Institutional Investors and the Use of Intermediaries in the Shareholder Voting Process

The Role of the Proxy Advisory Industry

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Abstract

Proxy advisors play an important role in the decision making process of institutional investors in regard to ballots to be cast in the general annual meetings of the companies in their portfolio. Thereby they help the institutional investors make a well-informed decision i.e. fulfill their fiduciary duty. Besides their function as information intermediaries proxy advisors take care of all ancillary aspects of balloting a vote through the voting chain. Both scholars and regulators have been examining the (potential) influence or power of these agencies. This thesis examines the current state of the proxy advisory industry and the research conducted by academic scholars and regulators on proxy advisors. In the academic literature research on proxy advisors is generally limited to examining the statistical relation between the advice given by proxy advisors and the actual votes cast by institutional investors. In this thesis a different perspective is taken and it is argued that the proxy advisory industry is an essential and influential link in the voting chain.

Contents

1 Introduction

Every year after corporations have published their annual reports institutional shareholders have to make decisions on governance concerns for all the corporations they have invested in, in order to fulfill their fiduciary duties. For mutual funds and pension funds the number of decisions, i.e. votes, made can ascend up to as much as 50,000, as is the case for the largest Dutch pension provider Algemene Pensioen Groep (APG) (Van der Heiden, 2015, April 28). Due to the vast number of decisions to be made and the resulting votes to be cast, large investors outsource the time-consuming research process on how to vote to intermediaries. These information intermediaries are called proxy advisors and provide recommendations on how to vote and sometimes are authorized to directly vote for the shareholders (Belinfanti, 2008).

The most influential and largest proxy advisor in respect to voting recommendations made and market share held is Institutional Shareholder Services (ISS) (Choi, Fisch and Kahan, 2008, 2010). ISS is estimated to advice institutional investors concerning half of the world's common stock on governance related questions, and 15 to 20 percent of mutual funds are said to have given ISS permission to automatically vote in their name (Belinfanti, 2008). An example of the delegation of votes to a proxy advisor is the merger between Hewlett-Packard (HP) and Compaq (Diamond & Yevmenenko, 2003). Barclays Global Investors (GBI), delegated its voting rights for their, close to sixty million, HP shares in regard to the merger completely to ISS by letting the proxy advisor vote automatically for GBI (Belinfanti, 2008). Furthermore the recommendations given by proxy advisor ISS are estimated to be followed more than 90 percent of the time by investors with regard to elections held by non-U.S. firms (Iliev, Lins, Miller & Roth, 2015). However the smaller proportion, when advice is not followed, is said to be about the most controversial decisions that have to be made (Van der Heiden, 2015, April 28).

In the last decade the role of proxy advisors has raised concerns with both the United States Security and Exchange Commission (SEC), the European Commission, as well as other financial authorities (Belinfanti, 2008; ESMA, 2013; Schouten, 2012). This is due to the important role proxy advisors have, even though there is little accountability and little, although slightly increasing, regulation (Belinfanti, 2008). Take for example APG, this pension provider uses recommendations of proxy advisors despite concerns about the accountability and regulation faced by these proxy advisors by authorities and academics. This means that APG is outsourcing part of the governance decisions influencing the return on 30 percent of the total collective

pension funds available in the Netherlands to proxy advisors. Thereby it is making 20 percent of Dutch families dependent on a very limited number of proxy advisors (APG does indicate it uses proxy advisors, but not their number nor their identities) (Algemene Pensioen Groep, 2013).

In contrast to the important role of proxy advisors there are signs that indicate that proxy advisors may not efficiently operate as intermediaries. The use of the proxy advisors is said to create negative economic consequences in regard to their function in helping institutional investors make well-informed decisions, in order for institutional investors to fulfill their fiduciary duties (see for example Larcker, McCall & Ormazabal, 2013, in regard to stock option repricing; and Larcker, McCall & Ormazabal, 2015, in regard to say-on-pay voting). Furthermore potential market failures, i.e. market fails to efficiently allocate resources, in the proxy advisory industry have been subject to investigation of the European Securities and Markets Authority (ESMA) (2012), along with a recent review by the SEC on the extent to which institutional investors fulfill their fiduciary duties with support by the use of proxy advisory services over a four year period (2010-2014) (SEC, 2014; Sorkin et al, 2015) (both negative externalities and market failures will be further addressed in subsequent sections of this thesis).

Another point of caution in relation to potential inefficiencies in the proxy advisory market is the lack of competition that seems to be present in the proxy advisory market. ISS has a U.S. market share of 61 percent and faces only one big competitor, U.S. based Glass Lewis (Alexander et al., 2010; Belinfanti, 2008). Moreover these two proxy advisors together are said to hold 97 percent of the U.S. market (ESMA, 2012). The lack of competition in the proxy advisory market is further suggested by findings that state that only ISS and Glass Lewis to have an significant influence on shareholder voting outcome (Choi, 2008, 2010).

Furthermore a conflict of interest seems to arise for ISS since it not only recommends on how to vote but also gives companies advice on how to improve their governance structure (Belinfanti, 2008). There are known cases for which these services are provided in regard to the same company (e.g. Disney, Belinfanti, 2008; for an empirical analysis of conflicts of interest in the proxy advisory industry see Li, 2013). As indicated by the analysis of the entrance of Glass Lewis, due to a lack of competition in the proxy advisor market, conflicts of interest seems to be even more pronounced than it would have been in a situation with more competition, (Li, 2013).

For example there has been cases where firms change their remuneration plans, e.g. Disney, in order to get a positive voting advice on their remuneration plans from ISS. This

directly shows the potential power of ISS who besides giving Disney advice on their governance structure also gives recommendations to some of Disney's shareholders on how to vote on Disney's remuneration proposals. This not only gives ISS influence on Disney's governance decisions but also creates a potential conflict of interest by representing both sides in regard to these decisions during the general vote on these topics (Larcker et al. 2015). Moreover according to Belinfanti (2008) proxy recommendations are sometimes followed blindly. Further in relation to non-Anglo-Saxon European countries it is claimed that, due to the U.S. governance model used by influential proxy advisors, these agents are not able to give decent advise to European institutional investors (Volunté & Zaby, 2013).

This thesis will focus on the potential large influence of the proxy advisory industry as information intermediaries for institutional investors and the potential magnitude on economic and social outcomes, together with multiple concerns about the functioning of proxy advisors, by policy makers, regulators and scholars. Based on these factors the following question is formed: *To what extent is the proxy advisory industry functioning efficiently in its role as information intermediaries for institutional investors?*

I.e. is the use of proxy advisors the best alternative for institutional investors, and to what extent are negative externalities and market failures present in the proxy advisory industry.

In the first part of this thesis the role of proxy advisors in the decision-making process and actual casting of votes by institutional investors will be described. This section deals with the functioning and background of proxy advisors, the evolution of the industry, the imposed regulations these agents have to conform to, and the methods used and findings presented in the academic literature. After this part a theoretical framework is provided to provide further insight in the proxy advisory industry. Then an example from the field of the use of an proxy advisor by a big institutional investor will be provided. The consequences of the use of proxy advisory industry in, and on, the decision-making process and actual casting of votes by institutional investors will be discussed in the discussion section before concluding remarks and recommendations are presented.

2 The role of proxy advisors

What is the role of proxy advisors in the decision-making process and actual casting of votes by institutional investors?

2.1 Function

Proxy advisors are information intermediaries which perform their services mostly for institutional investors. As information intermediaries proxy advisors provide a source of information and help investors to vote timely and well-informed (Alexander et al., 2010; ESMA, 2012). Institutional investors have to comply with regulations and are expected to follow guidelines provided, e.g. by the SEC in the U.S. and the ESMA in Europe, to make well-informed decisions, i.e. fulfill their fiduciary duties, when balloting their votes regarding governance issues of the parties they have invested in (Alexander et al., 2010; Hitz & Lehmann, 2015). Furthermore due to the limited resources available by investors, these investors are said to prioritize with respect to the size of the stake and the importance of the subject of vote (ESMA, 2010). However in order for these institutional investors to fulfil their fiduciary duties they have to make well-informed decisions. As stated in the introduction for an institutional investor, e.g. for the biggest Dutch pension fund APG who has to analyze and decide how to vote on 50.000 different points, this is a large time and personnel consuming and costly ordeal. Most institutional investors simply do not have those kind of in-house resources. This is where the proxy advisors enter the market by providing institutional investors recommendations on how to vote.

The way proxy advisors come to their recommendations are found to differ between one another (Alexander et al., 2010) and are said to depend on where the proxy advisor is based (ESMA, 2012). U.S. based proxy advisors are stated to depend more on their own set of policies when developing their recommendations whereas European based proxy advisors are said to follow the policies of their clients more (ESMA, 2012).

Proxy advisors are said to offer their services on a subscription basis as consultants. According to Alexander et al. (2010) vote recommendations are send to institutional investors a few weeks before the balloting of their vote is scheduled in the form of a written research report. In line with Belinfanti's (2008) findings, Choi et al. (2008) state that some proxy advisors go further by actually vote in the name of their clients. ISS (2016c) indeed states that it 'execute votes on your behalf' however it also states that their clients keep control of their vote. Although when looked at the structure ISS presents on how they provide their proxy services, the client

gives their proxy ballots together with vote instruction. From that point on it is ISS who further executes the voting process (see figure 1 p.13) (ISS, 2016c).

Big European investors are said to use more than one proxy (ESMA, 2013). However based on survey data of U.S. pension funds it is stated that there is little internal decision making in regard to shareholder voting by pension funds and that these agents rely heavily on outside agents such as proxy advisors (Choi & Fish, 2008).

In the upcoming sections a more detailed overview of proxy advisors will be provided on an individual basis, with more detail given to the most influential, i.e. biggest, agents, after an overview of the proxy voting process and the development of the proxy advisory industry is given. Furthermore the proxy recommendations by proxy advisor are not found to be one-size-fits-all (Ertimur, Ferri & Oesch , 2013), although the weights given to the different variables taking into account for their analysis are not completely disclosed (Belinfanti, 2008; Choi et al., 2008) which has led to questioning and criticizing the transparency of proxy advisors by both regulators, (e.g. ESMA, 2012, 2013), and scholars (e.g. Larcker, McCall & Tayan, 2013; Volonté & Zaby, 2013) along with questions about the agency costs that come with the use of proxy advisors (e.g. Belinfanti, 2008). These and other possible pitfalls that might arise from the use of proxy advisors will be discussed in more detail in later sections of this paper. First an overview of the voting chain in which the proxy advisory industry makes recommendations for institutional investors will be discussed.

2.2 Voting chain (contextual background)

The voting chain consists of multiple agents: the shareholders, e.g. institutional investors, their custodians also referred to as global custodians, sub custodians also referred to as local custodians (Broadridge, 2009), the companies invested in and to be voted on, and other agents such as proxy advisors and third-party processors of shareholder communication like Broadridge (Autoriteit Financiële Markten [AFM], 2016).

A shareholder can ballot its vote in two ways, attend the annual general meeting or vote by proxy (AFM, 2014). The formal would be theoretically ideal since this would make for a straightforward and transparent process that is easy to audit and control whether votes are cast and are cast correctly. Since the former is not possible for big institutional investors who would have to attend hundreds (or thousands) of meetings, taken together with the fact that most of

these annual general meetings take place between March and May, a lot of voting is conducted by proxy.

The ballots, i.e. the shares to be voted on, are held by custodians. They hold the actually accounts of a shareholder. These custodians have sub custodians who hold the actual shares in the market (AFM, 2014).

The voting chain starts when the ballot from a company held in the portfolio of an institutional investor is send to the sub custodian. These proxy materials are generally given 35 to 40 days before the general meeting (Broadridge, 2016a). The sub custodian then sends the ballot to the custodian who holds it for the institutional investor. When proxy advisors are used, institutional investors often give permission to the custodians to send these ballots, including the corresponding paperwork, to the enlisted proxy advisor (AFM, 2014).

