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

Private research reports

ISS Special Situations Research

Analysis

September 29, 2017

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 cap gap, the identified peers are al so 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.

Record Date	Aug. 11, 2017
Meeting Date	Oct. 10, 2017

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September 29, 2017

Historical Performance—Financial Metrics

	FY 2017 6/30/2017 (mils)	FY 2016 6/30/2016 (mils)	FY 2015 6/30/2015 (mils)	FY 2014 6/30/2014 (mils)	FY 2013 6/30/2013 (mils)	FY 2012 6/30/2012 (mils)	Two-Year CAGR	Five-Year CAGR
Market Cap	$ 222,896	$ 225,379	$ 212,265	$ 212,661	$ 211,012	$ 167,831	2.5 %	5.8 %
Income Statement								
Revenue	$ 65,058	$ 65,299	$ 70,749	$ 80,510	$ 82,581	$ 83,680	(4.1)%	(4.9)%
COGS	$ 32,535	$ 32,909	$ 37,056	$ 41,010	$ 41,391	$ 42,391	(6.3)%	(5.2)%
SG&A	$ 16,694	$ 17,049	$ 18,616	$ 22,760	$ 24,552	$ 24,421	(5.3)%	(7.3)%
R&D Expense	$ 1,874	$ 1,900	$ 2,000	$ 2,000	$ 2,000	$ 2,000	(3.2)%	(1.3)%
EBITDA	$ 16,775	$ 16,519	$ 14,183	$ 17,881	$ 17,312	$ 16,496	8.8 %	0.3 %
Adjusted EBITDA	$ 17,174	$ 17,534	$ 18,406	$ 19,130	$ 18,215	$ 19,113	(3.4)%	(2.1)%
Operating Income	$ 13,955	$ 13,441	$ 11,049	$ 14,740	$ 14,330	$ 13,292	12.4 %	1.0 %
Net Income	$ 15,326	$ 10,508	$ 7,036	$ 11,643	$ 11,312	$ 10,756	47.6 %	7.3 %
EPS (Adjusted)	$ 3.89	$ 3.76	$ 4.08	$ 4.14	$ 4.03	$ 3.86	(2.3)%	0.2 %
Balance Sheet								
Cash & ST Investments	$ 15,137	$ 13,348	$ 11,612	$ 10,686	$ 5,947	$ 4,436	14.2 %	27.8 %
Total Debt	$ 31,592	$ 30,598	$ 30,350	$ 35,417	$ 31,543	$ 29,778	2.0 %	1.2 %
Shareholder's Equity	$ 55,778	$ 57,983	$ 63,050	$ 69,976	$ 68,709	$ 64,035	(5.9)%	(2.7)%
Cash Flow								
Operating Cash Flow	$ 12,753	$ 15,435	$ 14,608	$ 13,958	$ 14,873	$ 13,284	(6.6)%	(0.8)%
Capex	$ (3,384)	$ (3,314)	$ (3,736)	$ (3,848)	$ (4,008)	$ (3,964)	(4.8)%	(3.1)%
Free Cash Flow	$ 9,369	$ 12,121	$ 10,872	$ 10,110	$ 10,865	$ 9,320	(7.2)%	0.1 %
Margins and Return Ratios							Change (ppt)	Change (ppt)
Gross Margin	50.0 %	49.6 %	47.6 %	49.1 %	49.9 %	49.3 %	2.4	0.6
EBITDA Margin	25.8 %	25.3 %	20.0 %	22.2 %	21.0 %	19.7 %	5.7	6.1
Adjusted EBITDA Margin	26.4 %	26.9 %	26.0 %	23.8 %	22.1 %	22.8 %	0.4	3.6
Operating Margin	21.5 %	20.6 %	15.6 %	18.3 %	17.4 %	15.9 %	5.8	5.6
Return on Assets	12.4 %	8.2 %	5.1 %	8.2 %	8.3 %	7.9 %	7.2	4.4
Return on Common Equity	27.8 %	17.5 %	10.5 %	16.9 %	17.1 %	16.3 %	17.3	11.4
Return on Invested Capital	11.9 %	10.5 %	8.0 %	10.8 %	10.9 %	9.5 %	3.8	2.3

Source: Bloomberg Finance LP

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Dissident Critique

The dissident argues that despite a decade of turnaround promises and portfolio changes, P&G is still experiencing market share losses and continues to be characterized by suffocating bureaucracy, aging brands, and lack of innovation. The dissident argues that this negative scenario is made worse by a complacent board that has failed to articulate a consistent and effective long-term strategy, and that has appeared content to reward management for sustained corporate underperformance relative to peers.

