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Shareholder Activism: Why Should Investors Care?

RESEARCH STRATEGY & ANALYSIS

Shareholder Activism: Why Should Investors Care?*

FILIP BEKJAROVSKI
TSE PhD student
Amundi Research

MARIE BRIÈRE
Amundi Research

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Abstract

Institutional investors have large and diversified portfolios with substantial company ownership and strong incentives to monitor and influence the firm's business. Active ownership is becoming a key component of their investment process. We describe the various channels though which shareholders can challenge corporate decision making, including the ones most favored by institutional investors: voting at general meetings and behind the scene engagement, and we survey evidence on their effectiveness.

Overall, empirical findings in the literature are consistent with the view that active ownership is profitable to active owners and beneficial. Both financial and ESG performance of targeted firms tends to improve following successful engagement. Active ownership, even if leading to substantial costs in some cases, can be profitable to active owners.

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I. The role and roots of shareholder activism

Shareholder activism refers to **investors' influence on firms' policy** though the use of an ownership position. Gillan and Starks (2007, p. 55) define active shareholders as "investors who, dissatisfied with some aspect of a company's management or operations, try to bring about change within the company without a change in control." Tirole (2006, p. 27) states that active monitoring "consists in interfering with management in order to increase the value of the investors' claims."

The need for activism is rooted in the **separation between firm ownership and control** (Jensen and Meckling, 1976). Intuitively, managers have their own interests which can diverge from those of shareholders. The issue cannot be completely addressed via contracts as there is an underlying inability to foresee all future contingencies (Shleifer & Vishny, 1997). Moreover, monitoring is costly and all contract clauses may not be easily enforceable in court. Consequently, managers retain residual rights of control as financiers are not informed extensively about everyday firm operation. Shareholder supervision is thus necessary to ensure the proper functioning of modern corporations.

Environmental and social activism is often motivated by a **misalignment of preferences between shareholders and management**[1]. In the presence of externalities generated by the firms, it is often in investors' interest to minimize the potential costs of those externalities by influencing the firms' businesses. Large institutional investors who own diversified and long-term portfolios, are often universal owners, with substantial equity stakes (Mattison et al., 2011). This makes them exposed to the risks of large externalities resulting from environmentally and socially irresponsible firm behaviour.

Shareholder activism finds its origin in the 1930s. After the Great Depression, a number of laws were passed to reform the governance of businesses. However, shareholders found these laws inadequate and initiated actions to force companies' management to effect change. For example, in 1949, the Association of Independent Telephone Unions bought shares of American Telephone and Telegraph as a bargaining tool to address the pension benefit cut. Most of these activist actions were ineffective. Dissatisfied shareholders would rather "vote with their feet"; i.e. divest the companies than challenge management.

In the 1970's, shareholder activism was revitalized. First, the Securities and Exchange Commission (SEC) adopter a **rule (Rule 14a-8 of the Securities Exchange Act of 1934) allowing shareholders of public companies to submit proposals**. Second, institutional ownership grew rapidly over that period. Large pension funds, but also mutual funds and hedge funds, started to be more active. CalPERS (California Public Employees' Retirement System)

[1] *We focus here on shareholder activism, as bondholder activism is a less common practice (Gao, 2009)*

was one of the first pension funds to initiate an active ownership policy (Smith, 1996), initiating discussion with the management of companies, filing proxy proposals, or even launching public campaigns (for example through press releases) to force companies to change their policy.

In 2003, the US Securities and Exchange Commission (SEC) made a new step in **requiring mutual funds to disclose how they vote on proxy proposals presented at shareholder meetings**. This new rule followed the 2001-02 corporate scandals and a series of federal government intervention into firm's corporate governance in the Sarbanes-Oxley Act.[2] Mutual funds were criticized for having potential conflicts of interests with their portfolio firms (business relations, pension plan management, etc.). The objective was to increase their engagement in firms' governance and to improve transparency.