The two leading proxy advisors use online platforms on which their clients, the institutional investors, can log on and oversee the ballots received by the proxy advisors through the custodians and sub custodians from the companies invested in by institutional investors (AFM, 2014; Glass Lewis, 2016c; ISS, 2016e). Based on these ballots the proxy advisor commissions the research internally in order to make recommendations.

Big institutional investors often have their own set of internally developed policies that are given to the proxy advisor and are used as a set of guidelines to the issues to be voted on (e.g. Algemene Pensioen Groep, 2009, 2015; Glass Lewis, 2014; ISS, 2014).

On the provided platform by the proxy advisor, institutional investors then are able to log on to oversee both the ballots to be voted on and the research made available by the proxy advisor. Based on this information the institutional investor can indicate how they have decided to vote, e.g. in favor of, or withhold from voting (where withhold will be counted as an against vote) (Broadridge, 2016b; Glass Lewis, 2016c; ISS, 2016e).

After this decision the proxy advisor takes this information to Broadridge. Broadridge consolidates all the voting information and then sends it to the sub custodians who then go and actually vote. Broadridge is a third-party processor of shareholder communications and proxy voting (Broadridge, 2016c), the market leader in the US of its part in the voting chain and holds a dominant position in Europe (AFM, 2014). This agent is used particularly to make sure there is secure communication mostly through SWIFT (Society for Worldwide Interbank Financial Telecommunications) (Broadridge, 2016d).

The sub custodians collect the votes through a system whereby the votes of multiple clients are placed into one account, sometimes referred to as an omnibus account (AFM, 2014; Broadridge, 2009).

The steps from link to link in the voting chain are almost entirely conducted electronically with the exception of the step between the sub custodian and the company who issued the ballots i.e. the company invested in, which in most cases takes place on paper (Broadridge, 2009).

2.2.1 Challenges in the voting chain

Since the voting chain functions as a contextual background for proxy advisors in this thesis, only a brief non-exhaustive overview of challenges existing in the voting chain are provided (a complete analysis of the voting chain is beyond the scope of this thesis, as it could serve as a thesis on its own).

There are many links in the voting chain and thereby multiple places where something can go wrong, which as a result can lead to a vote that might be rejected or might not get at a company's shareholder meeting at all. It has been indicated by Broadridge (2009) that approximately 5 percent of the votes are lost. Furthermore all these links make it hard if not impossible to hold one party accountable when something goes wrong.

The Dutch regulator AFM (2014) indicates that there is no good functioning audit trail, i.e. no good option for institutional investors to check if votes have been cast, and whether votes have been cast correctly. This is based on indicated issues such as the way custodians collect votes through the use of one account and protection of privacy through which it becomes hard or impossible to get to the needed information. Based on their analysis the AFM (2014) comes up with the following recommendation: introduce a level playing field, in the way the voting chain functions, at European, or more preferably global, level. Which according to the AFM (2014) could be achieved through the use of technology in the form of a global communication system.

2.3 Proxy voting process

The preparation for the voting recommendations start after the agenda of the general meeting of the clients' company of interest is published. At this point proxy advisors start collecting data for their recommendations. Besides information of the audited company on financial reports such as annual reports, other sources of data are used such as 'regulatory disclosures', 'newspapers' and other 'media', 'trading venues, data vendors and custodians' (ESMA, 2012).

Proxy advisors often use predefined measures, i.e. a basic framework in the form of a schedule, to get to their voting recommendations. The published agenda of the general meeting is dissected in comparable sections for the analysis and the gathered data is checked on correctness. Moreover different measures are used by proxy advisors to control for the integrity of their data such as the use of a second analyst. In the recommendation-forming analysis both directions given by clients together with other policies of those clients, as well as factual data and more subjective data, are taken into account by proxy advisors (ESMA, 2012).

Besides publicly available data proxy advisors sometimes use dialogues, often in the form of conference calls (Alexander et al. 2010), to get better insights and understanding of the assessed company and to take into account critiques given (ESMA, 2012). However some proxy advisors are said to refrain from dialogues since it might lead to possible inside information (ESMA, 2012). Furthermore it is stated that proxy advisors do not take into account the remarks given to them, even when mistakes made about factual assumptions were pointed out (Böckli et al., 2015), even though some proxy advisors state the sole reason for providing the final contents of recommendations before they release their recommendations to their clientele is in order to take into account initial feedback (ESMA, 2012).

The final voting recommendations are provided based on the deadline given by the client and are synchronized with the order of the general meeting (ESMA, 2012). Besides voting recommendations proxy advisors also provide an alternative in the form of descriptive reports that help investors with their analysis (ESMA, 2012).

Some proxy advisors go one step further and provide the service of actually voting and managing vote records and all other aspects in regard to balloting the vote of shareholders (ISS, 2016c). ISS for example provides these services through an online platform, ‘the ProxyExchange’ (ISS, 2016c). These services and how they are provided will be addressed in more detail on an individual basis in the industry participants section.

Note that matters discussed in general meetings are generally put on the agenda by the directors of the company if they call the meeting or by influential shareholders, where for influential shareholders holds, the bigger the interest held, the stronger its voice. This means that big institutional investors, like pension funds, could have an influence on these agenda points, especially when these institutional investors have shared interest and join forces.

2.4 Historical background and important regulations

The role of proxy advisors has evolved over the last three decades largely due to increases in market demand and regulatory changes. The first proxy advisors emerged midway in the 80's, with the founding of Proxy Monitor Inc in 1984 and ISS in 1985 in the United States and Pension and Investment Research Consultants (PIRC) in 1986 in the United Kingdom (Belinfanti, 2008; Choi et al., 2008; Hitz & Lehmann, 2015).

However a basis for the later demand for proxy advisors was made in 1974 when the U.S. Department of Labor obliged pension fund fiduciaries to act solely in the interest of the labor force that participated in these pension funds (Alexander et al., 2010). The second step taken by the U.S. Department of Labor that increased demand for proxy advisors was in 1988. It was then indicated that it is a fiduciary duty of the management of the pension fund to vote on stock owned by the pension fund plan (Belinfanti, 2008).

Another cause stated for the growth of the proxy advisory industry during the 1990's and early 2000's is the increased institutional ownership of publicly traded equity securities (Choi et al., 2008). The institutional ownership of these equity securities are said to have risen with 23 percent from 1992 to 2005 (Choi et al., 2008).

During the 1990's and early 2000's ISS developed to be the biggest and dominant agent in the proxy advisory market partly due to events such as the demise of Enron and WorldCom and the scandals surrounding it (Belinfanti, 2008). As a result institutional investors became more reliant on proxy advisors to get a better assessment of the companies they had invested in and thereby demand increased for proxy advisors.

ISS gained absolute dominance in the U.S. market for a brief moment in 2001 when it merged with its competitor Proxy Monitor thereby creating a monopoly (Choi et al. 2008). The U.S. based proxy advisory industry had been an oligopoly up to the merger. However during the following years in the 2000's new entrants entered the U.S. proxy advisory market (Hitz and Lehmann, 2015).

Within the academic literature there exist consensus about the decisive point for the development of proxy advisors.[1]The key point for the vast demand for proxy advisory

[1] According to Alexander et al. (2010), Belinfanti (2008), Choi et al. (2008,2010), Cotter et al. (2010), Diamond and Yevmenenko (2003), Iliev et al. (2015), Larcker, McCall and Ormazabal (2013; 2015) and Li (2013).

recommendations came with regulatory change enforced by the SEC in 2003. This regulatory change specified institutional investors, including mutual funds, to use written policies and procedures as well as required annual reports of their voting records (Alexander et al., 2010; Belinfanti, 2008; Choi et al. 2008). These regulations were conceived to make sure proxy voting was conducted in the best interest of the agents the proxy advisors represented and thereby taking further care that institutional investors fulfilled their fiduciary duties (Alexander et al. 2010; Choi et al., 2008). As discussed in the introduction, for a large fund to make well informed decisions on all the proxy votes would mean excessive extra costs. The demand caused by the SEC imposed regulations in 2003 lead to new entrants, such as U.S. based proxy advisor Glass Lewis which is currently the most important competitor of ISS (Choi et al. 2008, 2010).

The imposed regulations and other events has led to a dramatic increase in the demand for proxy advisors. In turn it would eventually give these agents such a special position in the market that in the early 2010's it caused both the SEC in the United States to reevaluate the position of proxy advisors, and the ESMA in Europe to investigate the questions whether and how to further regulate the proxy advisory industry (Hitz & Lehmann, 2015).

Compared to the U.S. the European proxy advisory market is still developing and 'virtually unregulated' (Hitz and Lehmann, 2015; ESMA, 2012). However as previously stated proxy advisors have gained the attention of authorities, along with scholars and media in continental Europe. Proxy advisors were investigated for the first time in Europe by the ESMA in 2012 by analyzing the role of the proxy advisory industry in the European market through raising 12 points for consultation (ESMA, 2013). The points for consultation concerned six subjects:

1. 'Correlation between proxy advice and investor voting behavior'; the explanation of, and meaning of influence of proxy advisors on voting outcomes.
2. 'Investor responsibilities'; whether proxy advisors cause risk for shifting investor responsibilities and weaken shareholder rights.
3. 'Conflicts of interest'; whether proxy advisors face, and if so, mitigate and are transparent about, possible conflicts of interest.
4. 'Voting policies and guidelines'; possible improvements to be made in this regard by including local market conditions and/ or by improving dialogue between proxy advisors and investors.

5. ‘Voting recommendations’; possible improvement to be made in this regard, in respect to, while further taking into account transparency, methodology used, dialogue and skillset and experience of proxy advisors.
6. ‘Policy options’; which policy option by ESMA should be implemented (ESMA, 2012).

These 12 points for consultation were used to consider which of the following four policy options was considered to be best: (1) ‘No EU-level action’, (2)’Encourage member states and/or industry to develop standards’, (3) ‘Quasi-binding EU-level regulatory instruments’, (4) ‘Binding EU-level legislative instruments’ (ESMA, 2012). Note that the ESMA stated in their 2012 report that they did not have the ‘competence’ to analyze competition nor entry barriers in the proxy advisory market and did not have this as their primary focus. Besides the ESMA (2012) gave three explanations that argued the correlations found between proxy advisors and investors voting behavior not to be particularly bad; (1) this could also be due to good functioning of the market, (2) big European advisors were said to use more than one proxy advisor, and (3) the outcome could also be the effect of a different reason. This is explained by the ESMA (2012) through the line of reasoning that there are only three ways to vote, either vote for, against or abstain from voting, whereas there are multiple reasons why an agent, the proxy advisor or the institutional investor decide on a certain vote and thereby are able to come to the same outcome based on different lines of reasoning (note that in the U.S. market there is often only the choice between for or withhold). Furthermore the ESMA report (2012) focused more on conflicts of interest through (1) proxy advisors providing services to both sides, (2) proxy advisors with interests in issuer, (3) proxy advisors being part of group from which other group members function in board of issuer (ESMA, 2012).

Based on responses of the six main proxy advisors in Europe, institutional investors, scholars and ESMA’s own investigation, this led the ESMA (2013) to conclude that no direct regulation was needed, since no clear market failure was recognized. However the ESMA (2013) noted potential questions in regard to conflicts of interest, low transparency about the process on how proxy advisors come to their recommendations and its limitations, and entry barriers for new and small proxy advisory firms. Therefore it is said to be important to come to a better understanding and assurance of what is to be expected of proxy advisors (ESMA, 2013). The ESMA therefore came up with recommendations to improve these points of integrity and

transparency, proxy advisors should develop a code of conduct, thereby choosing policy option (2) as stated in their 2012 report. Note that the ESMA thereby left competition related issues unchanged. The code of conduct was made by the six leading proxy advisors in Europe under the supervision of an independent chairman called the Best Practice Principles Group (Best Practice Principles Group [BPPG], 2014). These six leading proxy advisors were U.S. based ISS and Glass Lewis, German based IVOX, UK based Manifest and PIRC, and France based Proxinvest (Hitz & Lehmann, 2015). The code of conduct was released the following year, 2014, under the title 'Best Practice Principles for Shareholder Voting Research Providers' (BPPSVRP) (BPPG, 2014).

