THE CONFERENCE BOARD

DIRECTOR NOTES

Information Intermediary or De Facto Standard Setter?

Field Evidence on the Indirect and Direct Influence of Proxy Advisors

by Christie Hayne and Marshall Vance

The authors examine whether proxy advisory firms primarily serve an information intermediary role by providing research and voting recommendations to shareholders or directly influence executive compensation by exerting pressure on firms to adopt preferred pay practices. Through a field study, the authors find that proxy advisors are perceived as both information intermediaries and agenda setters and that these roles provide leverage to enable such advisors to exercise significant influence over executive pay practices. In this *Director Notes* report, the authors describe research findings related to the influence of proxy advisors in US corporate governance. The authors find that boards feel, and sometimes yield to, pressure to conform to compensation practices recommended by proxy advisors despite their own preferred compensation philosophies, even in the absence of overt proxy advisor scrutiny or negative shareholder votes. They also find that proxy advisors are susceptible to conflicts of interest and generally use a one-size-fits-all approach to voting recommendations. Overall, however, such advisors are viewed as improving compensation practices by increasing transparency and accountability and fostering dialogue between firms and their shareholders.

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Introduction

The role of proxy advisory (PA) firms is a contentious issue.[1] On the one hand, PAs fill an information intermediary role by processing large amounts of information and providing voting recommendations to institutional investors on matters such as executive compensation and governance. On the other hand, critics contend that PAs have outsized influence on proxy voting outcomes, which potentially allows them to exert pressure on firms to adopt PAs' preferred practices. While these views are not mutually exclusive, examining PAs' role(s) is important for understanding executive compensation design. If PAs primarily serve as information intermediaries, their influence on compensation practices likely occurs only *indirectly* through their ability to facilitate investors' monitoring through shareholder votes. If PAs can apply pressure on firms to adopt favored compensation practices, they may be able to *directly* influence compensation practices. In this latter case, the effect of PA influence depends on the quality of PA recommendations.

Ultimately, whether PAs influence executive compensation practices depends on how *internal* stakeholders responsible for designing compensation (i.e., board directors with support from human resources (HR) executives and compensation consultants) perceive the role of PAs, which, in turn, helps determine how these stakeholders respond to PA recommendations. Thus, key questions include:

1. How do internal stakeholders perceive the role(s) of PAs, and, relatedly, how do they respond to their influence in terms of compensation design?
2. How do internal stakeholders perceive the quality of PA recommendations and the resulting influence on compensation practices?

The purpose of this *Director Notes* report is to shed light on these questions.

To address these questions, the authors used qualitative field research methods, which are well suited to investigating "how" questions as well as providing an understanding of the context and the process through which individuals evaluate alternatives and make decisions. The authors conducted 37 interviews with board directors, HR executives, and compensation consultants of mainly mid-, large-, and mega-cap public companies to understand how they view the role and influence of PAs with respect to compensation design. Notably, field research elicits the perspectives and opinions of participants. The authors' role is to aggregate participant views in a meaningful way but not to opine on whether those views are accurate.

The authors found that PAs are perceived as having broad indirect influence on compensation practices by supporting investors' monitoring efforts through an information intermediary role. However, they also found evidence that PAs wield direct influence by identifying preferred practices and enforcing their adoption through voting recommendations. Respondents overwhelmingly view PAs' recommendations and general guidelines as "telling them what to do" and frequently share examples of PAs' influence on their compensation design choices. The study also examines respondents'

1 Proxy advisory firms are hired by institutional investors to provide research and voting recommendations in advance of shareholder votes.

perceptions of the quality of PA recommendations. Respondents generally agreed with common criticisms of PAs such as that PAs are susceptible to conflicts of interest and that PAs employ one-size-fits-all analyses leading to standardized recommendations. Interestingly, none of the respondents were able to identify negative outcomes from PAs' potentially conflicted role; however, they did feel that PAs' overly standardized processes had impaired PA recommendations and reduced the quality of compensation design. Notwithstanding these criticisms, we find that internal stakeholders believe PAs fill a positive role and have improved compensation practices in other ways, primarily by increasing the transparency and accountability of executive compensation and providing an impetus for firms to engage with institutional investors.