II. The various forms of shareholder activism

Effecting change is easier for majority shareholders (or groups with controlling interest) as the threat of managerial replacement is credible. But dispersed shareholders also have a range of tools at their disposal to challenge management when displeased with corporate policy. Shareholder activism can take various forms: (1) **exit** (sell shares, take an offsetting bet), (2) **vote** (form coalition/express dissent/call back lent shares), (3) **engage** behind the scene with management and the board, (4) **voice** displeasure publicly (in the media), (5) **propose** resolutions (shareholder proposals) or (6) **initiate** a takeover (acquire a sizable equity share). We first describe the channels before surveying evidence on their effectiveness.

Exit

Shareholders that are dissatisfied with firm policy can choose to sell their shares. On first impression, exit seems to be inconsistent with the entire concept of shareholder activism. Coffee (1991) even argues that market liquidity and the ability of investors to easily sell shares has had a detrimental impact on corporate governance. However, the *threat* of exit has the potential to reduce agency costs (Admati & Pfleiderer, 2009). **Large shareholders can threaten to sell company shares** and therefore drive down stock prices. If managerial compensation is tied to stock prices, then managers can personally be affected. For the channel to work however, the threat of exit must be credible. In reality, this may not always be the case as investors often face fixed exogenous commitments to firm investments and may encounter considerable transaction costs to achieve exit. Additionally, the threat must be seen as a source of new negative information by the market in order to affect prices.

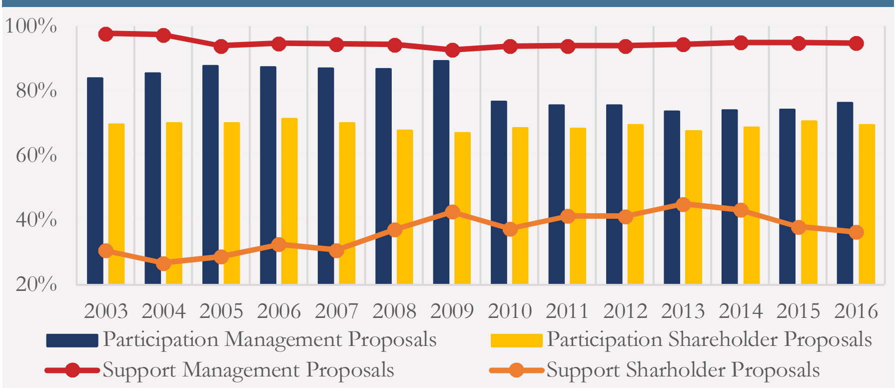
[2] *The Sarbanes-Oxley Act imposed among other things new financial control and reporting requirements (for example to strengthen audit committees, perform internal control tests, set personal liability of directors for the accuracy of financial statements, etc) on publicly listed companies.*

Survey results suggest that exit due to poor performance is quite common and has been **used by 49% of institutional investors** (McCahery, Sautner & Starks, 2016). Moreover, 39% of survey participants indicated they have used exit as a response to governance concerns. Overall, **funds with shorter holding horizons and smaller ownership stakes are more likely to 'vote with their feet'** (Duan & Jiao, 2016). Intuitively, funds with short holding horizons have a comparative advantage in exit and trading on performance related information. A large ownership stake on the other hand, implies higher liquidity constraints and greater benefits from successful active engagement.

Vote

Voting at general meetings is another way to influence companies' decisions. Voting participation is relatively high in the US for both management (between 74% and 89%) and shareholder sponsored proposals (between 67% and 71%) (Figure 1). High participation can be attributed to the fact that **mutual funds**, who hold between a quarter to a third of US shares in the past decade (Duan & Jiao, 2014), **have a fiduciary duty in the US to cast votes in the best interest of shareholders** (Morgan, Poulsen, Wolf & Yang, 2011). In general, institutional investors vote on 90% of their shares. They can easily cast votes trough the platforms of proxy advisory agencies such as ISS. Retail investors, who have limited access to voting platforms and are not required to cast votes, make use of only a third of their votes (Fisch, 2017).