Since not all proxy advisors are said to work the same the principles are based on a 'comply-or-explain' framework, and as a result are not strict rules but are principle-based, consisting of three main principles (BPPG, 2014).

The first principle of the BPPG (2014) 'Service Quality' states: 'Signatories provide services that are delivered in accordance with agreed client specifications. Signatories should have and publicly disclose their research methodology and, if applicable, "house" voting policies'.

The second principle of the BPPG (2014) 'Conflicts-of-Interest Management' states: 'Signatories should have and publicly disclose a conflicts-of-interest policy that details their procedures for addressing potential or actual conflicts-of-interest that may arise in connection with the provision of services'.

The third principle of the BPPG (2104) 'Communications Policy' states: 'Signatories should have and publicly disclose their policy (or policies) for communication with issuers, shareholder proponents, other stakeholders, media and the public'.

The principles are provided with signatory statements of the five remaining proxy advisors (IVOX was acquired by Glass Lewis mid-2015) (PRNewswire, 2015) and founding members of BPPG and can be found on the independent functioning website of the BPPG (2015). From the signatory statements of the five remaining proxy advisors it follows that all five comply with the three principles of the BPPG[2].

Based on the signatory statements the goal set by the ESMA (2013) to gain more understanding and assurance for stakeholder with regard to proxy advisors through the use of the

[2] ISS (2014), Glass Lewis (2014), Manifest (2014), PIRC (2014), Proxinvest (2015).

BPPSVRP of the BPPG seems to be reached, as the signatory statements, according to the ESMA (2015) provide further insight in the functioning of the participating proxy advisors. However the extent of the actual effect of the actions instigated by the ESMA on the proxy advisory industry are uncertain. Furthermore note that the signatory statements could also be read like marketing brochures with, for example, Manifest (2014) using terms such as 'meets or exceeds'. Another example, ISS (2014) states that its subsidiary ISS Corporate Solutions in some cases gives advice to an issuer ISS gives voting recommendations about during the same period. ISS states that this potential conflict of interest is mitigated through the use of system they themselves developed and a law firm, they paid, assessed it to be reliable (ISS, 2014).

A follow up report in December of 2015 issued by the ESMA (2015) says that proxy advisors were taking steps towards increased transparency. The ESMA based this on the finalized BPPSVRP and the corresponding signatory statements made by the participating proxy advisors. Further note that based on the publications of ESMA in 2012, Hitz and Lehmann (2015) provided support for the influence of proxy advisors in Europe. They based their research on German data from 2010 with respect to 85 German firms involving 1664 voting items. Although smaller than the effect found in the U.S. a negative voting recommendations by ISS was found to be related to an 8.5 percent decrease in supportive shareholder votes (based on correlations). These findings were not present in 2013 when the ESMA presented its conclusions about proxy advisors in Europe. However these findings might give the ESMA incentive for regulation of proxy advisors in future times as the ESMA (2013) stated that it would not impose regulations in part because it did not have evidence of the influence of proxy advisors in Europe. This incentive might be even stronger for the ESMA when scholars start delivering more findings in support for influence of proxy advisors in the European market.

Around the time the BPPG in Europe released its principles and corresponding signatory statements, the SEC released a bulletin mid-2014 with guidance that focused on actions of not only proxy advisors but also on investors (SEC, 2014). In this bulletin, the Staff Legal Bulletin No. 20, further guidance for agents in the proxy advisory industry was provided. In this bulletin it was stated that investors should be more careful with their fiduciary duties by better monitoring their contracted proxy advisors. Furthermore proxy advisors, as stated by the ESMA in Europe, should disclose any potential conflicts of interest. It was further addressed in the bulletin that its release contained only guidance, no rule nor regulation, and no further measures nor actions nor

other incentives were given, in contrast to the BPPSVRP by The BPPG in Europe, to accommodate further or increased compliance by the agents of the proxy advisory industry. It is stated by Sorkin et al. (2015) that after reviewing the proxy advisory industry by the SEC for four years, there is changed very little: the obligations imposed are mostly imposed on the institutional investors, no fundamental changes are made that influence the power of proxy advisors, institutional investors are still allowed to completely rely on the recommendations of third parties. Further note that the biggest proxy advisors in both the U.S. and Europe are ISS and Glass Lewis.

2.5 Proxy advisory industry and its participants

Due to first mover advantage the proxy advisory industry now has a 'classic oligopoly structure' (Larcker et al., 2015). According to U.S. Government Accountability Office (as cited in Belinfanti, 2008) and the ESMA (2012) US market shares for proxy advisors are distributed as follows: ISS has a market share of 61 percent, Glass Lewis has a market share of 36 percent and the remaining proxy advisors together hold a market share of 3 percent.

The leading proxy advisors in Europe are U.S. based ISS and Glass Lewis, U.K. based Manifest and PIRC, and France based Proxinvest (Hitz & Lehmann, 2015). One other European based proxy advisor worth mentioning is Expert Corporate Governance Service (ECGS), a France based joint venture, including six European proxy advisors, together with a Canadian and Australian proxy advisor (Hitz & Lehmann, 2015). In the Netherlands ISS is hired 57 percent of the cases the services of a proxy advisor are employed, Glass Lewis 26 percent of the cases and for the remaining 17 percent alternative proxy advisor are used in order to obtain voting recommendations. Furthermore in 13 percent of the cases the services of a proxy advisor where used, a proxy voted for the institutional investor during the shareholder meeting (Monitoring Commissie Corporate Governance Code, 2010).

It is presented by Choi et al. (2008, on director elections) that four of the main proxy advisors based in the U.S are different in the way they used factors in the analyses conducted to formulate their recommendations. Namely ISS is found to be more focused on governance-related factors, whereas Glass Lewis is more focused on audit and or disclosure-related variables, Proxy Governance to be more focused on compensation-related factors and Egan-Jones, as small proxy advisor that will be addressed in the upcoming section, to employ an 'eclectic' mix of factors to attain their recommendations (Choi et al., 2008). However exact weights given to the

different factors, which consist of virtually all factors that are said by economist to be of influence, are not given.

In Table 1a. some demographics of individual participants in the proxy advisory industry are given. The two biggest proxy advisors, ISS and Glass Lewis, provide services both in the U.S. and Europe and are considered to be most influential worldwide. This duopoly, i.e. ISS and Glass Lewis, will be discussed in more detail in the following section. After the section on ISS and Glass Lewis table 1b. gives a further, non-exhaustive, overview of some of the participants in the proxy advisory industry. The fringe players described in table 1b. hold a combined market share of 3 percent and therefore only basic, limited, descriptions are given.

Table 1a. Demographics participants in the proxy advisory industry (non-exhaustive).

Proxy Advisor	Based	Headquarters	Established	Description
ISS	U.S.	Rockville	1985	*see text for extensive description*
Glass Lewis	U.S.	San Francisco	2003	*see text for extensive description*
Egan-Jones	U.S.	Haverford	2002	*see table 1b*
Proxy Governance	U.S.	Vienna	2005	*see table 1b*
Proxinvest	France	Paris	1995	*see table 1b*
PIRC	UK	London	1986	*see table 1b*
Manifest	UK	Essex	1995	*see table 1b*
IVOX	Germany	Karlsruhe	2006	*see table 1b*
ECGS	Worldwide	*See description*	2001	*see table 1b*

Source: *see footnote*[3].

2.5.1 Institutional Shareholder Services

ISS was founded in 1985 and is considered to be the leading proxy advisor in the world with roughly 1600 institutional clients. ISS (2016a; 2016b) has approximately 900 employees in 12 countries and gives recommendations about approximately 8.5 million votes covering over four trillion shares, for 38,000 companies across 115 countries every year. Since April 2014 ISS is part of Vestar Capital Partners, a private equity firm.

ISS is said to have over "1700 institutional clients managing $26 trillion in assets, including 24 of the top 25 mutual funds, 25 of 25 of the top asset managers and 17 of the top 25 public pension funds" (Daines et al., 2010). Taken together with the statements made by ISS (2016c) that they are growing, the numbers however indicate that over a five year period ISS has

[3] Based on Alexander et al. (2010); ECGS (2016); Egan-Jones Proxy Services (2016); Glass Lewis (2016a); Hitz and Lehmann (2015); ISS (2016a; 2016b); Manifest (2016); PIRC (2016); PRNewswire (2010, 2015); Proxinvest (2016).

lost approximately 100 institutional clients. Further "ISS is incorporated in Delaware and registered as an SEC regulated investment adviser" (Hitz & Lehmann, 2015).

ISS works according to the proxy voting structure presented in figure 1. After ISS has received the voting ballots of their clients together with their clients vote instructions, they will cover all other aspects involved with the voting (ISS, 2016c). ISS (2016c) 'receive(s) your proxy ballots, work(s) with your custodian banks, execute(s) votes on your behalf, maintain(s) vote records and provide(s) you with comprehensive report'. On the side of its clients holdings, the upper left parts of figure 1., ISS organizes the holdings and ballots of their clients from which ISS communicates with its clients' custodian banks whom safeguard the assets of its and ISS's clients. The other side of the process, the lower left part of figure 1. including 'Proxy Procurement & Agenda Coding', contains the actual formalizations of the voting recommendations, the process of obtaining all information needed, together with further preparations and the processing of data in regard to making recommendations. ISS provides its service for the actual voting and keeping track of the records through an online platform (ISS, 2016d). Its services are offered through the standard platform, ProxyExchange, and a more advanced subscriptions based version of the platform, ProxyExchange Premier (ISS, 2016e).

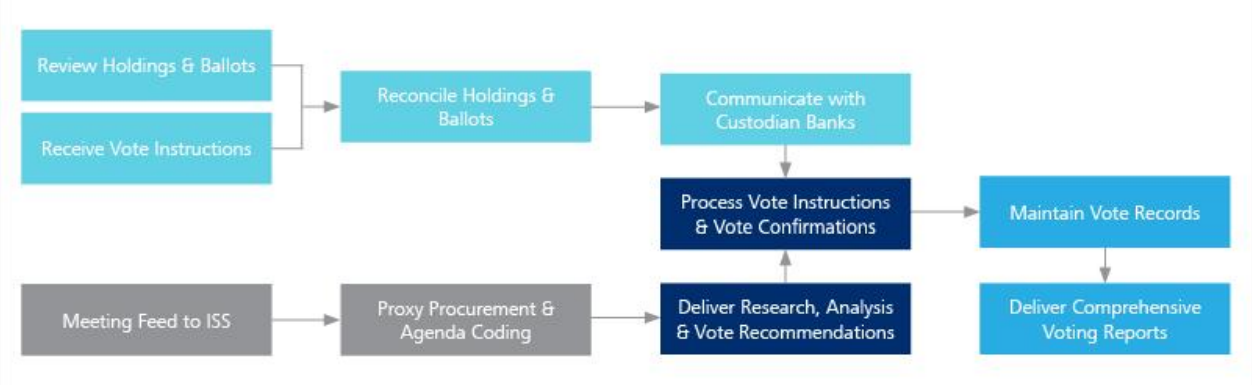

Figure 1. Proxy voting process Institutional Shareholder Services.
Source: ISS (2016c).

ISS (2014) states it uses three main voting policies: (1) Client custom policies (400 custom policies provided in 2013); based on the clients voting policy, (2) ISS specialty policies; based on 'sustainability' and 'socially-responsible investing' perspectives, and (3) ISS benchmark policies; which are according to the Generally Accepted Principles of Good Governance.