This study makes several contributions:

- First, the authors provide evidence for PA influence in a broader context than has been shown in the existing literature. Prior studies primarily examine PA influence in the context of adverse PA recommendations or voting outcomes, which are relatively rare. They find that boards proactively manage compensation issues, known to be "hot buttons" of PAs, to avoid negative vote consequences in the first place. Moreover, they find evidence of PA influence on compensation practices even in firms under no obvious pressure from PA scrutiny or shareholder votes.
- Second, the authors contribute to the recent debate about whether PAs are "helpful or harmful";[2] concern over the influence and quality of PA recommendations is a key driver of recently proposed legislation intended to restrain PA influence (e.g., H.R. 5311, H.R. 10).[3] In November 2019, the SEC proposed amending rules governing proxy solicitations that would impose stricter rules and reporting requirements on PAs.
- Third, the finding that internal stakeholders perceive PAs as information intermediaries, agenda setters, and de facto "standard setters" helps reconcile disparate conclusions about the economic role of PAs in research and practice. The interview data reflect the perceptions of internal decision makers who interpret PA guidelines and must choose whether and how to implement compensation changes. These stakeholders' perceptions suggest that PAs fulfill a more nuanced role than has been identified in prior studies.
- Fourth, the interviews provide rich narratives that enhance the evidence from archival studies. The authors' research method enables them to provide direct evidence of PA influence on specific executive compensation practices. The authors' findings also relate to the broader literature on executive compensation design. Respondents describe changes to both the size and structure of executive compensation in response to the known policies and vote recommendations of PAs.

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2 *Corporate Shareholder Meetings: Proxy Advisory Firms' Role in Voting and Corporate Governance Practices,* Government Accountability Office (GAO), Report 17-47, November 2016.

3 The Corporate Governance Reform and Transparency Act (H.R. 5311) was introduced for legislative consideration in 2016. Subsequently, key provisions of this bill were rolled into the proposed Financial CHOICE Act in 2017 (H.R. 10) as part of a larger effort to scale back legislation in the Dodd-Frank Act of 2010.

On the whole, the authors' analysis suggests that PAs have both positive and negative influence but are generally perceived as improving the alignment of pay practices with shareholders' interests. The intent of this research is to focus explicitly on PAs' role in compensation design. While generalizations to other governance issues should be made with caution, the authors note that respondents regularly provided examples beyond compensation issues, alongside the compensation-specific examples included in this *Director Notes* and the related published paper, suggesting that many of the implications from this study may apply to PAs' role and influence more broadly.

Research Methodology

- Interviews were conducted with 8 board directors (all with compensation committee experience); 18 HR executives (usually the most senior position with specific responsibility for executive compensation) who report to boards and research and implement compensation design; and 11 senior-level compensation consultants who advise boards on compensation design issues. All interviewees regularly attend compensation committee meetings and are familiar with how PA influence is perceived in the boardroom and incorporated in compensation design. Interviews also included representatives from four of the five PA firms in the US to obtain a balanced perspective.
- For the 26 public issuers represented in the sample, the authors diversified as many criteria as possible including industry, firm size (i.e., 5 mega-cap, 14 large-cap, 4 mid-cap, and 3 small-cap firms), and level of PA scrutiny (i.e., 10 of 26 firms were currently facing or had recently faced PA scrutiny).
- The authors discontinued recruiting participants at the point of saturation—when participants stopped providing novel insights.
- Both researchers participated in all but one of the interviews, which were conducted by telephone and lasted an average of 65 minutes. Using a semi-structured approach, the authors developed their script according to a few, more exploratory early interviews and by leveraging existing research and key themes from theory.
- Using qualitative data analysis software, the authors coded the interview transcripts according to PAs' roles, executive compensation design that was influenced (or not) by PAs, and common criticisms of PAs and the resulting impact on the quality of compensation design. The authors tested and challenged key insights and expectations from their theoretical lens, either retaining or rejecting them as they were or were not supported. They also remained alert to anomalous data throughout the analysis.