The dissident proposes a corporate restructuring plan designed to reduce red tape and streamline decision making, change the company's insular culture, align management compensation with market share gains, and focus on innovation to revitalize P&G brands.

In order to quell concerns, the dissident states that it is not advocating for a break -up of the company, nor suggesting that the CEO be replaced, nor suggesting cost cuts in R&D or marketing, nor proposing that the company take on excessive margin. The dissident also notes that it is not even attempting to replace a director, as it will seek to reappoint incumbent director Ernesto Zedillo to the board if Trian CEO Nelson Peltz is elected in his place.

Company Performance

The dissident reports that P&G underperformed the average return of a dissident-selected peer group by 4 percent over one year, 9 percent over two years, 25 percent over three years, 37 percent over four years, 51 percent over five years,

Peers
Beiersdorf
Church & Dwight
Clorox
Colgate-Palmolive
Edgewell
Henkel
Kimberly-Clark
L'Oreal
Reckitt Benckiser
Unilever

	Periods 1-Year	2-Year	3-Year	4-Year	5-Year	10-Year
Top performer	42%	68%	76%	97%	175%	403%
Peer Average	15%	32%	48%	67%	118%	210%
S&P 500	21%	28%	35%	64%	102%	97%
S&P 500 Consumer Staples	10%	27%	39%	56%	90%	171%
P&G	11%	23%	24%	30%	67%	93%
Number of peers that outperformed P&G (out of 10 peers)	5	8	8	10	10	9

Source: Dissident's white paper.

and 117 percent over 10 years. P&G's performance was among the bottom three over all periods other than one year. The dissident believes that this underperformance represents compelling evidence as to the ineffectiveness of the P&G organizational structure and the company's lack of innovation.

Operational Performance

According to the dissident, P&G organic sales CAGR (compound annual growth rate) since 2011 has significantly underperformed peers. While the peer average was 3.7 percent, P&G posted the second worst organic sales growth of just 2.3 percent.

The dissident reports that P&G market share is down in 68 percent of the top 20 country-categories. The dissident also notes that P&G has lost market share in each individual category on a global basis over the past three- and five-year periods.

The dissident argues that this has resulted in core EPS growth below peer average. P&G core EPS declined by a 0.1 percent compound annual rate from 2011 to 2017 while peers grew on average at a 7.4 percent CAGR. The dissident also contests the idea that adverse currency exposure has been the main driver of P&G's EPS underperformance, as peers such as Colgate-Palmolive and Kimberly-Clark grew EPS at a faster rate despite facing more significant currency headwinds. If cumulative EPS is analyzed over the same 2011-2017 period, P&G's EPS declined 1 percent in the face of an 18 percent negative FX impact on sales. Over the same period, Colgate-Palmolive grew EPS 18 percent in the face of a 29 percent negative FX impact on sales, while Kimberly-Clark grew EPS 36 percent in the face of a 19 percent negative FX impact on sales. The dissident also argues that a portion of the EPS growth in FY2017 was due to a $125 million cut in advertising spend. The dissident characterizes this cut as a benefit to near-term earnings at the expense of long-term growth.

According to the dissident, as revenue and earnings growth have stalled, the dividend per share growth has become unappealing and the payout ratio has become the highest in the industry. From 2011 to 2017, P&G grew dividends by 37 percent while the payout ratio moved from 50 percent to 69 percent. By comparison, peers grew

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Analytic Framework

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?

When the dissidents are seeking a minority position on the board, ISS does not require a detailed plan of action, nor that the dissidents prove their plan is preferable to the incumbent plan. Instead, ISS will require that dissidents prove that change is preferable to the status quo and that the dissident slate will add value to board deliberations of the issues at hand.