In one aspect ISS is different from other proxy advisors, namely that it also offers other consultancy services to improve governance practice (Alexander et al. 2010) as well as governance ratings (Hitz & Lehmann, 2015). This is the main reason it is often criticized for being unable to give independent advice, by providing these services a potentially conflict of interest arises (see explanation previous section) (Belinfanti, 2008). ISS is said to often use conference calls for contest votes at which opposing sides in a proxy contest can present and defend their arguments. However when it comes to non-contest votes ISS uses pre-specified protocols (Alexander et al., 2010). Furthermore ISS works on a subscription bases for which it gives its clients voting recommendations together with a detailed report that describes on what their recommendations are based (Choi et al., 2008). However based on research reports directly purchased from ISS it is found that the weights used for the relevant factors influencing the subjects on which recommendations were to be made and were to be voted on were not disclosed (Larcker et al., 2015). Though from the reports if followed that all possible factors that might influence the decisions on how to vote were included in the reports of ISS (Larcker et al. (2015). However without the disclosure of the weights given to these factors it in the first instance seems to confirm the critique of the lack of transparency as stated by economic authorities such (ESMA, 2013) and scholars (e.g. Belinfanti, 2008). Further not all factors were included when creating recommendations on say-on-pay by ISS. ISS is said to not take into account stock options nor restricted stock with time based vesting, two factors which are considered to be important elements of performance-based pay (Larcker et al., 2015).

2.5.2 Glass Lewis

Glass Lewis (2016a) was founded in 2003, has its headquarter in San Francisco and is considered to be the second largest proxy advisor in the world. With over 360 employees it operates in 100 countries with over 1200 clients including most of the world's largest pension funds and mutual funds as well as asset managers, covering with its recommendations over 17,250 companies (Glass Lewis, 2014). Glass Lewis manages over $25 trillion in assets and is a portfolio company of the Ontario Teachers' Pension Plan Board and Alberta Investment Management Corp. Glass Lewis is like its main competitor ISS incorporated in Delaware, in contrast to ISS it is however not registered as a SEC regulated investment advisor (Hitz & Lehmann, 2014).

Glass Lewis its research process follows the steps as shown in figure 2. It is said to collect data from 'stock exchanges, regulators, companies, custodians, transfer agents' for which the data

are all combined in Glass Lewis's database which is disclosed to its clients (Glass Lewis, 2014). Furthermore Glass Lewis (2016c) provides its services through the online platform Viewpoint where its clients are given the opportunity to 'filter' data to their liking, i.e. either include or exclude certain 'data points' in Glass Lewis's database. The services provided, like its main competitor ISS, include the handling of the ballots, the actual voting and maintaining and organizing voting data for the annual meetings.

Glass Lewis (2014) states it uses two main policies: (1) shareholder policies, based on custom polices of clients, and (2) Glass Lewis's 'house' policies, which are according to the Generally Accepted Principles of Good Governance. However note that Glass Lewis (2014) states that all their clients receive the same reports with same recommendations and that these reports are not 'customized to any client or client investment strategy'.

Figure 2. Glass Lewis Research Process.
Source: Glass Lewis (2014).

Glass Lewis, like its main competitor, holds conference calls where different parties can voice their arguments in a proxy contest and then defend their side of the argument. Another aspect Glass Lewis has in common with ISS is that it does not evaluate non-contested votes on a case-by-case basis (Alexander et al., 2010). However in contrast Glass Lewis does not provide other services like ISS does that might lead to potential conflicts of interest.

Like ISS Glass Lewis does not take into account stock options nor restricted stock with time based vesting in regard to forming voting recommendations on say-on-pay votes (Larcker et al., 2015). Furthermore it is said that Glass Lewis, compared to ISS, is significantly less open with its policies. This conclusion was however partially based on the fact that Glass Lewis refused to sell their reports to the authors making these claims (Larcker et al., 2015). However when looked at the signatory statements made with regard to the BPPSVRP and other information made available regarding their practices Glass Lewis (2014) seems less transparent

in its practices as compared to ISS (2014). To date Glass Lewis (2016b) however does provide sample proxy reports downloadable from their website.

Glass Lewis seems to be increasing both its U.S. market share with the takeover of Proxy Governance's client base (PRNewswire, 2010) and its European market share with its recent acquisition of German based IVOX (PRNewswire, 2015).

Table 1b. Further description participants in the proxy advisory industry (non-exhaustive).

Proxy Advisor	Description
Egan-Jones	Egan-Jones Proxy Services started offering proxy advice commercially in 2003 both domestically in the U.S. and outside their domicile. It is part of Egan-Jones rating co., a credit rating agency, and provides its services on an annual subscription basis according to the number of companies covered for a flat fee of $12.50 per company.
Proxy Governance	Proxy Governance used to be the fourth prominent U.S. based proxy advisor which did evaluate non-contest items on a case-by-case basis. However in early 2011 they transferred their client base to Glass Lewis and ceased to exist.
Proxinvest	Proxinvest is an independently-owned company that provides its services only to investors. It offers its recommendations through its site, mostly based on European based companies at prices varying between 500 and 1000 euro per report, if purchased individually. Further Proxinvest is a founding member and shareholder in the joint venture ECGS and is partially owned (20%) by the Swiss pension fund foundation Ethos.
PIRC	PIRC is the largest and oldest European proxy advisor. PIRC is privately-owned and is regulated by the Financial Conduct Authority. It is stated to manage over 1.5 trillion pounds in assets.
Manifest	Manifest operates in more than 80 markets covering more than 7,600 companies with its recommendations, has two offices with approximately 40 employees in total, the first in Essex, the second located in Australia. Besides proxy recommendations it also provide other governance related services.
IVOX	IVOX used to be Germany's leading proxy advisor however in mid-2015 IVOX was acquired by Glass Lewis.
ECGS	ECGS is a joint venture consisting of eight entities from which six are European based: German based DSW, Swish based Ethos, Dutch based Shareholder Service, Italy based Frontis Governance, UK based Manifest and France based Proxinvest, and two non-European based proxy advisors: Canadian based Investissement Responsable and Australian based SIRIS. This joint venture tries to present its services conform to the different regulations, laws and cultures between nations.

Source: *See footnote*[4].

[4] Based on Alexander et al. (2010); ECGS (2016); Egan-Jones Proxy Services (2016); Glass Lewis (2016a); Hitz and Lehmann (2015); ISS (2016a; 2016b); Manifest (2014, 2016); PIRC (2016); PRNewswire (2010, 2015); Proxinvest (2016).

3 Overview of literature on the proxy advisory industry

The proxy advisory industry has been of particular interest in both the fields of economics and law. In law related journals the body of literature reports the extent to which advice given by proxy agencies is followed (Cotter, Palmiter & Thomas, 2009; Schouten, 2012), how recommendation are made and its significance (Choi et al. 2008, 2010) and its factual and theoretical implications (Belinfanti, 2008). Within the economics literature most of the attention has been on studying the quality of governance advice and influence on shareholder voting of proxy advisors[5].

Furthermore approximately half of the existing body of literature on proxy advisors talks about the 'effect' or 'influence' of proxy recommendations on shareholder voting outcome based on correlational findings (see table 2). Some authors explicitly state that the correlations found are no causal explanations whereas other authors write about how the recommendations of proxy advisors 'lead' to certain voting behavior by shareholders. More precisely the existing literature has examined the extent to which the recommendations made by proxy advisors are correlated with actual voting outcomes in retrospect. Depending on the subject of voting ISS recommendations are found to correlate with shareholder votes cast in the range of 6 and 27.1 percent. For Glass Lewis these correlations are found to be either 3.6 or 12.9 percent depending on proposal type. An overview of the correlations found in the existing empirical studies is presented in table 2 and will be further discussed in the following section. The 'second half' of the existing body of literature on the proxy advisory industry will also be discussed in more detail in the subsequent section. Note that in order to avoid unnecessary repetition earlier stated literature on the proxy advisory market will not always be repeated (see appendix 1 for the

[5] See Alexander, Chen, Seppi and Spatt (2010); Bethel and Gillan (2002); Cai, Garner and Walkling (2009); Daines, Gow and Larcker (2010); Ertimur, Ferri and Oesch (2013); Iliev et al. (2015); Li (2013); Morgan, Poulsen and Wolf (2006); Volonté and Zaby (2013).

organization of the following section).

Table 2. Correlations found between voting recommendations and actual votes cast.

Author	Published	Voting subject	Negative/ Positive Recommendation*	Correlation with voting outcome
Bethel & Gillan	2002	Management proposals	?	13.6% - 20.6%
Morgan et al.	2006	Stock-based compensation plans	-	x: –19.8%
Cai et al.	2009	Uncontested director elections	-	-19%
Ertimur, Ferri & Muslu	2009	Shareholder proposals	+	+25%
Choi et al.	2010	Uncontested director elections	-	ISS: between -6% & -13.1%, Glass Lewis: 3.6%
Daines et al.	2010	Director elections	+	+16.4%
Ertimur, Ferri & Maber	2012	Option backdating	-	-27.1%
Ertimur et al.	2013	Say-on-pay	-	ISS: -24.7%, Glass Lewis -12.9%
Hitz & Lehmann**	2015	Management proposals	-	-8.5%
Malenko & Shen	2015	Say-on-pay	-	-25%

*Based on ISS recommendation unless stated otherwise, x=unknown, **Based on European data.

3.2 Proxy advice and actual voting outcome

3.2.1 Management proposals

The first study (to the best of my knowledge) to present a relation between proxy advisory recommendations and shareholder voting is conducted by Bethel and Gillan (2002). Bethel and Gillan (2002) examined the relation between shareholders, managers and proxy advisory recommendations in regard to shareholder voting and proposal passage. With the use of data on the 1998 proxy season from companies in the S&P Super-Composite 1,500, routine and non-routine management proposals were analyzed. By using a univariate comparison they find that voting recommendations made against management by ISS, depending on the type of proposal, lead to an increase of between 13.6 and 20.6 percent votes cast against management. Based on these findings it is concluded by the authors that ISS can ‘substantially affect voting results’.

Hitz and Lehmann (2015) examined the influence of proxy advisors in Europe. They used data regarding 185 German firms on 1664 general meeting voting items during 2010. Their results suggest that ISS has an influential role in Germany, although the effect found is smaller than the effect found in the U.S.. It is stated that a negative vote recommendation by ISS causes supportive shareholder votes to decrease with 8.5 percent. Furthermore Hitz and Lehmann (2015) found this effect to be the strongest for firms with high free float, i.e. the number of shares outstanding minus restricted shares, low voting turnout and firms owned by shareholders with relatively high ISS clientele.

3.2.2 Director elections

Cai et al. (2009) examined the relation between uncontested director elections and shareholder votes. Data from the ISS's Voting Analytics database consisting most of the companies of the Russell 1000 and 2000 from 2003-2005 were used for the analysis. By conducting a multivariate regression analysis they find that a negative voting recommendation from ISS for an uncontested director election leads to 19 percent fewer votes cast in favor of the proposal. Cai et al. (2009) conclude ISS voting recommendations to have a significant economic impact.

Choi et al. (2010) examine the power of the recommendations given by proxy advisors in uncontested director elections using data from S&P 1500 listed companies during 2005-2006. In their study they try to distinguish between causation and correlation by examining not only the recommendations given by proxy advisors but also other underlying factors that might influence shareholder votes. Based on their multivariate regression analysis ISS is found to be the most powerful proxy advisor and Glass Lewis to be the only other proxy advisors to be of influence on voting. The other two examined proxy advisors Egan-Jones and ProxyGovernance are not found to have an influence. Further the impact of proxy recommendations is said to be highly reduced when firm-specific factors are taken into account. In conclusion Choi et al. (2010) find the effect of proxy recommendations for ISS to be between 6 and 13.1 percent, and for Glass Lewis to be 3.6 percent.

Daines et al. (2010) in their paper on governance ratings dedicated a section on whether voting advice of proxy advisors is influential. Data of a U.S. sample on positive ISS recommendations mostly on director elections and to a smaller extent on compensation plans and auditor ratifications during the period 2005-2007 were used for the analysis. Based on their

analysis it is found that a positive recommendation from ISS lead to a 16.4 percent increase in votes cast in favor of the proposal.

3.2.3 Say-on-pay

Morgan et al. (2006) investigated trends in management-sponsored shareholder voting with the use of data of S&P 500 companies on stock-based compensation proposals over the period 1992-2003. In one of their multivariate regression analyses a correlation is presented between negative voting recommendations and negative votes cast of 19.8 percent. Based on their analysis Morgan et al. (2006) state that negative voting recommendations of proxy advisors lead to less votes in favor of a proposal.