Proxy Advisor Background and Context

PAs sell research reports and voting recommendations on key issues such as executive compensation to institutional investors in advance of annual shareholder meetings. These reports are paid for on a subscription basis by institutional investors and not by the companies that are the subjects of the reports. In the US, there are five PA firms. Institutional Shareholder Services (ISS) and, to a lesser extent, Glass Lewis are the dominant firms in the industry with an estimated combined market share of 97 percent.[4] With increasingly numerous ballot issues arising for shareholder vote, and, particularly, since the onset of say-on-pay voting as part of the Dodd-Frank Act of 2010, the demand for PAs' services has grown, and, in turn, the potential role of PAs in shareholder voting has expanded significantly.

PAs research and make voting recommendations for thousands of corporate issuers each year. PAs' business model depends on economies of scale from leveraging standardized research processes based on publicly available data (e.g., proxy statements and other SEC filings) and, in turn, selling each report to potentially hundreds of investor clients. While investors may purchase custom reports with voting recommendations tailored to their own preferred policies, PAs issue "benchmark" reports and recommendations based on PAs' espoused guidelines for "best" practices. PAs develop and periodically revise these benchmark policies based on proprietary surveys and input from various market participants, particularly large institutional investors. PAs make their policies available on their websites, and, hence, issuers are generally able to assess whether their own practices align with PAs' benchmark practices.

Role of proxy advisors

While PA influence on voting outcomes is well recognized, the nature and extent of PAs' influence on compensation practices is debated among market participants and academics, most notably over whether PAs primarily influence compensation practices indirectly through an information intermediary role or whether they have direct influence through identifying and promoting compensation and governance "best" practices. The authors consider boards' fiduciary duty to shareholders and draw on theory to predict how boards respond to PA guidelines and their corresponding roles and influence.

Boards of directors—with support from HR executives and compensation consultants—are elected by shareholders to implement pay practices that are in the best interests of owners. In turn, directors are monitored by shareholders and disciplined through proxy voting. As information intermediaries, PAs can indirectly influence compensation practices by providing research reports and recommendations to help institutional investors execute their fiduciary duty to monitor through shareholder votes.

4 See Copland, J., D.F. Larcker, and B. Tayan. 2018. The big thumb on the scale: An overview of the proxy advisory industry. Rock Center for Corporate Governance at Stanford University Closer Look Series: Topics, Issues and Controversies in Corporate Governance No. CGRP-72; Stanford University Graduate School of Business Research Paper No. 18-27. Available at SSRN: https://ssrn.com/abstract=3188174

Directors acting in the interests of shareholders, however, will not necessarily follow PA guidelines as they are expected to have in-depth familiarity with the firm's strategy, specific circumstances, and unique executive characteristics in order to identify optimal pay practices. PAs do not have firm-specific information beyond what is publicly available and must make recommendations for thousands of firms in a short period, which puts them at a significant informational disadvantage relative to boards in terms of optimal pay design for a given firm.

In contrast to the indirect influence of their information intermediary role, PAs may, in effect, have direct influence on compensation design by setting and promoting compensation and governance "standards" in the form of their publicly available benchmark practices. PA representatives interviewed emphasized that their guidelines come from an aggregation of institutional investor preferences while acknowledging that many governance and compensation issues are not viewed uniformly among investors. Further, informed voting is costly for investors, and institutional investors may face a free-riding problem and outsource voting to PAs with limited concern for the process underlying vote recommendations.[5]

Ultimately, whether PAs' influence compensation practices depends on how firms' internal stakeholders—especially the compensation committee of the board of directors—view PAs' role and influence. Accordingly, the authors examine the following research question: How do internal stakeholders perceive the role(s) of PAs, and, relatedly, how do they respond to their influence in terms of compensation design?

Criticisms of proxy advisors

While PAs have been subject to various criticisms, two primary concerns may undermine the quality of PA recommendations and guidelines. First, critics argue that PAs may be influenced by conflicts of interest. For example, ISS has a dual business model that includes selling both voting recommendations to institutional investors and consulting services to corporate issuers on how to improve their vote outcomes. Second, critics contend that PAs use a one-size-fits-all approach. To maintain profitability while providing recommendations for thousands of firms, PAs standardize and streamline their research processes to reduce costs and meet tight timelines imposed by proxy voting season.[6] Hence, the quality of voting recommendations may suffer when PAs fail to account for important firm-specific details and context.

