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Proxy advisory firms: What they are & why you should care

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Proxy advisory firms provide a valuable service in helping investors make wise choices about their shareholder votes. In addition, by the nature of their industry, proxy advisors are experts in governance, and their recommendations often set the stage for best practices for good governance. Investors rely on proxy firms all year round, not just during proxy season.

Because proxy firms act as consultants for companies and also represent shareholders, a strong potential exists for a conflict of interest. For this reason, boards and investors alike should better understand what proxy advisors are and how they help bridge the shareholder-board divide. To help, this article will explain:

- What proxy advisory firms are, and who pays for them
- Why proxy advisory firms are important
- The most common proxy advisory firms
- How the proxy advisory process is changing
- The value proxy advisors offer boards

What are proxy advisory firms?

Proxy advisory firms uncover risks associated with board proposals and guide their institutional investors about these issues so they can cast more informed votes.

The firms first emerged to provide the knowledge shareholders need around voting times. While shareholders have the opportunity to vote their shares at the annual general meeting, it's not always possible for them to appear in person, making it difficult to assess the specific issues and risks.

Instead, proxy advisory firms provide the information and recommendations investors need to make better voting decisions. Proxy firms have particular influence over key issues like:

- Proxy voting, especially the new universal proxy
- Environmental, social and governance (ESG) proposals
- Executive compensation
- Board recruitment and diversity
- Confirmation of board directors

Who pays for proxy advisory firms?

Investors pay for proxy advisory firms. In exchange for their services, proxy advisors charge fees back to the investors. This means proxy advisors have to prove their value to investors through a track record of impactful voting recommendations.

Why are proxy advisory firms important?

Proxy advisory firms are important because they fill the information gap between companies and their shareholders. They give investors the insights they need to cast informed votes while helping boards set better standards for governance.

Both boards and investors find value in proxy advisors because they:

- **Offer voting recommendations:** Investors don't always have the time and resources to do the proper research or understand the agendas for numerous shareholder proposals to make informed decisions on voting. Instead, proxy advisory firms complete the analysis and offer recommendations for them.
- **Keep up with emerging issues:** Shareholder proposals can now surface throughout the year. In many cases, it makes practical sense for investors to rely on the recommendations of their proxy advisors, who are better informed on the distinctions of current and emerging issues.
- **Serve as governance experts:** Proxy advisors' deep governance expertise has created a broader role in regulation. They're often the first to establish metrics for evaluating corporate governance practices. They were the first to make recommendations for board composition and highlighted the importance of having more women on boards.
- **Advise on ESG issues:** Proxy advisory firms took note of the investor focus on ESG and made companies aware of these principles. As the economic climate ebbs and flows, proxy advisors are the first on alert and are the prime advisors to inform companies and shareholders.
- **Influence board decisions:** Board directors listen to what proxy advisors have to say on many matters. Over 70% of board directors and executive officers stated that they examined the guidelines on executive remuneration by ISS and Glass Lewis before making decisions about their executive remuneration packages.

Who are the major proxy advisory firms?

There are five leading proxy advisory firms in the U.S., but two firms are responsible for roughly 97% of the proxy advisory market. The major proxy advisory firms are:

- Institutional Shareholder Services (ISS)**:** ISS is the U.S.'s largest proxy advisory firm, providing recommendations on 40,000 shareholder meetings each year.
- Glass Lewis & Co**:** The second largest firm in the U.S., it advises on proxy voting for 20,000 shareholder meetings in 100 countries.

- Egan-Jones Proxy Service: A subsidiary of a credit-rating agency, this firm is lesser-known, largely because it doesn't disclose how many meetings it advises.
- Segal Marco Advisors: Formed in 2017, this is one of the newest of the major firms. It has 600 clients and focuses on labor-union multi-employer pension plans.
- ProxyVote Plus: Founded in Illinois, this is the smallest of the major firms, serving an estimated 150 corporations.

The changing proxy advisory process

The proxy advisory process may sound like a win-win; shareholders get deep insights and recommendations on corporate proposals, while boards get critical counsel on governance issues. But the reality is far more complicated.

In recent years, regulators, lawmakers, publicly traded companies and other parties have debated whether proxy advisory firms have too much power. ISS and Glass Lewis, for example, manage thousands of clients and trillions of assets every year.

While proxy advisory firms state that they put the best interests of the shareholders first, representing both shareholders and corporations introduces a strong potential for a conflict of interest. Additionally:

- **Proxy companies are largely unregulated:** They have no requirements for reporting and transparency, making it difficult and even impossible to hold them accountable.
- **Non-clients cannot access any reports and recommendations that the proxy advisors make on the same matters:** There's no way for shareholders or portfolio managers to know how advisory firms made their recommendations or how they get compensated.
- **Internal firewalls may not be enough:** The purported separation between the two sides of the business may not effectively mitigate the conflict of interest. Some would like to see proxy advisory firms have more regulations on them.
- **Proxy advisory firms don't have a fiduciary duty:** They have no clear obligation to act in shareholders' interests. Many firms say they do but lack the transparency to prove they only act in the best interest of investors.

Why are proxy advisory firms losing power?

Proxy advisory firms are losing power because, over the years, they've arguably become *too* powerful. A recent report from the Securities and Exchange Commission noted that Glass Lewis and ISS control an estimated 38% of shareholder votes.

The report states, “Unfortunately, these firms have grown so powerful that they now serve akin to quasi-regulators to capital markets — despite no statutory authority.”

While there’s no clear evidence of how influential proxy advisory firms are on investor voting and board decisions, proxy advisory firms have largely operated outside of common market forces; two firms continue to dominate regardless of their service records.

Proxy advisory firms could continue to lose power or, at the very least, have that power moderated if the SEC and Congress further regulate proxy advisors.

How proxy firms are valuable for boards

Though the role of proxy firms may be changing, they continue to offer valuable insights and counsel to boards across the U.S. Their expertise spans both shareholder sentiment and the business landscape, helping boards keep pace with both current and emerging issues.

Boards can look to proxy advisory firms to:

1. **Uphold good governance:** Proxy advisors are regarded as governance experts. They can help boards identify governance improvements that increase board effectiveness and improve the board-shareholder relationship.
2. **Recommend new initiatives:** Proxy firms largely led the charge on board composition and compensation, ensuring boards remain responsive to the desire among shareholders for greater board diversity and fair remuneration.
3. **Advise on emerging issues:** As shareholders look to ESG, proxy advisory firms have helped boards keep up. Proxy advisors deeply understand what shareholders care about and can help boards stay ahead of changing sentiment on key issues like this.
4. **Share proxy insights:** Shareholder activism is rising, and the universal proxy rule will encourage more shareholders to express their views. Proxy firms keep boards abreast of changing shareholder sentiment, avoiding any surprise proxy fights come proxy season.

Proactively prepare for proxy season

For most companies, the proxy season runs from late April through early June, with a peak week in May. This is when most companies file their proxy statements containing shareholder votes with the Securities and Exchange Commission (SEC) and hold their annual general meetings.

Though it's a season for positive change, it's also a source of enormous stress — and that's without the surprises that shareholder proposals introduce. A strong partnership with a proxy advisor firm can cut down on any shocks, but so can effective preparation.

Download our proxy season checklist to learn the seven-step plan every board needs to prepare for the next annual general meeting.

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