Ertimur, Ferri and Muslu (2009) examine the effect of shareholder activism on CEO pay analyzing data from shareholder activism events of companies in the S&P's 1,500 index between 1997 and 2007. They find that positive voting recommendations made by ISS are associated with an increase of 25 percent of positive votes cast and conclude that therefore ISS has a 'significant incremental impact'.

Ertimur et al. (2013) examine the role of proxy advisors with mandatory say-on-pay votes as focal point. Data on annual meetings of S&P 1500 firms during the year 2011 is used. The results of one of their regressions suggest that no 'one-size-fits-all' approach is used by proxy advisors in making their recommendations. The author however note that this does not mean proxy advisors are 'correct'. Furthermore proxy advisors are more likely to advice 'against' recommendations when there is poor firm performance and high levels of CEO pay.
According to Ertimur et al. (2013) proxy advisors do what they are intended to do, process substantial amounts of information for institutional investors and thereby reducing the costs for institutional investors to make well-informed decisions. Finally it is stated that the effect of a negative recommendation on a say-on-pay proposal by ISS leads to a lower positive voting outcome of 24.7 percent, whereas a negative recommendation on say-on-pay proposal by Glass Lewis leads to a 12.9 percent decrease in positive votes cast (Ertimur et al., 2013).

Malenko and Shen (2015) examine the role of the proxy advisory industry through the use of a rather new statistical approach in economics, the regression discontinuity model. Since the start of the millennium this approach has slowly become more common as an empirical tool in economics (Porter, 2003). For this approach they use data of the ISS Voting Analytics data-base covering companies listed in the Russell 3000 index during the period 2010-2011. In a regression

discontinuity model a fixed cutoff is used in order for the researcher to artificially create or mimic a pre- and post-treatment effect near this threshold, thereby trying to imply a causal relation through a quasi-experiment. Based on such an analysis it is said that negative voting recommendations made by ISS on say-on-pay proposals lead to a 25 percent decline in supportive votes cost regarding the proposal.

The strongest correlation in the literature is found by Ertimur, Ferri and Maber (2012). They examined the option-backdating scandal of 2006-2007 and its effect on executives. The Glass, Lewis & Co. Yellow Card Trend Alert Report 2007 is used to select firms involved in the backdating scandal. Based on their analysis they find that negative recommendations given by ISS with regard to the option-backdating to firms lead to 27.1 percent decline in supportive shareholder votes.

3.2.4 Shareholder compliance with voting recommendations

In a study on the extent to which recommendations provided by ISS are followed by mutual funds Cotter et al. (2009) state that voting patterns of mutual funds are found to be more consistent with ISS recommendations than with the voting patterns of overall shareholders. Based on mutual fund voting data from 2003-2008 it is said that voting of mutual funds is more often in line with ISS recommendations than with manager recommendations in regard to non-routine management proposals, shareholder proposals, anti-takeover proposals and corporate governance proposals (Cotter et al., 2009).

Schouten (2012) examined whether institutional investors follow proxy advisors blindly based on data from three Dutch pension funds and one UK asset fund by measuring deviations from voting recommendations. He hypothesized that due to the allocation of resources, decisions which influence performance the strongest would have more resources allocated to them. His findings are in line with his hypothesis that the three Dutch pension funds as well as the UK asset fund tend to deviate relatively more often from voting recommendations on three points: when these funds have a large stake in the firm, when a firm performs relatively poorly, or when the proposal has potentially important value implications.

Iliev et al. (2015) attempt to systematically analyze shareholder voting across countries focusing on non-contested elections. They mainly use the ISS Voting Analytics database containing 2.3 million proxy votes cast by U.S. based institutional investors to non-U.S. based firms across 46 countries between 2003 and 2009. The findings of Iliev et al. (2015) suggest that

in 90 percent of the cases the institutional investor rejects management recommendations, it is because these institutional investors follow ISS.

3.2.5 Proxy advisors as a source of new information

Alexander et al. (2010) used contested director elections in the U.S. and recommendations made by ISS regarding these elections in order to examine the information content provided by proxy advisor. Based on their analyses they find that proxy recommendations are a new source of information and a good predictor for the outcome of the vote. Furthermore they state these recommendations play a 'certification role' in that investors change their evaluation in regard to dissidents if ISS offers advice in favor of these dissidents.

With respect to director elections during the annual general meeting is should be noted that the majority of these elections are uncontested (Cai et al., 2009). Technically this would mean receiving a single vote would be enough to win the election (based on plurality voting). This has however been mitigated through a shift to majority voting catalyzed by increased shareholder activism (Choi et al, 2010). Thus in the vast minority of elections to choose members of the board of directors there are contested elections, i.e. the incumbent director faces a rival, the dissident. This makes the vote more meaningful as it provides the shareholder with an actual choice, between the incumbent and the dissident and thereby a proxy advisors' recommendation becomes more meaningful (Alexander et al. 2010).

3.3 Notes in regard to previously presented literature

Overall note that the analysis conducted in the literature presents correlational findings, no irrefutable causal relations are provided. Furthermore to more precisely examine the influence of proxy advisors only votes of clients, i.e. institutional investors, that use those proxy advisory recommendations should be used to compare voting outcome with proxy advisory recommendations instead of the overall voting outcome. Otherwise the outcome would lack validity, the variable of interest is not measured in isolation, instead other factors are taken into consideration that should not be taken into consideration. This notion will be further addressed later in the upcoming section.

On individual basis note that correlations presented by Bethel and Gillan (2002) are 'not tabled', i.e. no formal presentation of these findings were given, both percentages were stated in a sentence, (Bethel & Gillan, 2002, p.25) nor was a significance level presented regarding these correlations in the results section of the article. Furthermore the use of an 'univariate

comparison', i.e. based on their description, a one-on-one comparison of variables, is highly susceptible to omitted-variable bias. Another important point of caution is that the data used stems from before 2003, the decisive point in the proxy advisory industry when the SEC imposed its new regulations. Therefore the presented findings should not be used to answer questions in regard to the current state of the proxy advisory industry.

The notion on questions in regard to the current state of the proxy advisory industry also holds for the study conducted by Morgan et al. (2006). The data used in their analysis is from before 2003, the point the SEC imposed its key regulations.

To the knowledge of the author there is only one European based study (Hitz & Lehmann, 2015) that presents a relation between proxy recommendations and actual voting. The data used is based on Europe's biggest economy, Germany. Furthermore note that the European market is not uniform and therefore one should be cautious to generalize these findings to the European market in general.

The treatment effect used in order to present as a strong effect of recommendations on actual voting outcome (25 percent change in vote) by Malenko and Shen (2015) is based on an artificial cut-off point, i.e. a statistical tool. Statistics however do not make causal effects.

The strongest relation between proxy voting and actual voting outcome in the literature is presented by Ertimur et al. (2010). This study however is based on the evaluation of companies whose executives had indulged in fraudulent practices in regard to option-backdating. It follows that there already existed a strong incentive to be more critical and give a higher priority to these issues to ballot their votes on for shareholders (notion of ESMA on prioritizing, 2012), thereby making it already more likely to vote against remuneration proposals by management regardless of the voting recommendations given by proxy advisors.

Based on the findings presented by Schouten (2012) the question arises whether these findings indicates that proxy advisors give bad, or at least not case specific, advice, since when it becomes important, i.e. the stakes are higher, firms tend to deviate more often form the advice given. Even though proxy advisors state to give custom advice. The moment this case specific advice is most important, it does not seem to be of value, i.e. firms deviate from the advice given to them by their proxy advisor(s). However note that big institutional investors in Europe are said to use more than one proxy advisor (ESMA). Thus do firms really deviate or mix advice of different proxy advisors and add own analyses?

In line with this question these deviations in regard to pension funds could also be a result of the fact that pension funds more often than other investors consider social-welfare factors, i.e. display higher levels of shareholder activism, besides corporate governance related factors. Although proxy advisors state (see earlier section) that they use different forms of policies depending on the client they provide services to, this does not mean these factors are weighted equally by client and proxy advisor.

Furthermore it could be argued that proxy advisors therefore might also give advice that would not be optimal for these funds in regard to low profile decision for which less resources are allocated. If provided with enough resources, these low profile decisions would also be examined more carefully by institutional investors, which again might lead to more deviations from the recommendations given by proxy advisors. Although as a singular performance measure, a certain decision might have less of an impact and therefore the recommendations of a proxy advisor could be, and are likely, to be more easily followed by the institutional investor. This could however change the economic consequences dramatically when hundreds of these lower weighted decisions are added up. Then the value of institutional investors investments might be affected significantly. This would mean, only if all previous stated assumptions are proven to be right, that the fiduciary duty of institutional investors is not fulfilled as should be, indicating a market failure through the use of services provided by the proxy advisory industry.

3.4 Theoretical perspective on empirical examination of proxy advisors

From the overview of literature it follows that the influence, sometimes referred to as power, of proxy advisors on voting outcome during general annual meetings has been covered extensively by scholars. However to understand these publications it is useful to think about what influence of proxy advisors exactly means and how this could be examined and measured. There are multiple ways proxy advisors could potentially influence voting of institutional investors and thus the voting outcome. There are multiple questions that could be asked in order to examine influence, such as: Do voting recommendations influence the actual voting outcome? Do these recommendations have an effect on whether or not an investor cast its vote? Do voting recommendations change the opinions of institutional investors? From an alternative perspective, relying more on economic theory, it could be examined through the notion: If there is no influence then there should not be a future relation possible, no party would be willing to pay the proxy advisor for its services. From this alternative perspective it can be easily suggested that

proxy advisors have an influence since these agents are still present in the market and has been for quite some time. What is prominent in the literature is the comparison between a recommendation, either positive or negative, made by the proxy advisor and the voting outcome. Beside discussing the ideal situation to test influence of proxy advisors it is also relevant to give further explanation to the question what the reported correlations in the literature actually mean in the context of voting. A shareholder most of the time has to decide between either the option to vote for, or withhold (vote against) from voting, with respect to a proposal.

3.4.1 Indications for an ideal situation

In an ideal situation one would like to compare how a company votes on an agenda topic of the annual general meeting without voting recommendations and with voting recommendations. Since the company can decide how to vote on a topic only once this is not possible. To overcome this problem there should be multiple randomly assigned groups. One of the groups, the 'control group', does not receive voting recommendations from a proxy advisors whereas the other group, the 'experimental group', receives voting recommendations. Researchers should then be able to measure how these groups have voted in order to compare the differences in voting outcome to see how the advice of proxy advisors influences the vote.

Furthermore it should be measured whether an investor cast its vote and whether this is influenced by the institutional investor receiving voting advice, in order to answer the second question on whether voting recommendations have an influence on an investors' decision to vote. Here arises a strong selection effect, only the investor that is inclined to cast it vote will demand the services provided by the proxy advisory industry. Solely when an institutional investor deems this more efficient then doing the research internally. It follows, investors who have no inclination to vote will never ask for voting recommendations. This question proves to be problematic since there seems to be a causal relation present, the demand for voting recommendations is only present when the investor has the intention to vote otherwise these services would not be demanded. However proxy advisors might facilitate voting in such a way that it otherwise would be impossible for the investor to cast its vote.

In order to answer the question on whether voting recommendations change opinions of institutional the conditions need to be stricter, i.e. further specified. The researcher should be able to measure the initial stance of the institutional investor. Then after the investor is provided with voting recommendations the researcher should be able to measure the actual vote cast. Deviations

from the initial stance might indicate a change of opinion. However note that the use of proxy advisors is often elicited in order for the institutional investor to gain an opinion, the research needed in order to have a 'well-informed' opinion is outsourced to the proxy advisor. Thus in order to answer this question, the initial opinion of institutional investors should actually exist on all the issues to be voted on during the annual general meeting before the proxy advisor provides its recommendations.