Prior research yields mixed findings concerning the quality of PA recommendations, and so the authors examine an additional research question: How do internal stakeholders perceive the quality of PA recommendations and the resulting influence on compensation practices?

5 See, for example, David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "Outsourcing Shareholder Voting to Proxy Advisory Firms," *Journal of Law and Economics* 58, no.1 (February 2015): 173–204.

6 ISS reports that their research covers more than 20,000 firms (www.issgovernance.com/about/about-iss/).

Research Findings

How do internal stakeholders perceive the role(s) of proxy advisors?

In each interview, the authors asked respondents to describe the role of PAs in the design of executive compensation. Most respondents believe PAs have broad influence in the process of designing executive compensation, as reflected by the following perspective from an HR executive: "ISS is like an umbrella hanging over the whole thing, or a dark cloud maybe [laughs]."[7] In addition, other roles were considered as they appeared in respondents' narratives and examples of how they believed PAs influenced their firms' compensation practices. In the following sections, the authors analyze the PA influence highlighted by internal stakeholders and organize their analyses according to whether the role implies a relatively indirect or direct influence on compensation practices.[8] Table 1 shows the frequency with which respondents identified the various roles.

Table 1 **Summary of the Role of Proxy Advisors**

	Role	Internal Stakeholders (N=37)	
Relatively Indirect Influence	Information Intermediary	26	70.3%
	Agenda Setter for Institutional Investors	9	24.3
	Safe Harbor	20	54.1
Relatively Direct Influence	Agenda Setter for Internal Stakeholders	37	100.0
	Standard Setter	37	100.0

Indirect influence A majority of respondents (26 of 37) regularly referred to PAs' role in aggregating and compiling information from firms' proxy statements to provide vote recommendations to institutional investors. Thus, respondents view PAs as improving institutional investors' monitoring efficiency. In connection with this role, one HR executive explained, "Proxy advisors serve a purpose; they provide shareholders with guidance.…ISS and Glass Lewis serve an important role in that regard [reviewing proxy filings]." As respondents reflected on this information intermediary role, they suggested—as expressed by one compensation consultant—that PAs are "helping investors filter through their portfolio companies." When PAs are viewed as intermediaries, institutional investors must still review the PA report they receive and make informed voting decisions.

7 Note that respondents often specifically referred to ISS in their responses. Other than when respondents were describing the consulting role that relates only to ISS, respondents usually noted that their comments referred to PAs more generally. Similarly, when respondents referred to "ISS and Glass Lewis," they usually intended to speak of PAs in general.

8 Although the authors organize the analyses of PAs' roles in terms of "indirect" versus "direct" influence, they recognize that, in practice, most roles fall on a continuum, and, thus, a dichotomous classification is unlikely to fully capture the nuance of PA influence.

Some respondents (9 of 37) expressed the belief that the reports and voting recommendations disseminated by PAs become potential agenda items for institutional investors. Aligning with prior research,[9] PAs therefore indirectly influence firms' compensation practices through their role in setting agendas for institutional investors. For example, as expressed by an HR executive:

> [Investors] don't have large staffs, and they have a lot of companies to look at during a proxy season…ISS is almost like an outsourced analytical group for them. They get the ISS report, and they look at it, and, if everything looks noncontroversial, if you will, they probably just voted. If there are things that flag or pique their [institutional investors'] interest, they take a deeper dive.

Another respondent relayed that investors focus on proxies that receive a negative vote recommendation from a PA: "It's how [investors] manage how many proxies they actually read." Because internal stakeholders perceive that PAs set agendas and screen compensation issues for investors, they believe that adopting PA benchmark practices will allow them to avoid additional scrutiny of their compensation programs.

