Creating Controversy in Proxy Voting Advice

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NBER Summer Institute 2022, Corporate Finance

July 11, 2022
Background

- **Proxy voting**: M&A, director elections, ESG, executive compensation
  - rise in the number and complexity of proposals to vote on
  - rise in institutional investor ownership

- **Proxy advisory firms**
  - sell research to institutional investors
  - key players: ISS (>60% of the market) and Glass Lewis
  - research report and a binary (often public) vote recommendation
The Procter & Gamble Co. (PG): proxy contest with Trian Fund Management

Vote Recommendation: Vote FOR dissident nominee Peltz

Executive Summary

Trian Fund Management, a 1.5 percent shareholder, seeks to replace one of P&G’s 11 directors. The dissident criticizes the company’s bureaucratic corporate structure, insular culture, and lack of innovation, which it believes to be the root causes of P&G’s long-term underperformance. Seeking to demonstrate that this is a minimally invasive campaign centered on the strength of its candidate’s potential contribution, Trian has proposed only one nominee, Nelson Peltz, who has stated that he would, if elected, seek to immediately reappoint the targeted incumbent, former Mexican President Ernesto Zedillo.

The company argues that Peltz would be a disruptive presence on the board, possibly derailing the execution of management’s turnaround plan under the leadership of CEO David Taylor (who was appointed in November 2015), which has begun to show results.

In analyzing proxy contests, ISS focuses on two central questions:
1. Have the dissidents made a compelling case that change is warranted?
2. If so, which nominees are most likely to drive that change?

Total Shareholder Return (TSR)
P&G is the largest consumer packaged goods (CPG) company in the world, with a market cap more than four times that of most companies in the peer group referenced by both the board and dissident in their investor presentations. Despite the large market gap, the identified peers are also P&G’s direct competitors. As such, they represent a valid peer group for our TSR analysis.

Our TSR analysis focuses on two different periods: A five-year period to evaluate how the board’s actions over the long term have impacted shareholder returns, and a short-term analysis which accounts for the tenure

Special Situations Research delivers comprehensive, independent research on high-profile economic proposals including M&A and proxy contests, and on the implications for shareholders of evolving trends in corporate governance and shareholder rights.

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Private research reports

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September 29, 2017

Discontent Critique

The data does not fully support the claims of various press and so-called experts that ISS is underperforming. ISS’s strong performance over the past several years is evidenced by the numerous accolades that the firm has received from the financial industry, regulatory agencies, and the general public. The data also shows that ISS’s robust performance has been consistent across different markets and industries, and it continues to outperform its peers in terms of both active and passive management. The data further highlights the importance of ISS’s commitment to protecting shareholders and stakeholders, and it demonstrates the firm’s ability to deliver value to clients and investors.

Analytic Framework

In any given context, ISS provides two key considerations: 1. Is Change Warranted? and 2. Which Nominees? 

1. Is Change Warranted?

- ISS’s Total Shareholder Return (TSR) is in line with the industry average, demonstrating that ISS’s performance is in line with the market. The firm’s TSR is comparable to that of its peers, indicating that ISS is not underperforming.
- The data also shows that ISS’s performance is consistent across different regions and sectors, indicating that the firm’s performance is not limited to a specific market or industry.
- ISS’s TSR has outperformed that of its peers, indicating that ISS is a strong performer in the industry.

2. Which Nominees?

- ISS provides a comprehensive and objective analysis of the candidates, ensuring that clients are well-informed about the nominees and their qualifications.
- The data shows that ISS’s nominees have a strong track record of success, with a high likelihood of contributing to the firm’s overall performance.
- ISS’s nominees are well-positioned to deliver value to clients and investors, indicating that ISS is committed to protecting shareholder interests.

ISS Conclusion: Which Nominees?

Given the comprehensive analysis, ISS’s nominees are a strong and well-qualified slate of candidates. The firm has a strong track record of success, and its nominees are well-positioned to deliver value to clients and investors. ISS is committed to protecting shareholder interests, and its nominees are well-positioned to contribute to the firm’s overall performance.

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ISS RECOMMENDS HUNTSMAN SHAREHOLDERS VOTE STARBOARD'S BLUE PROXY CARD

NEWS PROVIDED BY
Starboard Value LP
Mar 14, 2022, 17:04 ET

Concludes that Starboard Has Made a "Compelling Case" That Change is Required on the Board to "Address Concerns with Management Accountability and Ensure That the Interests of Shareholders are Prioritized"
Motivation

• Empirical evidence: ISS has a strong effect on votes
  • Alexander et al. 2010, Ertimur et al. 2013, Iliev and Lowry 2015, Malenko and Shen 2016: 25% effect on say-on-pay votes

• Proxy advisors’ strong influence has led to concerns and regulatory discussions about the quality of their advice

Do proxy advisors have incentives to produce high-quality research reports and recommendations?
Motivation

Proxy advisors face a fundamental conflict of interest:

- maximize profits from information sale
- do not maximize value for asset managers and operating companies
  - otherwise, public recommendations would perfectly represent all their information
  - but then no one would subscribe to their reports

How should proxy advisor design recommendations and research reports to maximize profits from information sale?
This paper

What we do

- Model of strategic voting with a seller of information (proxy advisor)
- Proxy advisor produces two signals ("information design")
  - Private research report - available to subscribers
  - Public vote recommendation - available to everyone
- Each shareholder decides whether to buy the research report
This paper

Main result

- PA will design recommendations to “create controversy”
  - biased against the alternative that is a priori more likely to be value-increasing
    (e.g., biased against management in say-on-pay votes)
  - but will produce precise and unbiased research reports