Even if such an initial opinion would exist and it would be able to measure it, another question is needed to be answered, do proxy advice provides the investor with new valuable information? If based on this question it is suggested this not to be the case, one could argue that the institutional investor is blindly following the proxy advisor. Thereby leaving the answer on the former question, whether the institutional investor actual has changed its opinion (or even had an opinion on the issue in the first case) to be ambiguous.

Furthermore proxy advisors beside giving voting recommendations also play an important role as proxies in the voting chain. These two 'main' services might have an interaction effect, which depending on the specific question asked, need to be distinguished.

3.4.2 Reality

Due to the structure of the voting chain it seems impossible to distinguish between the votes of institutional investors who have used the services of proxy advisors and the investors who did not use these services.

Another issue that occurs when one tries to examine the causal effect of voting recommendations on voting outcome is that proxy advisor are said, and have stated, to at least in some occasions, use the guidelines as provided by institutional investors. This makes it a very peculiar ordeal to examine the direction of a possible causality.

3.4.3 Correlations

When correlations are mentioned in this thesis, these are technically the interpretations of regression coefficients that come out of the regression analysis of the research conducted and presented in the related literature. The presented correlations in the literature range from 3,6 percent up to 27,1 percent. For binary or ternary voting possibilities this might seem a little low. A possible explanation for these outcomes might be the failure to be able to distinguish between institutional investors who have solicited the services of proxy advisors and the institutional investor who did not.

3.4.4 Concluding remarks

Under these non-ideal circumstance it is hard to guarantee the internal validity of the researched variables of interest and thus the reliability of the correlations found. In extension it makes efforts by academics to present findings that suggest causal relations based on these correlations, together with their further reasoning why there might exist a probable causal relation, a precarious ordeal. It follows that supportive evidence based on such practices should be viewed with caution. Due to the structure of the proxy advisory market and the voting chain in which proxy advisors operate, implying causation might come off to be a too bold of a statement.

3.5 Recapitulation

From the literature surveyed above it follows that most correlations found between voting advice by proxy advisors and actual voting outcome are in regard to say-on-pay proposals. Furthermore these relations are also said to be strongest in regard to say-on-pay proposals. When examining the overall relations presented in the literature there is quite some variation found in the size or scope of the relations, depending on the data used. Furthermore support is presented in favor of the notion that the relation between voting recommendations and actual voting outcome is different depending on which proxy advisor made the recommendations. These findings seem to be according to the market share of these proxy advisors. Based on the first European analysis an initial indication for a relation between voting recommendations given by proxy advisors and actual voting outcome is found, although it is said to be smaller.

3.6 Indications for potential market failures in the proxy advisory industry

The following section of the literature indicates potential inefficiencies in the proxy advisory market. In order to look at potential inefficiencies in the proxy advisory market the following definition of a market failure as coined by Bator (1958) is used as a benchmark: ‘the failure of a more or less idealized system of price-market institutions to sustain “desirable” activities or to stop “undesirable” activities’. An extensive and defined theoretical overview in regard to the proxy advisory industry, the type and characteristics of the goods provided by proxy advisors, market failures and organisation failures will be given after the first sub question has been answered. The main purpose of the following section is to continue to give an overview of the existing literature.

3.6.1 Economic consequences

Larcker, McCall and Ormazabal (2013) provide results that suggest that recommendations made by proxy advisors do not add value for shareholders with regard to stock option repricing. Using a sample of 264 stock option repricing's between 2004 and 2009 they examine the extent to which the board of directors conform to the advice of ISS and Glass Lewis. The results of the analysis show that firms who follow the recommendations of proxy advisors have a significantly lower market reaction, lower operating performance and higher executive turnover.

Larcker et al. (2015) use say-on-pay vote data from the Russell 3000 index to examine the economic consequences of the use of proxy advisors by institutional investors. In line with previous literature on say-on-pay voting recommendations proxy advisors are said to have an 'impact' on the outcome of this voting process. They further find that compensation plans are changed beforehand by firms in order to align them with the likings of proxy advisors. This is said to be done in order to obtain a positive voting recommendation (Larcker et al., 2015). However the changes made to the compensation plan by firms prior to the formal shareholder vote are found to have a significantly negative effect on the firms stock.

3.6.2 Conflicts of interest

Li (2013) examines empirically whether and when conflicts of interest can arise within the proxy advisory industry. Over the period 2004-2011 the ISS's Voting Analytics database and Glass Lewis's Proxy Paper database are used to examine these questions. It is stated by the author that there exists a real threat of conflict of interest for ISS and it is further argued that this could be countered with increased competition (Li, 2013). Which, according to Li (2013) is further suggested through further analysis for which he includes, the later entrant to the proxy advisory market Glass Lewis, in his analysis.

3.7 Qualitative oriented publications

In a short overview of literature, Larcker, McCall and Tayan (2013) indicate a lack of transparency in regard to proxy advisors on how these agents develop their recommendations. It is stated that although their analyses limit itself to ISS, both ISS and Glass Lewis should demonstrate their policies used and recommendations given more clearly. Four issues are stated regarding ISS that influence the accuracy of the policies used by ISS (Larcker, McCall & Tayan, 2013). The first issue stated, in regard to the data collection process is that it relies on a small group of participants. A policy survey sent out by ISS obtained responses from 97 institutional

investors which is equal to a 69 percent decrease in responses compared to four years earlier (2008-2012). The authors argue that this occurrence is particularly troublesome because stronger opinionated investors are said to be more likely to participate and thereby over-weighting some viewpoints and under-weighting other viewpoints. There is however no explanation given for this decline in response. The second issue stated by the authors is that no real disclosure is given by ISS on the composition of the respondents (Larcker, McCall & Tayan, 2013). Thereby it might be the case that recommendations by ISS might be partly biased because of possible selection bias. The third issue noted is in regard to the design errors. The authors give examples such as wrongfully framing questions and the limited options in the response choices given. The way to interpret these responses are further blurred through the use of vague qualifications instead of preset thresholds or other benchmark conditions to hold their survey results against, thereby making it hard to access how ISS comes to its recommendations. The fourth issue is in regard to the way ISS deals with feedback, which, if at all, according is noted to look arbitrarily (Larcker, McCall and Tayan, 2013).

Belinfanti (2008) examined the factual and theoretical implications of the use of proxy advisors on governance policy by mainly focusing on mutual funds and the proxy advisor ISS. She addresses multiple negative implications of ISS, namely, the significant agency cost generated which she describes as ‘problems that may arise when a party outsources certain decisions and actions to a third party’. Further the lack of, or absence of, traditional monitoring and control devices of market constraints e.g. competitors, as well as transparency and fiduciary duties are said to be problematic by Belinfanti (2008). Furthermore ISS also issues advice to companies how to optimize their governance structure and thereby providing services to both sides in turn creating a conflict of interest. She further concludes that there are currently no effective procedures to control ISS agency costs.

Volonté and Zaby (2013) analyze in an overview of literature proxy advisors from an European perspective. They state multiple concerns such as the methodology used by proxy advisors, conflicts of interest that might arise, and lack of both competition and transparency. According to Volonté and Zaby (2013) the two biggest, U.S. based proxy advisors, ISS and Glass Lewis, do not take into account specific features of national corporate governance that differ from governance in the U.S. Volonté and Zaby (2013) find it unlikely that these proxy advisors are

able to accurately deal with the different culture and political landscape nor make dependable recommendations for pension funds in Switzerland, Austria, Germany, France and Italy.

3.8 Notes in regard to previously presented literature

The following points should be taken into account with respect to transparency. As encouraged by the ESMA (2013) in regard to the disclosure of potential conflicts of interest and policies used, transparency seems essential for a good functioning proxy advisory market. Notwithstanding in regard to the weights given by proxy advisory to their analysis it does make sense for these agents to not disclose these weights, it is part of their revenue generating practice. Disclosing this private information would make it hard for these agents to stay competitive.

In regard to the article of Volonté and Zaby (2015), the authors state multiple concerns or rather questions since they do not provide significant support for their rather strong statements. Further research is advised to provide further support for their claims.

3.9 Recapitulation

Based on the review literature it follows that he use proxy advisors might not always function efficiently as information intermediary, it is stated that the presence and use of proxy advisors can be value deteriorating for the firms proxy advisors make their recommendations on for the institutional investors. However based on the presented findings this could also be due to bad governance of the issuing firms. Instead of critically appraising the given recommendations these recommendations could be too easily followed. Furthermore the fact that firms change their compensation plans is their own responsibility. When as a result of these actions the firm value decreases this could be explained as bad governance. Nevertheless the notion of firms changing their compensations plans in order to receive positive voting advice raises the questions whether proxy advisors are too powerful.

Besides theoretical support, empirical support is presented for the notion that there exist a threat of conflicts of interest for proxy advisor ISS.

Theoretical perspective Most of the questions and concerns raised can be traced back to competition and transparency, better transparency could answer the questions and concerns in regard to conflicts of interest, methodology and policies used. In line with regulators scholars state a lack of transparency in the proxy advisory industry, i.e. an indication of undesirable activity in the proxy advisory market is presented, thereby indicating a possible market failure.

However note that with the publishing of the signatory statements a step towards better transparency has been made.

3.10 Answer sub question

What is the role of proxy advisors in the decision-making process and actual voting by institutional investors?

Proxy advisors work as information intermediaries in order to provide assistance mainly to institutional investors in order for these investors to vote in time and well-informed. Besides their role as information intermediaries proxy advisors help institutional investors with processing their votes through the voting chain, i.e. help the institutional investor cast their vote which includes all ancillary conditions such as the administrative and communicative tasks involved with casting ones vote. Recapitalized the role of proxy advisors in the decision-making process and actual voting by institutional investors is to aggregate all resources needed to cast a well-informed vote by the institutional investor and to provide a platform from which a institutional investor can make a well-informed decision. After their role as information intermediary and aggregation platform, the proxy advisory industry also fulfills a ‘broker-like’ function of taking care of all other ancillary conditions needed to get the institutional investors votes through the voting chain.

4 Theoretical framework

4.1 Voting recommendations as information goods and market implications

Before starting with the discussion of the proxy advisory industry it is essential to first provide a clear theoretical framework in order to be able to make a critical evaluation in this thesis. Typically economic goods are categorized using the criteria of rivalry and excludability. A good is rival when the consumption of a good by one consumer decreases the amount of the good available for other consumers. A good is excludable when it is possible to exclude another consumer from consuming the good (Rosen and Gayer, 2010; Varian, 1999). When a good is both rival and excludable it is a private good. However when a good is nonrival and nonexcludable it is a pure public good. If there is a combination of the these two forms it is called an impure public good, i.e. 'a good that is rival and/ or excludable to some extent' (Rosen & Gayer, 2010, p.55). It follows that the voting recommendations provided by proxy advisors are an impure public good since they are excludable, through the protection of intellectual property rights (Schmidt, 2006) but however nonrival since the reports can be used infinitely without having to use additional resources, i.e. the reports can be excessed by institutional investors on the (existing) platforms provided by the proxy advisors.

Another characteristic of voting recommendations is that it is an experience good. In order to evaluate the value of the good you have to experience it (Varian, 1999). The institutional investor will only know whether the standard of the report provided by its proxy advisor is up to par after it has reviewed the report. However in order to view the report the investor first has to purchase the report. Varian (1998) provides different ways the described situation can be overcome in the market, some of which are exhibited in the proxy advisory industry: 'previewing and browsing' and 'reputations'. Previewing and browsing can be seen in practice in the form of sample reports provided on the websites of the proxy advisors. Reputations can be explained and defined to a far more technical extent (although not necessary in the current context) with the use of the rhetoric's of game theory. The act of proxy advisors selling voting recommendations to institutional investors, and institutional investors buying these recommendations from proxy advisors can be described as a dynamic (infinitely repeated) game with imperfect information. For such a game a Bayesian Nash equilibrium exists and can be basically formulated as the following set of strategies: the institutional investor (player A) uses the services of the proxy advisor (player B), as long as the proxy advisor provides the institutional investor with service

that is up to par, which together with specified beliefs for both players about the type of the other player, optimizes the expected payoff for both players (Tadelis, 2013). If we further assume that the payoff of continuing or taking part in the transaction is bigger than discontinuing or not taking part in the transaction it can be easily understood that the nature of voting recommendations as an experience good should not form a problem and therefore need not to be further addressed for the current purpose of this thesis.