1 - Evolution of support and participation



The participation rate is the ratio of shares voted for and against relative to the number of shares outstanding. The support rate is the ratio of shares voted 'for' relative to the company specific denominator base. The most common denominators are 'for + against' (73%) and 'for + against + abstain'' (22.7%). Data comes from 'Company vote results data' (ISS Voting Analytics) which tracks management sponsored and shareholder governance sponsored resolutions on SP1500 firms. In total there are 370917 voted resolutions in the data.

Source: Amundi Reseach

Support rates tend to be very high for management sponsored proposals (Figure 1). Support for shareholder sponsored resolutions is on the rise compared to the previous decade. Nevertheless, there is considerable variation in support between resolutions. Routine votes such as the ratification of auditors receive very high support rates (98.3%). On the other hand, even common issues such as declassifying the board of directors, can be quite contentious (average support of 81%).

Analysing funds voting behaviour has become easier since the SEC required mutual funds to publicly disclose their voting records in 2003. The empirical evidence suggests that the most common voting pattern of institutional investors is to **support board independence, oppose takeover defences and oppose unequal voting rights** (dual class shares) (Appel, Gormley, & Keim, 2016). Subsequent research revealed that **funds with lower costs and higher benefits of voting** (i.e. larger, more concentrated funds and funds with lower turnover) **are more inclined to have an independent voting policy** and to depart from proxy advisors' recommendations (Iliev & Lowry, 2014). Mutual funds also tend to vote in support of shareholder proposals that are thought to be wealth increasing (such as board, governance, compensation proposals) and their support increases the probability that a proposal will pass and see implementation (Morgan, Poulsen, Wolf, & Yang, 2011).

Engage behind the scene

Behind the curtain engagement involves private communication between activist shareholders and the firm's board or management, that tends to precede public measures such as vote, shareholder proposals[3] and voice. In a sense, the existence of other forms of public activism can be taken as a signal that behind the scene engagements were unsuccessful. When it comes to environmental and social issues, writing to the board or management is a common method though which shareholders can express concern and attempt to influence corporate policy behind the curtain; alternatively, face to face meetings with management or non-executive directors are a more common behind the scene engagement method when it comes to governance (McCahery, Sautner & Starks, 2016; Barko, Cremers & Renneboog, 2017). Needless to say, behind the scene engagement is difficult to measure. However, surveys and proprietary databases can help shed some light on the prevalence and effectiveness of the channel. Early work suggested that private communication with management is taken extensively by hedge funds (Brav et al. 2008). More recently, McCahery, Sautner and Starks (2016) find that **65% of their survey participants, that represented a broad group of institutional investors, have had direct discussions with management**

[3] *There are numerous cases, especially in the US, where shareholder proposals are tabled first which subsequently opens the door to negotiations with management.*

in the past five years. Similarly, 45% of survey participants indicated that they have had a private discussion with the board without the presence of management. This suggests that behind the scene engagement is common among a broader group of institutional investors.

Voice concerns publicly

Survey results suggest that public criticism is rarely used by institutional investors (13%) (McCahery, Sautner & Starks, 2016). Even if public criticism, for example through the media, can help with coordination and awareness, investors fear to lose their leverage (the threat) when they display dissent publicly (Solomon, Soltes, & Sosyura, 2014; Aggarwal, Erel, & Starks, 2015).

Media attention seems to influence the voting policy of institutional investors. Aggarwal, Erel, & Starks (2015) examine the relation between voting and media coverage in the period encompassing and surrounding the great financial crisis. They find that more contentious shareholder proposals gained more support during the crisis, with the biggest spike in the first proxy season. Moreover, institutional investors were less likely to support management proposals and to follow the vote recommendation of ISS. The change in public opinion that occurred during the crisis seems to have induced investors to form more independent views from those of proxy advisors and to support more shareholder proposals and less management.