Intuition

- PA “creates controversy” \( \Rightarrow \) increases the probability of a close vote
  \( \Rightarrow \) increases the value of research report
Model setup
Players

- $N$ shareholders. Each has one share and one vote
  - maximizes value of his share minus info acquisition costs

- Monopolistic proxy advisor
  - maximizes profits from selling information
Proposal to be voted on

- Proposal is accepted if it receives $\frac{N+1}{2}$ or more votes

$$u(\text{Accept}, \theta) = \begin{cases} 1, & \text{if } \theta = 1 \\ -1, & \text{if } \theta = 0 \end{cases}$$

$$u(\text{Reject}, \theta) = 0$$

- PA knows $\theta$; shareholders have prior belief $\Pr(\theta = 1) = \mu$
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- Value to shareholder $i$ is $v_i \times u(\cdot, \theta)$
  - $v_i$ is an i.i.d. private realization
  - shareholders’ interests are aligned, but how much they care about the proposal differs across them
  - differences in compensation, size, or regulatory scrutiny
• Look for symmetric equilibria

• Information design policies are time-consistent
Proxy advisor designs a private signal $R$ ("research report") and a public signal $S$ ("recommendation")

- $R$: how the state maps into research report
  - signal space $R$ and distributions $\phi(r|\theta = 0)$, $\phi(r|\theta = 1)$

- $S$: how the content of research report maps into recommendation
  - signal space $S$ and distributions $\gamma(s|r)$ for each $r \in R$
Optimal information design

1. **Private research report is fully informative**
   - *Intuition:* This maximizes the revenue from fees charged to subscribing shareholders

2. **Public recommendation is not perfectly informative**
   - Either uninformative (no information for free), or informative but biased against the a priori likely alternative
   - *Intuition:* Strategic design of public recommendations increases shareholders’ willingness to pay for private report
Value of subscribing to the report

What is the value of subscribing to the report for shareholder $i$?
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What is the value of subscribing to the report for shareholder $i$?

- If does not subscribe, votes based on recommendation
- If subscribes, votes based on more informative report
- Additional info is beneficial only if his vote makes a difference

$\Rightarrow$ Value of subscribing is $\frac{v_i}{2} \Pr(\text{close vote})$
  - only shareholders with $v_i \geq \bar{v}$ subscribe

How should PA design recommendations to maximize the probability of a close vote?

- for a given $\bar{v}$
Design of recommendations

- Non-subscribers vote based on their posterior belief given the recommendation $\mu_s = \Pr(\theta = 1|s)$
Design of recommendations

- Plot $Pr(\text{close vote})$ for all possible posterior beliefs $\mu_s$.
- Close vote is likely if $\mu_s \approx 0.5$, and unlikely otherwise.
Design of recommendations

- Possible ways to design recommendations:

  - **Fully informative**: $\mu_{for} = 1; \mu_{ag} = 0 \Rightarrow \Pr(\text{close vote}) = 0$
Possible ways to design recommendations:

- **Uninformative:** $\mu_s = \mu \Rightarrow \Pr(\text{close vote})$ is large for $\mu \approx 0.5$
Possible ways to design recommendations:

- **Uninformative:** \( \mu_s = \mu \Rightarrow \Pr(\text{close vote}) \) is small for large \( \mu \)
Design of recommendations

- Bad proposal: always recommend “against”
- Good proposal: both “for” and “against” (creating controversy)
Design of recommendations

- Close vote occurs upon “against” recommendations
- Shareholders are rational ⇒ can’t recommend “against” too often
Design of recommendations

- Close vote occurs upon “against” recommendations
- Shareholders are rational \( \Rightarrow \) average posterior equals prior
Implications
Rubberstamping

- Shareholders will
  - rubberstamp recommendations that go along their priors
  - not rubberstamp recommendations that contradict their priors
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- Say-on-pay votes (Malenko and Shen, 2016):

- Same for uncontested director elections (Ertimur et al., 2018)
Information content of reports and recommendations

Do reports contain different information than recommendations?

- Advisor does not “lie”: report provides more nuanced information

Ertimur, Ferri, and Oesch (2013, 2018): Reports upon negative ISS recommendations differ in how severe the concerns are.

Survey of large asset managers by Bew and Fields (2012): Institutions value the reports, value of recommendations is "distinctly secondary".
Do reports contain different information than recommendations?

- Advisor does not “lie”: report provides more nuanced information

- Ertimur, Ferri, and Oesch (2013, 2018):
  - Reports upon negative ISS recommendations differ in how severe the concerns are
  - More severe concerns in the report $\Rightarrow$ more votes against

- Survey of large asset managers by Bew and Fields (2012):
  - Institutions value the reports
  - Value of recommendations is “distinctly secondary”
One-size-fits-all approach

“Controversy” can be implemented via the one-size-fits-all approach
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Overboarded Directors: Generally vote against or withhold from individual directors who:
- Sit on more than five public company boards; or

- Many directors with $>5$ seats can be value-increasing
  - report will contain information about qualifications
- Without reading the report, shareholders don’t know the reason for negative recommendation $\Rightarrow$ vote is close
Reinterpretation of empirical evidence

- Votes of major asset managers are often more “pro-management” than ISS recommendations (Bubb and Catan, 2021; Bolton et al., 2020, Brav et al., 2022)
- Sometimes interpreted as evidence of pro-management bias of large asset managers
- The paper suggests a reinterpretation:
  - proxy advisors’ recommendations may not be the right benchmark
  - can be biased against management to create controversy
Conclusion

- Optimal design of research report and recommendations by a profit-maximizing proxy advisor
- Advisor designs recommendations to “create controversy” but produces unbiased and informative reports
- Reinterpretation of the empirical voting patterns