Proxy advisers have inherent incentive to create controversy, study shows

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When an institutional investor uses recommendations from a proxy adviser to cast a vote on shareholder issues, they may want to proceed with caution.

Professional proxy advisory firms have an incentive to publicly recommend a vote contrary to what company management proposes, according to a new study by Nadya Malenko and Andrey Malenko, associate professors of finance at the University of Michigan's Ross School of Business.

That doesn't necessarily mean the advisers make misleading recommendations, but it does suggest investors should be aware of the situation, they argue.

Proxy advisers are firms that analyze proposals to be voted on by a company's shareholders, and then sell their analysis to the shareholders. Although they have existed since the 1980s, they have become more prominent lately due to the rise of institutional investors, which have large portfolios and need the proxy advisers' services.

At the same time, proposals to be voted on have become more complex, Nadya Malenko says.

The detailed research reports that proxy advisers provide to their clients are private, but their bottom-line recommendations on how to vote often become public knowledge through the media.

In earlier research, Nadya Malenko found proxy advisers are directly responsible for moving an average of 25% of the votes on proposals related to executive compensation. Whether this strong influence should be a concern depends on the quality of proxy advisers' advice, she says.

"If they're providing informative research and recommendations, that's great because they are making voters more informed. But if the quality of advice is poor, then this influence is concerning," she said.

The Malenkos' paper focuses on a fundamental conflict: Advisers'

research reports are more valuable to the shareholders if the outcome of the vote is uncertain. Therefore, proxy advisers have an incentive to make recommendations that are "controversial" and go against what the company proposes, Nadya Malenko says.

"If we think about their business model, they are sellers of information. They get their profits from selling their research to shareholders," she said. "By biasing their recommendations against the more likely alternative, proxy advisers give shareholders more incentives to invest in information."

She says the new findings do not necessarily mean that advisory firms actually make bad recommendations in practice.

"This is a theory paper; it highlights that this problem, this fundamental conflict of interest, exists," she said. What we cannot say is whether this is really driving recommendations. We hope the next step for empirical research will be to investigate that."

Meanwhile, however, the research could lead to reforms to address the conflict of interest.

"We hope our paper will create useful conversation," Nadya Malenko said. "One possible policy implication is to not allow these public recommendations. The proxy advisers' report could offer all the analysis, but would not conclude with a proscriptive recommendation to vote yes or no. It's not necessarily an optimal solution, but under certain circumstances it could help."

The research is available as a working paper online in the *SSRN Electronic Journal*

More information: Andrey Malenko et al, Creating Controversy in

Proxy Voting Advice, *SSRN Electronic Journal* (2021). DOI: 10.2139/ssrn.3843674

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