The influence of proxy advisory firms on executive remuneration

Many Australian board directors are wary of proxy advisory firms.

Listed companies with a greater than 10% negative vote on their remuneration reports tend to identify proxy advisory firms as the main source of negative sentiment for the less than satisfactory shareholder vote.

But boards have to face up to the fact that the proxy firms wield considerable influence, and that this will continue. Pragmatically, the best board response is to work on either addressing the issues that investors do not like in regard to remuneration, and/or improve disclosures and other communications to better inform shareholders why the remuneration arrangements are in their best interests.

The situation in the US is similar and felt so keenly that business lobbies took it to their politicians. In response to a request by two members of the US Congress the Government Accountability Office (GAO) researched proxy advisory firms’ influence. They released their report to the public in late July (see HERE).

Guerdon Associates was surprised at the conclusions of the report, which downplayed the influence of proxy advisers and the US firms’ conflicts of interest.

Note that we have no problem with potential conflicts of interest for Australian proxy firms. We consider them to be considerably less than those of their US counterparts (for example Risk Metrics’ ISS offers US corporations consulting
advice on equity plan design and governance, among other things, whereas ISS Australia does not provide corporate consulting at this stage).

It appears that the primary purpose of the GAO report was to home in on US subsidiary of Risk Metrics ISS’ conflicts of interest (i.e. taking on both investors and issuers as clients). It was argued that as ISS fully discloses its conflicts then these are not much of an issue for the report (although this side-steps the incentive to use ISS’ consulting services that is provided by the need to obtain their approval for equity plans, etc). This was supported by the mainly large institutional investors interviewed by GAO that indicated that they were comfortable with these conflicts.

Among other things, the GAO’s report noted that:

• There are over 28,000 public companies worldwide that send out proxy statements with over 250,000 separate items for resolution

• Other potential conflicts consist of owners of proxy firms that do business with both issuers and investors (and the owners of advisory firms serving on boards of other companies).

• ISS dominates the industry in the US, with more clients than the other 4 proxy advisory firms combined. (In Australia, it appears that there is a much more reasonable balance of market share between ISS and CGI Glass Lewis)

• Many of the investors that GAO contacted said that they do not vote their proxies; they hire asset managers who do that for them. (This would be the same in Australia, as almost all large superannuation funds hire fund managers and expect them to vote their proxies.)

• The report indicated that proxy advisory firms might have limited influence over proxy voting because most large
institutional investors that control the majority of proxy votes do independent research. (While we would expect that many Australian fund managers and some superannuation funds would also claim this, the reality is that they have limited resourcing to do this as thoroughly as the proxy firms in the short time available between the issue of proxies and the actual vote)

A flaw in the GAO report was taking at face value that many of these institutional investors said they make independent decisions. While some do, many of them probably vote the way the proxy firms tell them, despite their fiduciary duty to vote.

Remember that Australian institutional investors may hold positions in hundreds of companies, while US institutional investors may invest in thousands of companies. It would be a monumental task to conduct independent research about each item for each company’s ballot. To do so, an institutional investor would have to have a staff along the lines of a proxy adviser to adequately do the job. The reality is that investors are trying to keep their expense ratios down – and even the larger investors typically have only one or two employees dedicated to vetting voting issues.

The GAO report also looked at the barriers to competition and concluded that there were few. In other words, they think the current influence of a few firms on how investors vote would fade over time as more competitors enter the market. We think that here the GAO missed the target. There are real barriers to competition in the proxy advisory industry that ensures the current incumbents will continue to have significant influence. Because Australia is a small market, it will feel this more keenly than the US.

One of these is an international network. With exponential growth in Australian funds under management expected for many more years, and limited local places to put the money,
Australian institutions have no choice but to invest an increasing proportion offshore, increasing their reliance on international proxy advisory services. It takes a significant amount of capital to establish a proxy advisory presence in all major capital markets. The risk would be significant. Beyond Risk Metrics ISS and CGI Glass Lewis there are none that could hope to gain an appropriate global presence.

The second barrier to entry ensuring that the two Australian proxy advisers’ influence will remain significant is vote execution using advanced technology. This is less developed in Australia than the US. But over time we expect many more institutional investors will adopt voting platform technology marketed by the proxy firms, further entrenching their influence. After adopting a technology, few institutional investors will assume the risk inherent in moving thousands of accounts and ballots from tried and true CGI GL and ISS voting platforms to another provider. The chance that accounts would be lost, not voted, or voted incorrectly is far too great. A new competitor has a rough road to travel to try to duplicate the sophisticated vote execution platforms that these companies have built and are now introducing to Australia.

In short, we think the US report failed to emphasise the extent and likely continued influence of the dominant proxy advisers.

But do not get the wrong impression. Guerdon Associates believes that there is a very important need for proxy advisers. That the market can support just the two in Australia is a consequence of market depth and economies of scale. And two is better than one. Both Risk Metrics ISS and CGI Glass Lewis vary in their proxy voting policies in important and often subtle ways, and often have differing views on how their clients should vote their proxies. We have observed differences of opinion between the two firms on several contentious remuneration report votes (the remuneration proxies for Macquarie Bank and Zinifex being
just two recent examples).

These and other examples serve to illustrate the importance of institutional investors subscribing to both services. Contrary points of view will assist investors making up their own minds and developing consistent governance frameworks on important remuneration and other issues.

We urge investors to maintain an oversight to ensure there is at least healthy competition between the two. And while ensuring that neither becomes the dominant player in Australia by patronising both, we urge investors to still leave the door open (and in some cases open the door) directly to the companies they invest in to hear their side of the story.