Propose a resolution

In the US, proposing a resolution is a relatively cheap tool for shareholder activism[4] (Ferri, 2012). Shareholders who hold either 2000$[5] worth of company stock or 1% of company shares can submit a proposal (SEC rules 14a-8). In Europe, the threshold allowing to table a resolution varies by country. It is 5% of the firm's issued capital in the UK, 5% of the voting capital in France, 1% of the voting capital or €70,000 in Austria, 1% or €50 million of the firm's shares and certificates in the Netherlands, and CHF 1 million of the issued share capital in Switzerland. In Germany, Sweden, Norway, Finland, all shareholders having at least a single share can submit a proposal.

Shareholder proposals come from a variety of investors. Data from ISS Voting Analytics suggests that individual shareholders tend to submit the highest proportion of proposals (10.5%). Unions and pension funds are also relatively active (7.0% and 4.9% of proposals tabled respectively). In survey results, only **16% of institutional investors indicated using shareholder proposals as a tool** (McCahery, Sautner & Starks 2016). Overall, it seems that shareholder proposals tend to be rare among institutional investors.

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[4] *Costs are indirect and vary extensively depending on the degree and sophistication of legal counsel needed by the proposing shareholder.*

[5] *The required minimum amount must be held continuously for a year. The rule is placed to favors proposals from long-term investors.*

Table 1: Shareholder proposal support (2006 - 2016)		
Vote Results	% of proposed shareholder resolutions	Average Support
Voted	74.2%	64.8%
Majority Supported	44.2%	93.6%
Not Supported	30.0%	22.4%
Other (not voted)	25.8%	/

The occurrence of outcomes relative to total is indicated with '% of total'. Support is the average percentage of votes that were cast for a proposal. Data comes from the 'Shareholder proposals' database (ISS Voting Analytics) that covers resolutions on SP1500. Results are based on analysis of 21459 votes.

Approximately a quarter of shareholder proposals are never voted (because they are withdrawn before the vote for example). Almost a third of shareholder proposals don't receive majority support. Average support for voted shareholder proposals is 64.8% (Table 1). Overall, **mutual funds tend to vote against shareholder proposals; with relatively more support for resolutions on governance issues** (Morgan, Poulsen, Wolf, & Yang, 2011). **Social funds with low turnover ratios are more supportive of shareholder proposals** (Morgan, Poulsen, Wolf, & Yang, 2011).

Proposing a resolution does not have the same legal consequences across countries. **In the US, shareholder proposals that receive majority vote support are not binding**. It is up to the board to decide whether to proceed with implementation. Proposals supported by a majority of shareholders on the other hand, are **legally binding in the UK and most of Continental Europe except for the Netherlands** (Cziraki, Renneboog, & Szilagyi, 2010).

For the company, choosing not to implement a majority supported shareholder proposal can have consequences. Proxy advisory agencies, governance rating agencies and shareholder activists explicitly screen firms and directors based on their responsiveness to majority voted proposals (Ertimur, Ferri and Stubben, 2010). Unresponsive firms can trigger disapproval from proxy advisory agencies. For example, ISS has a policy to provide vote recommendations against incumbent directors for firms that do not implement proposals (Bach & Metzger, 2016). Similarly, the Council of Institutional Investors (CII), which represents the interest of a wide variety of American pension funds, asks CEOs what actions they took after a shareholder proposal has obtained "majority support". Boards singled out by CII may then be the target of coordinated "vote-no" campaigns in subsequent director elections. Moreover, majority vote support on shareholder resolutions can affect corporate behaviour through investors pressure on the firm by publicizing the issue and placing voting pressure through defiant voting on alternative resolutions. In other words, an unresponsive firm can trigger a dissent campaign (Bach, & Metzger, 2014). Moreover, even when shareholder proposals don't win, they can be a useful tool to signal dissatisfaction with management. In recent years, boards have become significantly more likely to implement non-binding, majority-vote (MV) shareholder proposals. While only 16.1% of non-binding proposals were implemented in 1997, this number rose to 40% in 2004 (Ertimur, Ferri and Muslu, 2010).