1. Is Change Warranted?

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 cap gap, the identified peers are al so 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 of the current CEO.

TSR over the five-year period ending Feb. 13, 2017 (the last trading day before the dissident made its position in the company public) was 58.9 percent, which was 54.5 percentage points below peer median and 27.3 percentage points below the S&P 500 Consumer Staples Index. Extending the analysis through Sept. 25, 2017, when this report was being prepared, the company's absolute performance improved to 69.4 percent. The company's relative underperformance improved slightly, to 54.0 percentage points worse than peer median and 23.2 percentage points worse than the index.

Total Shareholder Return	Five-Year: Through Unaff. Date 2/13/2017	Five-Year: Extended Through 9/25/2017	CEO Tenure (Since Nov. 1, 2015): Through Unaff. Date 2/13/2017	CEO Tenure (Since Nov. 1, 2015): Extended Through 9/25/2017
Procter & Gamble	58.9%	69.4%	20.0%	28.0%
Peer Median	113.4%	123.5%	6.3%	12.9%
S&P 500 Cons Staples Idx	86.2%	92.7%	10.5%	14.3%
Procter & Gamble B/(W)				
Peer Median	(54.5)	(54.0)	13.7	15.1
S&P 500 Cons Staples Idx	(27.3)	(23.2)	9.5	13.6

Source: Bloomberg Financial L.P. Peers include Beiersdorf Ag, Church & Dwight Co Inc, Clorox Company, Colgate-Palmolive Co, Edgewell Personal Care Co, Henkel Ag & Co Kgaa, Kimberly-Clark Corp, L'Oreal, Reckitt Benckiser Group Plc, Unilever Plc.

This negative picture changes when the current CEO tenure is analyzed. TSR from Nov. 1, 2015 (the date current CEO David Taylor started his tenure) through Feb. 13, 2017 was 20.0 percent, which was 13.7 percentage points above peer median and 9.5 percentage points above the S&P 500 Consumer Staples Index. Extending the analysis through Sept. 25, 2017, the company's absolute performance improved to 28.0

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September 29, 2017

board's uneven performance over the course of the last decade, the potential reward of adding new perspective and experience from Peltz seems, on balance, to exceed the possible risks of disruption in the boardroom.

2. Which Nominees?

Director nominees

The dissident has nominated the following candidate:

> **Nelson Peltz**, 75, is the CEO and a founding partner of Trian (2005). Previously, from April 1993 through June 2007, Peltz served as Chairman and CEO of Triarc Companies, Inc. which during that period of time owned Arby's Restaurant Group, Inc. and the Snapple Beverage Group. From 1983 to 1988, he was Chairman and CEO of Triangle Industries, Inc. Peltz serves as the non-executive Chairman of The Wendy's Company and is a director of Mondelez International, Inc., Sysco Corporation, and The Madison Square Garden Company. He previously served as a director of H. J. Heinz Company from 2006 to 2013, Legg Mason, Inc. from 2009 to 2014 and Ingersoll-Rand plc from 2012 to 2014.

The dissident has targeted the following incumbent for removal (although has also committed to seek to re-nominate Zedillo to the board if the dissident is elected):

> **Ernesto Zedillo**, 65, has served as a member of the board since 2001. He was the President of Mexico from 1994 to 2000 and currently serves as Director of the Center for the Study of Globalization and Professor of International Economics and Politics at Yale University. He has been a Director of Alcoa, Corp. since 2002 and Citigroup, Inc. and Promotora de Informaciones S.A. since 2010. Previously, Zedillo served on the audit committee of Union Pacific and as the Secretary of Economic Programming and the Budget for Mexico, as well as having held various positions at the Banco de Mexico.

According to the dissident's proxy, if elected as a director of P&G, Peltz intends to resign from at least one of the four boards on which he currently serves.

ISS Conclusion: Which Nominee?

Given his extensive CPG experience, and his firm's analytical capability and significant portfolio exposure to P&G, Peltz appears far more like a vested shareholder who could help the board look around the next corner and avoid future missteps than simply a "what's the harm" addition.