What makes voting recommendations such a special case is that these recommendations are information goods. This is as Bates (1985) describes it due to the nonrival nature and the cost structure of information goods. Due to these characteristics the basic economic criteria, marginal cost equal marginal revenue, does not hold. The cost structure for information goods consists of large fixed cost and small variable cost. The biggest proportion of the fixed cost are sunk and the variable cost do not increase with increased output, i.e. the cost to provide the report on company 'M' to a second institutional investor does not provide the proxy advisor with additional cost. Therefore the marginal cost equal to zero. From this cost structure economies of scale arise, the higher the produced output, the lower the average cost (Shapiro & Varian, 1999). Based on the described cost structure and returns to scale the market for information goods according to Shapiro and Varian (1999) 'Cannot look like textbook-perfect competitive markets'.

Another aspect that makes voting recommendation such a specific case as an information good has to do with the durability of the good. Voting recommendations are nondurable, the moment the annual general meeting has passed the value of voting recommendations are worthless. The company the recommendations were based on continues its operations and during the next meeting a year later, new financial- and operational data need to be analyzed in order to form relevant and insightful recommendations. This is where voting recommendations as an information good are distinguished, at least to some extent, from other information goods such as music, books, movies and other durable information goods. These are often used as the basis of analysis in literature on information goods (see for example: Schmidt, 2005; Shapiro & Varian, 1999; Varian, 1999; Viswanathan & Anandalingham, 2005). The information goods used in these examinations are often durable and can be consumed many years after being produced, i.e. classical masterpieces made a few centuries ago (Schmidt (2005, p.125) defines information goods as durable). To a different, smaller, extent this notion of durability holds for information goods such as financial statistics provided by agents such as Bloomberg. These goods still have

value for investors years later for example to look at the development of the value of a firm over time. To an even smaller extent this also holds for news, which is valued the most when it is 'fresh' however after a certain period it still holds some 'archived' or historical value. Furthermore Coase (1972) indicates that lower durability of goods may lead to securing monopoly prices.

Shapiro and Varian (1999) state that there exist two maintainable market structures for information goods, namely the dominant firm, based on economies of scale and cost leadership, and the differentiated product market. Varian (1999) states that information markets often display the structure of monopolistic competition. Furthermore Varian (1999) states that due to lack of entry barriers over time profits will be nonexistent. In monopolistic competition there are a lot of producers and these producers are said to have some market power through differentiation. This is not the case for the proxy advisory industry. There are not many competitors but instead two 'dominant firms' and some fringe firms that are too small to be able to meet the demand of big institutional investors. Furthermore the core product the proxy advisor delivers cannot be differentiated from other proxy advisors. Namely, a recommendation can be either to vote for a specific point on the agenda or withhold (against) from voting. Divergent reports from two proxy advisors would mean that one proxy advisor advices to vote for the point on the agenda and the other proxy advisor advices to withhold. Based on the same standard, either the standard set by the 'buyer' of the good, the institutional investor or the Generally Accepted Principles of Good Corporate Practice used as a benchmark by proxy advisors, it would mean by definition that one of the proxy advisors is giving wrong advice (assuming the opposing actions cannot lead to the same optimal outcome). However the way these core products are offered could be differentiated. The 'big two', ISS and Glass Lewis, both seem to use comparable strategies to provide and 'differentiate' their services. Furthermore barriers of entry do exist due to the structure of the proxy advisory industry and the vast economies of scale needed for firms in the proxy advisory market to stay in business. The vast amount of resources needed to yearly analyze the thousands of decisions on hundreds of firms over a short period of time in order to meet the demand of the institutional investors makes it hard for new firms to enter the market. As an attentive reader will have noted, the proxy advisory industry displays a market structure a step further from perfect competition than the monopolistic market structure for information goods that is described by Shapiro and Varian (1999) and Varian (1999): the proxy advisory industry has an oligopoly

market structure, more precisely a Duopoly. Thus ISS and Glass Lewis are holding 97 percent of the market, while providing in essence a homogeneous nondurable impure public information good.

The duopoly market structure is often studied and examined in economic theory. First Cournot (1838) examined the effects based on output. Then Betrand (1883) focused his examination on price after which Stackelberg (1934) enriched these models further by taking a sequential as opposed to a simultaneous perspective. Based on the situation the outcome in such a market can lead to both situations near or equal to perfect competition e.g. fierce competition in Betrand's model, and situations closer to monopoly outcomes. However since the economic criteria of marginal revenue equal to marginal cost does not perfectly hold for information goods another perspective is needed to further address the functioning of the proxy advisory industry.

However note that both proxy advisor show differentiating techniques for their core, 'homogeneous', goods through the way they offer their services around their voting research. Viswanathan and Anandalingham (2005) describe three pricing strategies that can be used by the providers of information goods: customisation, bundling and versioning. Customisation and versioning are very alike, customisation is described as the processes the information good provider uses to more precisely meet the customers' needs and versioning happens when customers have different willingness-to-pay for essentially the same good provided by the information good provider. Furthermore Bakos and Brynjolfsson (1997) state that the aggregation, such as bundling, of information goods becomes more attractive when marginal production cost are close to zero. As a result the authors state that in order to maximize economic efficiency the maximum amount of goods should be provided to all possible consumers in the market. According to Varian (1995) an economic optimum could be attained in a market setting of monopolistic competition with perfect price discrimination such that it will maximize the profit of the supplier and consumers' surplus and the deadweight loss will be accounted for by offering each consumer a slightly differentiated product, e.g. through difference in quality, so that each consumer pays their maximum 'willingness to pay' price. These strategies can be seen to some extent practiced by proxy advisors in the way they offer their overall services. An online platform is used by the proxy advisors to offer their services, with premium functions available on these platforms. Besides the report on an investee of the institutional investor, the whole process of voting by proxy, including all necessary steps to be taken to vote by proxy, are offered

as services, together with slightly differentiated forms of voting policies, by both proxy advisors. Caution is advised since monopolistic competition is not a duopoly, furthermore both big proxy advisor seem to follow the same 'differentiating' strategies and thus in essence are not really differentiating themselves from each other.

With the rise of internet the literature on information goods has risen, multiple studies have been conducted in regard to how information goods should be supplied and priced, the efficiency of aggregating or segregating these goods, and the effects of bundling have been examined[6]. However as stated by Bakos and Brynjolfsson (1998) with regard to how information goods should be offered 'existing theory and practice fail to provide clear guidance". Furthermore when it comes to the conundrum of information in economics or as Bates (1990) explains it as the 'dual role' of information, information as a good and information as 'a state of awareness', one of the critical assumptions in economic theory, no substantial theory on how to go about the notion of marginal cost being equal to zero are offered for oligopoly market structures. In regard to information goods the analysis of Varian (1995, 1999) and his analysis together with Shapiro (1999) approximates guidance through this conundrum the most, albeit for the market structure of monopolistic competition. From it follows a partial conclusion that does not provide the complete sought for framework to hold the presented information in this thesis against, namely that the market for voting recommendations, an information good in a duopoly market structure, is even within the information good market not your average market. However on the other hand it, as described in the previous paragraphs, show some indications of what to expect and how to tread the market for voting recommendations.

4.2 Market failures and organisation failures

The initial definition as given by Bator (1958) in economics of a market failure, 'the failure of a more or less idealized system of price-market institutions to sustain "desirable" activities or to stop "undesirable" activities' might prove to be a bit too ambiguous. As briefly described in the introduction a market failure occurs when a market fails to allocate resources efficiently. This statement should be further addressed and to do so the realm of welfare economics is entered. This is the field of normative economics which deals with the questions of what ought to be. When efficiency is examined or spoken of in the realm of welfare economics there is often meant

[6] See for example Bakos and Brynsjolfsson, 1997, 1998; Schmidt, 2006; Shapiro and Varian, 1999; Varian, 1995, 1999; Viswanathan and Anandalingam, 2005.

Pareto efficiency. Pareto efficiency is the situation in which no person can be better off without making someone else worse of.

Within welfare economics there are the First Fundamental Welfare Theorem and the Second Fundamental Welfare theorem. The proof the First Fundamental Welfare Theorem provides is that a Pareto efficient allocation of resources is formed in a perfectly competitive market, i.e. in any competitive equilibrium. Based on this theorem Rosen and Gayer (2010) state there are two main reasons why the allocation of resources is inefficient, market power and the non-existence of markets. Through market power, such as is the case for oligopoly market structures, firms may have the opportunity to set its price above marginal cost and thereby leading to a less efficient market outcome. When a market does not exist, it logically cannot provide an efficient allocation of resources. Rosen and Gayer (2010) relate this to two types of inefficiencies, asymmetric information and externalities. Where Rosen and Gayer (2010) describe asymmetric information as the situation in which one side of the economic transaction has better information about the transaction than the other side of the transaction, and an externality as a situation in which the actions of one of the parties affect a third party in such a way that it is not accounted for in the market price, or the 'market mechanism'. A negative externality would mean that these kind of actions have a negative influence on a third party. Herein the producer and the consumer are the first and second party, the third party is any other party or resource that is affected indirectly.

As has been described in the theoretical section on information goods, the price of these goods in a competitive market would be equal to marginal cost, which would be equal to zero. Then there would be no incentive for firms to produce the information goods. Thereby leading to a market failure. However one could argue, as Varian (1998) did, this problem could be dealt with through the use of intellectual property rights, creating a temporary monopoly on the good and thereby enabling the price to be set above marginal cost. However note that paradoxically through the use of market power, as is the case in an oligopoly, the same result could be attained which again indicates an inefficient allocation of resources. This however would be the lesser of the two evils or inefficiencies.

Nevertheless in regard to proxy advisors there are more factors at play. Whether ISS or Glass Lewis provides its report to an institutional investor, either based on Generally Accepted Principles of Good Corporate Practice or the institutional investors' internally developed set of

guidelines, these reports are expected (except for exact wording) to be perfect substitutes. Meaning that if one proxy advisor offers their report for 5 dollar, the other proxy advisor is inclined to offer its report at a price of $ 4,99. Then the initial proxy advisor is inclined to offer its report slightly lower to gain the complete market at a price of $ 4,98, and so on and so forth. In this scenario the proxy advisors are in a well-known form of competition, Bertrand competition, in which, in a competitive market, prices would again be driven towards marginal cost, equal to zero. Again this would lead to a market failure i.e. no one is willing to provide the good at a price equal to zero, thus non-existence of market. This indicates that even if the proxy advisory industry would be a perfectly competitive market, it could lead to a market failure through the cost structure of the provided information good, voting recommendations.

Examining and trying to explain the efficiency of the proxy advisory market by looking at market failures is only part of the analysis. When the attention is shift from solely the proxy advisory market as an entity, towards the voting chain in which proxy advisors operate, a more thorough analysis can be made. The market failure as described in the previous paragraphs could very well be the result of an organisation failure. Based on the provided historical background it follows that through imposed regulations in regard to well-informed decision making, together with the increased institutional ownership of publically traded equity, demands on institutional investors have changed. Furthermore it has been addressed that institutional investors are not able to internally make timely and cost-efficient evaluations of the investees in their portfolios in order to make well-informed decisions. This means the institutional investor as organisation fails to make these well-informed decision without the help of an outside party. It needs to outsource the research and proxy voting process, thereby creating the demand for the proxy advisory industry. It follows that proxy advisory help institutional investor to mitigate the organisation failure in order for the institutional investor to keep functioning (to some extent) efficiently.

5 The use of proxy advisors. An example from the field

5.1 The Dutch Institutional Investor

For this example a closer look is given at a large Dutch institutional investor. The institutional investor has over 4500 meetings regarding over 45,000 decisions, covering billions of euro's in assets a year. Most of the annual general meetings take place in the period from March to May. Their decision on how to vote during these meetings is based on internally developed policies and guidelines based on good corporate governance and practice. However the institutional investor is said to take idiosyncrasies of different markets into account.