Beyond influencing compensation by improving and/or focusing shareholders' monitoring efforts, many respondents (20 of 37) highlighted a more significant, albeit still indirect, influence: they believe that a significant portion of investors "blindly follow" PA guidance rather than carefully reviewing proxy statements and formulating their own assessments. Thus, PAs' recommendations provide a "safe harbor" for investors to discharge their fiduciary duty to vote their shares. A consultant who had witnessed such behavior at many organizations stated:

> When it comes to the smaller institutions, they don't have the resources to assess all these companies in a reasonable timeframe. They have to rely on ISS's assessment to vote on the various shareholder proposals, and a lot of them effectively outsource it to ISS, so they can say to the shareholders, "We have a consistent approach," and that is to follow ISS.

The authors' data analysis revealed that the role of PAs was evolutionary (9 of 37 respondents) since institutional investors of all kinds relied heavily on PAs for vote recommendations. Institutional investors were ill-equipped to deal with new regulations mandating their proxy votes, and it became necessary to rely on PA guidance. Respondents explained that institutional investors now read and evaluate proxy statements themselves rather than simply vote in line with PAs. As one HR executive explained, the use of PA guidance has "evolved to the point where they don't just unilaterally vote in line with Glass Lewis or ISS." That is, respondents believe investors are using PA research as a "check and balance" to complement their own analyses.

Besides PAs' role as "agenda setters" for investors, they also influence firms' compensation design process by setting the agendas for *internal* stakeholders. In particular, all 37 respondents characterized PAs as highlighting executive compensation issues to be discussed by compensation committees. Essentially, as one HR executive

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9 See Yonca Ertimur, Fabrizio Ferri, and David Oesch, "Understanding Uncontested Director Elections," *Management Science*, Articles in Advance (June 26, 2017): 1–21.

explained, the compensation committees want to know "what the latest hot buttons [are], and where is ISS [on them]?" A director indicated, "We sit in the boardroom, and we say, 'What is ISS saying about us?'" An HR executive stated that, "once a year, we do an overview of what we're hearing from both Glass Lewis as well as ISS." These quotes highlight PAs' role in identifying key issues for the agendas of compensation committees and HR executives. Moreover, regardless of whether PAs' agenda-setter role leads to changes to compensation design, it prompts boards to consider a wide range of compensation topics and, effectively, enhances their effort in conscientiously designing executive compensation.

From the authors' discussions with PA representatives, they learned that PAs view their influence on compensation practices as indirect and arising primarily through their avowed role as information intermediaries. PA representatives stated that investors must exercise their fiduciary responsibility related to proxy voting but, as one put it, "don't have enough time or resources to allocate towards proper research for all the companies in their portfolios." To resolve this dilemma, another PA representative explained, "institutional investors hire [PAs] to make their own voting processes more effective and efficient and to free them up to do the more thoughtful parts of the process." This PA representative elaborated:

> Our role has become much more one of being a data aggregator, of being an entity that can do the legwork of going out and finding all the critical information that institutional investors need to vote…That's something that the institutions could not do in a cost-effective fashion on their own. We're able to because we have the size and scale of our client base…We help to facilitate the process by which they can exercise their fiduciary responsibilities.

In sum, PA representatives clearly emphasized PAs' role as an information intermediary.

Direct influence Some respondents expressed skepticism about the extent to which PA benchmark guidelines are derived from institutional investors' preferences (which would imply indirect influence as an intermediary) and suggested that some "best" practices originate from PAs themselves (implying more direct influence).

Respondents provided examples of PAs' more direct influence on firms' pay practices and of instances when PAs are out of step with the general investor community. Moreover, several respondents (13 of 37) referenced PAs' known guidelines as being "preferences," "views," "opinions," or "beliefs," consistent with PAs at least partially establishing their own guidelines rather than simply aggregating investors' preferences. The authors' analysis indicates that all respondents (37 of 37) view PAs as either explicitly or implicitly telling firms how to design compensation.[10] Throughout interviews, respondents described PAs' guidance as reflecting what PAs "wanted" or "were looking for" in terms of pay practices.

10 Perhaps the most overt example of PAs' direct influence on compensation design is ISS's consulting line of business whereby firms explicitly seek out (and pay for) guidance on what constitutes acceptable compensation practice.