Although shareholders are recommended to support Peltz's election, we recognize that the removal of targeted incumbent Ernesto Zedillo is not a cost-free option. For a company with extensive global presence (operations in approximately 70 countries), a former Mexican president is obviously a significant asset to the board, especially considering recent developments such as the crisis in Venezuela. Peltz has prudently acknowledged this issue by promising to seek to re-nominate Zedillo to the board if he is elected.

Vote Recommendation

Trian presents a compelling case that a limited degree of boardroom change would be beneficial. The addition of one well-qualified nominee, who holds a large economic stake, appears likely to have benefits that outweigh the potential risks. Support for dissident nominee Peltz is recommended.

Public recommendations

ISS RECOMMENDS HUNTSMAN SHAREHOLDERS VOTE STARBOARD'S BLUE PROXY CARD

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

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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

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

- PA knows θ; shareholders have prior belief $\Pr\left(\theta = 1\right) = \mu$

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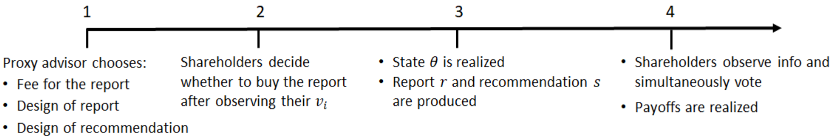
$$u\left(Reject, \theta\right) = 0$$

- PA knows θ; shareholders have prior belief $\Pr\left(\theta = 1\right) = \mu$
- Value to shareholder i is $v_i \times u\left(\cdot, \theta\right)$
    - 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

Timeline



- Look for symmetric equilibria
- Information design policies are time-consistent

Information design

Proxy advisor designs a private signal $\mathcal{R}$ ("research report") and a public signal $\mathcal{S}$ ("recommendation")

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

Value of subscribing to the report

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 $\frac{v_i}{2} \Pr(\textit{close vote})$

- only shareholders with $v_i \geq \bar{v}$ subscribe

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

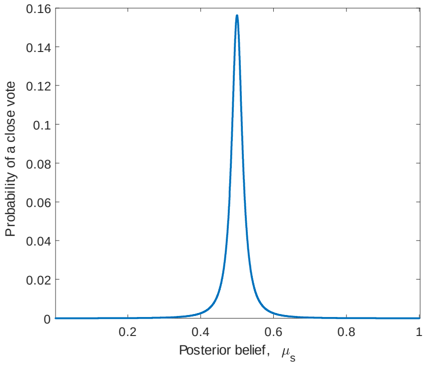
- for a given $\bar{v}$

Design of recommendations

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

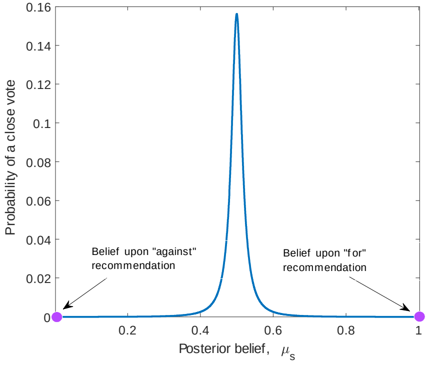
Design of recommendations

- Plot Pr(close vote) for all possible posterior beliefs μ_s
- Close vote is likely if $\mu_s \approx 0.5$, and unlikely otherwise



