourages shareholders to get informed ("+")
- but crowds out even more private info acquisition ("−")
- positive effect dominates if precision is high enough

Conclusion

Economic forces

- Proxy advisor provides a new informative signal.
- But crowds out too much private information acquisition (the "correlated mistakes" effect).
- Strategic fee setting creates another inefficiency.
  - overreliance if signal is imprecise; underreliance if signal is precise.

Results

- Advisor's presence improves the quality of decision-making only if the quality of its information is sufficiently high.
- Implications for regulations of proxy advisors' market power and transparency.