In discussing the overall governance landscape, respondents (15 of 37) spoke of PAs' guidelines using terms like "rules" that need to be followed or even "demands." Some respondents made analogies to PAs serving as de facto regulators. "You have to constantly be aware of [PAs] as if they were yet another regulator," said an HR executive. A compensation consultant observed: "[PAs] represent a quasi-regulator role as an ombudsman or as a police person." And a board director said, "I look at ISS and [the other PAs] that are essentially attempting to regulate the process."

In the authors' interviews with PAs, respondents emphasized that their business model depends on providing research and recommendations that institutional investors find useful. Accordingly, PAs identify institutional investors' views as the most important input to their policy development, which is inconsistent with the idea that PAs have their own preferences. However, former PA representatives acknowledged PAs' incentives to drive profitability. One respondent observed that, "when you devise new voting recommendations, it keeps you in business…. If you keep evolving your guidelines, then not only are you staying up-to-date with what's going on, but also, you are keeping yourself relevant." The other former PA representative described it as follows:

> [PA firm] is a for-profit organization, so, at the end of the day, they have their investors who are expecting that they will generate profit…. It's a balance between making sure that you are building the market favorably as well as generating enough revenue to make sure [PAs'] investors are happy.

A more benign possibility is that PA guidelines reflect institutional investors' views on average, but any given issuer's investor base may differ (at least on some issues). The PA representatives that were interviewed indicated that not all compensation issues are viewed uniformly among investors.

Perhaps unsurprisingly, PA representatives do not perceive that they are trying to tell firms what to do. A respondent who was recently employed by a PA firm but has since shifted into consulting provided a more nuanced take:

> I think proxy advisors have a fairly big, influential role. I'll also say that my opinion has changed somewhat since I've moved from [PA firm] to [consulting firm]. When I was at [PA firm], I thought we were commenting on pay practices and pay structures and not influencing them so much. Now that I'm at [consulting firm] and working with companies, I see [PAs] do influence pay design and pay structures.

Do firms acquiesce to PA influence? Nearly all respondents (36 of 37) reported that PA influence—both indirect and direct—manifests in changes to compensation design in response to PA guidelines and recommendations. For example, when asked whether boards compromise on their preferred compensation philosophy to align with PA guidelines, a consultant noted:

> That definitely happens. Companies feel pressure to scale back or change their mix of equity based on the proxy advisors' positions. They might even prefer to go with 100 percent stock options, but the discussion turns into, "Well, what if we went 67 percent stock options and 33 percent restricted shares? Then, how would the proxy advisors feel, and would that satisfy their issues?"

In contrast to numerous examples of being influenced by PAs, over half of respondents (28 of 37) also reported compensation issues on which they (or their consulting clients) were unwilling to compromise. For example, noting that PAs advocate for performance shares instead of the time-vesting equity used by his/her firm, an HR executive responded, “We’re not going to be able to check that box, but we’re okay with that because we believe in the plans that we’re offering.”

Summary In addition to highlighting the various roles that internal stakeholders perceive PAs hold, the evidence demonstrates that internal stakeholders respond to PA pressure by changing compensation design and adopting practices in line with PA preferences. That is, contrary to boards’ fiduciary duty to provide effective oversight, respondents described instances when they yielded to pressure to align their practices with ones legitimated by PAs.

How do internal stakeholders perceive the quality of proxy advisor recommendations?

To address their second question, the authors asked respondents to reflect on two primary criticisms commonly suggested in both academic and practitioner literature—that PAs are susceptible to conflicts of interest and that PAs employ one-size-fits-all analyses leading to standardized recommendations. Many respondents alluded to these criticisms before the relevant prompts arose in the interview script. This section also reports other criticisms of PAs that respondents identified in interviews. Table 2 shows the frequency with which respondents identified the various criticisms.

Conflict of interest ISS’s dual lines of business have given rise to criticism that PAs face conflicts of interest and that this could negatively impact the quality of their recommendations. A large majority of respondents (32 of 37) felt that ISS’s dual role was problematic. Still, respondents did value the fact that they were able to access ISS Corporate Solutions (ICS)—ISS’s consulting subsidiary—to ensure their executive compensation plans were within ISS’s “safe zone” (a term used by an HR executive) leading up to proxy voting season.