Three employees within the institutional investor deal with proxy voting. Although the institutional investor chooses not to disclose which proxy advisor they use in their investment reports, it is not a big secret which proxy advisor is used. The institutional investor argues that they hold their own internally developed voting policies and do not want people to think they are simply following the contracted proxy advisor. Nevertheless the institutional investor uses the services of the market leading proxy advisor.

In regard to dealing with policies and regulations across countries the institutional investor opens the accounts needed for the custodians, which in turn take care of the administrative issues. Furthermore after the institutional investor has indicated how to vote to the proxy advisor, the advisor takes care of the majority of related paperwork and ancillary conditions.

5.2 Services used by the large institutional investor

The services used by the large institutional investor are two-fold:

5.2.1 Function as an information intermediary

The proxy advisor helps the institutional investor implement their policies. Based on these guidelines the proxy advisor does the research for the institutional investor on how to vote on issues in regard to companies held in the institutional investors' portfolio.

5.2.2 Take care of the process of balloting votes throughout the voting chain

The proxy advisor is given permission by the institutional investor to collect the ballots that would otherwise be sent to the institutional investor, together with all the paperwork involved.

The institutional investor logs on to the online platform provided by the proxy advisor on which the proxy advisor indicates what ballots are received from the custodians of the institutional investor. On the same platform the research conducted by the proxy advisor is

offered to the institutional investor. Based on the provided information the institutional investor can indicate on the platform whether to put the vote for or withhold (against) the items to be voted on.

When the institutional investor has made its decision the proxy advisor takes further care of the vote and forwards it through the voting chain.

5.3 Consequences of the use of a proxy advisor for the large institutional investor

The actual decision still lies with the institutional investor, it remains its fiduciary duty to make a well-informed decision, however most of the research and the actual process of voting is outsourced.

The institutional investor has no legal relationship with sub custodians. There exists no hard guarantee a vote is successful or correct (due to structure of the voting chain). Furthermore no active monitoring of votes on whether the ballots have been cast, and cast correctly, is conducted by the institutional investor.

5.4 Power of proxy advisors from the institutional investors' point of view

Proxy advisors are said according to the institutional investor to be contingent leaders that can potentially influence the vote to an enormous extent. Recommendations are based on the framework and policies of proxy advisors, which are in line with the Generally Accepted Principles of Good Governance. Advice is given in order for the investees to conform to the given guidelines by the institutional investor. The institutional investor sees the proxy advisor as a starting point. Based on the proxy advisors' research and from it following recommendations, employees of the institutional investor check whether the given advice is correct. Thereby giving more weight and attention to more important issues that can be voted on.

5.5 Lack of competition from the institutional investors' point of view

The oligopoly market structure of the proxy advisory industry appears not to be a problem from the perspective of the institutional investor since proxy advisors operate based on the same principles. No differentiated products, only slight differences exist because of benchmarks used and the way opinions are expressed. The institutional investor experiences little variation between different proxy advisors.

5.6 Transparency

5.6.1 Transparency, the proxy advisor

The institutional investor has access to the market specific guidelines and policies used by the proxy advisor. Their proxy advisor discloses why they make certain recommendations, give insight in their research, and inform the institutional investor when a vote has been cast.

5.6.2 Transparency, down the voting chain

The proxy advisor reports back, when the proxy advisor itself gets a report back, on whether a ballot is approved or did not make it through the voting chain. However the institutional investor only learns through its proxy advisor what comes back from Broadridge. What happens further down the chain is not completely clear. Therefore accuracy of votes going through the voting chain is not completely clear, especially in regard to the sub custodian level.

6 Discussion

To what extent is the proxy advisory industry functioning efficiently in their role as information intermediaries for institutional investors?

There is a vast amount of research dedicated to the question whether proxy advisors have an influence on actual voting outcome. The presented findings do show relations although no irrefutable causal relation seems to be proven. Furthermore this potential influence for which indications have been shown in the literature is not necessarily bad. Multiple explanations for this notion are presented. It could be a sign of a good functioning market, the role of proxy advisors as an information intermediary should be influential, otherwise it would mean a waste of resources. Furthermore in regard to the question or concern whether proxy advisors are too influential, it is noted that big investors (at least in Europe) use multiple proxy advisors and have internally developed policies that serve as guidelines for proxy advisors. Note that the example from the field indicates (mere incidental support) that not all big institutional investors use multiple proxy advisors.

From the notion in the former paragraph the general question of this thesis arises, whether the proxy advisory industry is functioning efficiently, i.e. whether or not there are no occurring market failures. Since if this is the case influence on voting outcomes could benefit the voting industry. This can be reviewed to some extent by looking whether proxy advisors provide good voting recommendations and thereby add value to the market. Both positive and negative remarks are made in regard to the functioning of the proxy advisory industry. Some state that proxy advisors provide a source of new information and add value to the market, others state that their recommendations are not value increasing.

Further questions in regard to the proxy advisory industry and potential market failures are examined. Although beyond the scope of the European regulator scholars did review the level of competition in the market. The proxy advisory market seems to be a duopoly which is said to be partly the case through first-mover advantages of the incumbents and the existing entry barriers in the market, thereby creating potential, costly, monopoly power which might indicate a less efficient market. On the other hand it can be argued that through the complexity of the market and the sheer size of ballots to be cast and the from it following recommendations, or decisions, to be made, economies of scale are desirable in order to maintain a level of quality, smaller agents might not be able to guarantee.

The statements made in the former paragraph however need further specification. The proxy advisory industry is a market for non-durable impure public information goods. The industry provides some challenging economic characteristics. Since the marginal cost for these cost are equal to zero and the fixed cost substantial, in perfect competition there would be no incentive to provide products to the market. The theoretic cornerstone, an optimal outcome through perfect competition does not suffice in the proxy advisory industry.

Merely looking at potential market failures proves to be a too narrow approach. Through the examination of the voting chain in which the proxy advisory market operates it can be argued that in regard to institutional investors there is an organisation failure. Institutional investors are not able to process the whole voting process, including conducting the research to make an well-informed vote, internally. Through this organisation failure a market failure arises, i.e. the non-existence of the market for voting advice. Proxy advisors provide this market and thereby undo the market failure as a result of an organisation failure.

Furthermore the complexity of the proxy advisory market, the vast amount of information needed to make well-informed decisions, the undifferentiated product asked from and provided by the proxy advisory industry and the resources needed in order to provide these services, i.e. high fixed cost, make economies of scale almost essential.

In conclusion institutional investors, as shareholders, have become too big to meet the current process of casting votes and controlling of their votes under the current market and regulatory circumstances, i.e. fulfilment of fiduciary duties, internally. Therefore without the help of external agencies, the proxy advisors, this becomes virtually impossible for institutional investors.

Furthermore transparency seems to be an important element in current form of the proxy advisory industry. Some arguments in order to disclose and mitigate potential conflicts of interest as well as further policies are said to be relevant. This notion does however not hold for the critique that proxy advisors need to fully disclose the weights given to the variables used in their analysis.

Transparency seems to have been improved in response to the actions of the ESMA in Europe and the from it following signatory statements. Furthermore this might lead to a positive spill-over effect to the U.S. market since the biggest European market participants, ISS and Glass Lewis, are the biggest, U.S. based, proxy advisors.

Although the actions of the ESMA and the signatory statements that followed from it, for market leader ISS potential conflicts of interest do not seem to be completely mitigated. Taken together the presented findings in the literature, the statements, research and interviews conducted by the regulators of the U.S., Europe, and the Netherlands and the current structure of the voting chain, it is virtually impossible to state that proxy advisors do not have an influence on institutional shareholder voting. To support this as a causal effect empirically however has been proven to be challenging.

The stated influence is of importance, otherwise these agencies would have no use in the market. However the question remains whether the lack of liability of these agents with such an influence is desirable. There seems to be no equivalent or better alternative to proxy advisors present in the current voting chain, nor are these likely to emerge because of the complexity and size of the market.

Through this notion also comes the power or influence of the proxy advisory industry. A critical remark on the fiduciary duty of institutional investors should be made: there are known cases where the institutional investor does not actively monitor the validity of the research provided by their proxy advisor, since this would be, as is the case for doing the research themselves, an too extensive and thereby time consuming and costly process to do internally. Thus to some extend the institutional investor has to (blindly, since these agents are in not monitored nor is the quality of their work investigated by the institutional investors who solicit their services) rely on the work conducted by the proxy advisors. It could therefore be argued that institutional investors in the current system pay off or ‘outsource’ their fiduciary duty to the proxy advisors who in turn hold no accountability in the final voting process. This raises the question whether the policies issued in regard to fiduciary duties of investors in its current form is useful. What is stringent for institutional investors is to maintain a certain level of return on their investments, to keep in business. This incentive might be one of a stronger order, and one that makes institutional investor more likely to demand a certain level of quality from the proxy advisory industry than an imposed regulation on fiduciary duties and well-informed decisions making.

Under current circumstances the best alternative (note not first-best from a theoretical perspective) within the proxy advisory industry is to ensure as much transparency as possible. Improvements of transparency have been sought by the ESMA. Furthermore steps should be

undertaken in order to come to a good functioning audit trail through the voting chain, available for the process of casting votes by investors.

6.1 Future research recommendations

Even though the voting chain itself has not been the main focus of this thesis, the proxy advisory industry is one of many links in this process and it is evident this chain holds room for improvement. Multiple issues have been mentioned by regulators and industry participants: the number of links in the chain, this chain could become more efficient if the number of links would be reduced, the lack of a good audit trail, for which it would be highly recommended that direct contact between the institutional investor, or its proxy, and the sub custodian is improved and thereby overall transparency in the voting chain improves among other things. Overall there seems to be more room for improvement in the overall voting chain than the segment of this chain in which proxy advisor operate, the lack of transparency seems to be more pressing in the voting chain. Furthermore note that through a functioning auditing trial the examination of influence of proxy advisor would become more reliable since it would enable the researcher to distinguish between institutional investors, the proxy advisor(s), if so, they have used, and the actual outcome.

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Appendix 1 Organisation of literature with respect to the proxy advisory industry

Author	Published	Contents of data used	
Proxy advice and actual voting outcome			Correlation found
Bethel & Gillan	2002	Management Proposals	13.6% - 20.6%
Hitz & Lehmann*	2015	Management proposals	-8.5%
Cai et al.	2009	Uncontested director elections	-19%
Choi et al.	2010	Uncontested director elections	ISS: between -6% & -13.1%, Glass Lewis: 3.6%
Daines et al.	2010	Director elections	+16.4%
Morgan et al.	2006	Say-on-pay	–19.8%
Ertimur, Ferri & Muslu	2009	Say-on-pay	+25%
Ertimur et al.	2013	Say-on-pay	ISS: -24.7%, Glass Lewis -12.9%
Malenko & Shen	2015	Say-on-pay	-25%
Ertimur, Ferri & Maber	2012	Say-on-pay *special case: fraud*	-27.1%
Shareholder compliance with voting recommendations			
Cotter et al.	2009	Mutual fund voting data	.
Schouten*	2012	Pension fund and mutual fund voting data	.
Iliev	2015	Non-contested elections	.
Proxy advisors as a new source of information			
Alexander et al.	2010	Director elections	.
Indications for potential market failures in the proxy advisory industry			
Larcker, McCall & Ormazabal	2013	Stock option repricing	Economic consequences
Larcker et al.	2015	Say-on-pay	Economic consequences
Li	2013	ISS & GL databases	Conflicts of interest
Larcker, McCall & Tayan**	2013	Based on data on how proxy advisors come to their recommendations provided by ISS and Glass Lewis themselves	Transparency, methodology
Belinfanti**	2008	Literature overview/ theory	Transparency, agency-costs, conflicts of interest, competition
Volonté & Zaby*,**	2013	Short (literature) overview after Swiss referendum	Transparency, conflicts of interest, competition, methodology

*European based research/data, **More qualitatively oriented