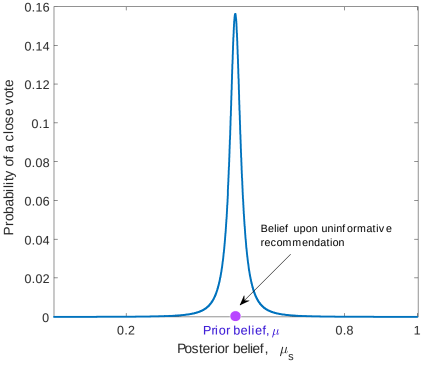
Design of recommendations

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



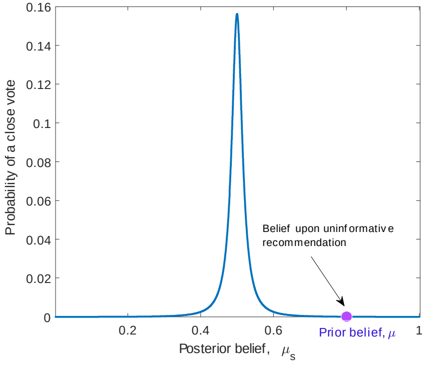
Design of recommendations

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



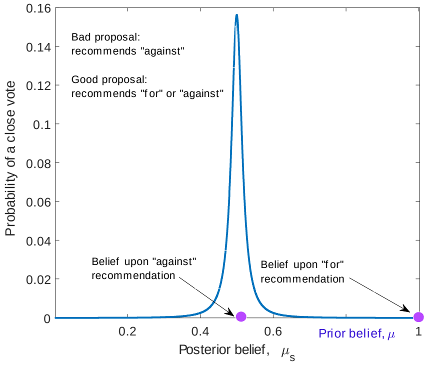
Design of recommendations

- Possible ways to design recommendations:
- **Uninformative**: $\mu_s = \mu \Rightarrow$ Pr(close vote) is small for large μ



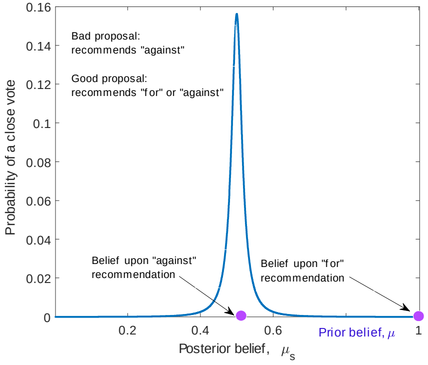
Design of recommendations

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



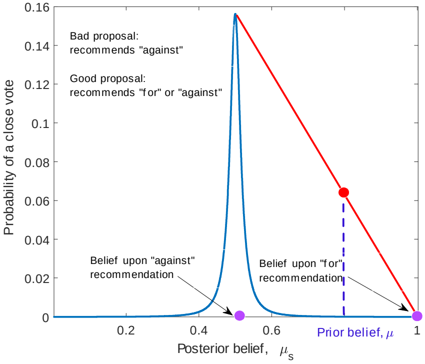
Design of recommendations

- Close vote occurs upon "against" recommendations
- Shareholders are **rational** $\Rightarrow$ can't recommend "against" too often



Design of recommendations

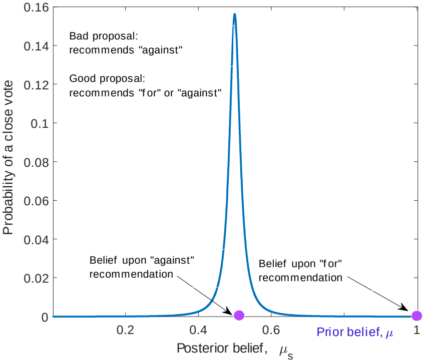
- Close vote occurs upon "against" recommendations
- Shareholders are **rational** $\Rightarrow$ average posterior equals prior



Implications

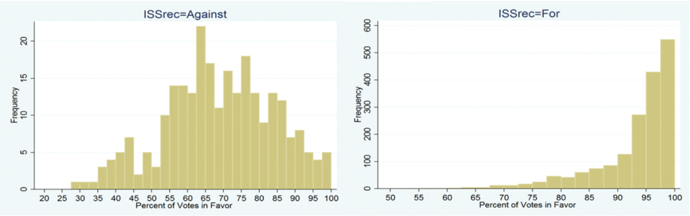
Rubberstamping

- Shareholders will
  - rubberstamp recommendations that go along their priors
  - not rubberstamp recommendations that contradict their priors



Rubberstamping

- Shareholders will
  - rubberstamp recommendations that go along their priors
  - not rubberstamp recommendations that contradict their priors
- 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

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
  - 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

One-size-fits-all approach

"Controversy" can be implemented via the one-size-fits-all approach

UNITED STATES
PROXY VOTING GUIDELINES

ISS

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