Table 2 **Summary of the Criticisms of Proxy Advisors**

Criticism	Internal Stakeholders (N=37)	
Conflict of Interest	32	86.5%
One-Size-Fits-All	32	86.5
Shareholder Misalignment	21	56.8%
Errors and Inaccuracies	16	43.2%
Lack of Transparency	15	40.5%
Unresponsive	10	27.0%
Inexperienced Staff	7	18.9%
Wastes Time/Energy	5	13.5%

Although the possibility for conflict of interest was mentioned regularly, none of the respondents had any specific experiences with this issue resulting in reduced PA recommendation quality. Instead, respondents made statements like this one from an HR executive: “I can’t prove that there is any sort of conflict there, but, from an optic standpoint, it does look odd;” and this one from a different HR executive: “They have their glass wall…so they’ve got two different branches that they say don’t cross, and I would say from my personal experience, they don't cross." Therefore, despite the apparent prevalence and awareness of the *potential* for conflicts of interests, the authors did not find any evidence of conflicts impairing PA guidance or issuers' compensation design.

All PA representatives were aware of this conflict of interest criticism. In fact, some indicated that their firm had deliberately excluded consulting from its business model to avoid this criticism.

One size fits all PAs also face criticism that their recommendations are too standardized and ignore firm-specific circumstances. In interviews with PA representatives, respondents described various heuristics and efficiencies that enable them to review and scrutinize thousands of proxy statements within the constraints of proxy season. For example, PA representatives mentioned building standardized models used for initial quantitative assessment and screening, hiring "stables" of temporary or seasonal analysts, and requiring that employees work long hours. Internal stakeholder respondents acknowledged some of the constraints and challenges faced by PAs and suspected that the processing efficiencies they employ lead to reports that do not accurately reflect firm-specific details. In fact, a large majority of these respondents (32 of 37) felt that PA recommendations were too standardized.

Respondents stated that PA guidance did not accommodate differences related to firm size (e.g., must small firms require CEOs to meet the 6x salary minimum ownership guideline?); firm age (e.g., if it had just completed an IPO); product lifecycles; pairing metrics with short- and long-term objectives; or, more generally, unique details of the firm's strategy. Peer group selection was another frequently cited compensation issue that is difficult to address with a formulaic approach. For example, a compensation consultant indicated "peer groups are the Achilles heel of the proxy advisors" and cause PAs to "[lose] a lot of credibility." In contrast to the conflict of interest criticism, internal stakeholders generally viewed the one-size-fits-all problem as impairing PA recommendations and, ultimately, reducing the quality of compensation design.

Regarding this one-size-fits-all criticism, a PA representative emphasized that their reports are "hand tooled" and that analysts "really do differentiate" with qualitative analysis. However, others acknowledged using formulaic and standardized processes but also emphasized the importance of judgment. A PA representative explained that, "due to the large volume of the companies they have to assess, [PAs] need a one-size-fits-all solution, right?" Further, PA representatives highlighted the advantages of standardized processes. For example, one PA representative said, "Regulators very much prefer to see things that are derived by some kind of formula versus somebody saying 'I like it' or 'I don't like it.'" Another added, "There is consistency because it's policy-driven."

Other criticisms Though not cited as frequently, respondents did make other criticisms of PAs. Many respondents (21 of 37) felt that PA guidance and recommendations often resulted in shareholder–executive misalignment. They believed that some PA-driven changes to their firms' compensation design led to the adoption of practices that did not motivate managers to make decisions in shareholders' best interests.

Another common criticism (raised by 16 of 37 respondents) is that PA reports contain errors and inaccuracies. Respondents felt that PAs sometimes did not understand the content in their proxy statement or the operational details of the firm or that PAs had outright missed specific details in their review of the proxy (e.g., use of a particular metric). Responding to this criticism, one PA representative emphasized that "technology and data…on which we've invested significantly…drives accuracy and timeliness" while another described his/her firm's "very robust process…of reviewing the data points," including multiple checks and reviews for accuracy. Some PA representatives pointed out that, for S&P 500 firms, they "share draft reports with companies…for fact checking" but noted that these firms—who receive approximately 48 hours to review the report due to time constraints in the process—often highlight their disagreements with PA conclusions instead.

Other criticisms of PAs raised by interviewees, noted in Table 2, include PAs' lack of transparency, unresponsiveness to issuers' concerns, inexperienced staff, and time/energy wasted dealing with PA matters.

Overall assessment of proxy advisors While the prevalence of these concerns in the authors' interview data is consistent with the critiques levied against PAs by issuers and industry groups, when they asked respondents to provide an overall assessment of PAs' impact on the quality of compensation practices, a more nuanced view emerged. Respondents believed that PAs had increased accountability for compensation practices, which has had a positive effect on executive compensation practices. As one compensation consultant put it, PAs shed light on "pay irritants."

Respondents also noted that PA scrutiny motivated issuers to increase their shareholder engagement. For example, reaching out to investors was frequently cited as the immediate response to an unfavorable PA report (and, sometimes, as a proactive step in anticipation of an unfavorable report). Noting this increased shareholder outreach, one director suggested, "What ISS has done is provided a service making companies more transparent," and another director observed, "Communication with shareholders is happening more and more…so that you can understand where your shareholders' heads are, if you will."[11]

Overall, a majority of respondents (20 of the 29 respondents to whom the authors posed this question)—even ones that highlighted areas of shareholder misalignment resulting from PA influence—believed that, from the perspective of shareholders, PAs improve executive compensation design.

Conclusion

Prior research identifies different roles for PAs with some concluding that PAs primarily fulfill an information intermediary role for institutional investors while other studies suggest that PAs' role is primarily to identify and promote "superior" governance and pay practices. The present study demonstrates a more complex role for PAs as they are able to promote their own preferred "best" practices (de facto standard setter), bring key compensation issues to the attention of institutional investors as well as internal stakeholders (agenda setter), and both aggregate shareholders' preferences and provide vote recommendations to institutional investors (information intermediary).

11 Respondents noted that PAs are not the only factor contributing to increased shareholder engagement and highlighted the difficulty of separating PAs' influence from, for example, say-on-pay regulation.

The authors find that boards respond to PA influence by making changes to their compensation design both before and in response to proxy voting, even when such firms are not facing the consequences of PA scrutiny. They also find evidence that boards adopt practices that contradict the firm's compensation philosophy and/or shareholder interests. Importantly, these findings are obtained from internal stakeholders—the individuals that face PA pressure—rather than from other stakeholders such as institutional investors. The interviews with PA representatives indicate that these individuals agree with the intermediary role ascribed to them but not with the de facto standard-setter role.

Overall, the interview data underscore boards' commitment to substantive monitoring and oversight and to designing what they see as reasonable and fair executive compensation packages. However, the influence internal stakeholders perceive from PAs can sometimes prevent them from following through as effective monitors, highlighting a more symbolic role. Hence, in addition to their fiduciary duty to provide effective monitoring and oversight on behalf of shareholders, boards also seem to be concerned about appearing legitimate and adopting "best" practices.

The authors' findings help inform the current debate among regulators and market participants over PAs' "outsized" power and influence and are relevant to US legislators as they consider whether to restrain this power and influence. A panelist of the SEC's roundtable on PAs summarized concerns about the extent and nature of PA influence: PAs—particularly ISS—have the potential to wield a "staggering amount of power" yet are "essentially unaccountable, unregulated…and [have] no actual skin in the game."[12]

Even if PAs endeavor to "do the right thing," this still reflects a structural problem that undermines the ability of the proxy voting system to fulfill its intended corporate governance role. The authors' evidence demonstrates the extent of PAs' power to influence corporate practices, lending validity to this concern. At the same time, the findings also demonstrate the positive influence of PAs, notwithstanding public comments and criticisms to the contrary.

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12 SEC. 2013, December 5. Proxy Advisory Firms Roundtable. Statement of Trevor Norwitz, Partner, Wachtell, Lipton, Rosen & Katz. Available at: www.sec.gov/spotlight/proxy-advisory-services/proxy-advisory-services-transcript.txt

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