Companies can also challenge shareholder proposals before they are voted. The SEC administers a 'no-action'[6] system that enables companies to omit shareholder proposals that do not meet certain hurdles. Proposals approved for omission usually relate to 'personal interests' of the submitting shareholder and 'ordinary business operations' that are small in terms of sales or at the discretion of management. A recent report suggests that US companies challenged nearly a third of shareholder proposals during the 2013-2015 period, half of which ended up being omitted from the ballot with prior SEC approval (Ceres, ICCR & US SIF, 2017).

Initiate or acquire

In contrast to the low-cost channels described above, the acquisition of a sizable equity stake to press for corporate changes via the threat of takeover and managerial replacement can be quite costly. **Some hedge funds specialized in this form of activism**, obtaining highly concentrated positions with the use of leverage. Compared to other institutional investors, they have comparative advantage to do so. Specialized hedge funds are not constrained by regulatory obstacles (maximum leverage, diversification requirement and liquidity constraints), can employ highly incentivised managers and have investors that are aware of the funds objectives and investment horizon. **Activist hedge funds tend to target small, high book-to-market firms that are profitable and have good returns on assets; but also firms that tend to have higher takeover defences and CEO pay** (Brav, Jiang, Partnoy, & Thomas, 2008).

A typical activist campaign starts with the public announcement of activist intentions with the SEC. Activists must fill a regulatory form (Schedule 13D) if they acquire more than 5% of the voting stock of a public company, with the intention of influencing its operations or management[7]. Activists tend to first engage with the company by formally sending a set of specific demands to management (restructuring, share repurchases, etc.). Rarely successful,

[6] *The informal no-action SEC letter implies that SEC staff would not recommend enforcement actions against enterprises that exclude the challenged proposal from the ballot.*

[7] *In practice, activist campaigns are typically launched with a much lower participation rate.*

this first stage is usually followed by a request for board representation (through a shareholder proposal or a public letter). If the activist does not obtain board representation, he may start soliciting other shareholders by filling a preliminary proxy statement, and eventually wage a proxy fight. The proxy contest can be an efficient way to press management to implement the activists' demands but it is also very costly. Only one fifth of initial 13D fillers request a board seat, only one-tenth initiate proxy contests (Gantchev, 2013).

III. Shareholder activism by institutional investors

The current practice of long term institutional investors

McCahery, Sautner and Starks (2016) conducted a survey among 143 large institutional investors with a long-term focus[8]. Their results suggest that **behind the scene engagement and voting** are the preferred activist tools of investors. Around 63% of the respondents in their survey state that they have engaged in direct discussions with management in the past five years, while 53% report voting against management as a shareholder engagement measure. Selling shares because of dissatisfaction with corporate performance or governance is also common and used by 49% and 39% of respondents respectively. More extreme engagement channels are only used moderately: 15% of respondents have taken legal actions and 13% have publicly criticized their portfolio companies. McCahery, Sautner and Starks (2016) find that shareholder proposal submission is rare among institutional investors (16%). They also find evidence that long-term investors intervene more intensively than short-term investors.

Passive funds and active ownership

Passive funds have quadrupled their ownership stake in US equities over the past 15 years and nowadays hold more than a third of all mutual fund assets (Appel, Gormley & Keim, 2017). The growth of passive funds has raised concerns over the future of firm supervision. There are two opposite viewpoints when it comes to the role of passive funds in firm's monitoring. The negative view is that **passive funds have limited incentives to monitor firm performance** as they are tasked with benchmark replication. If passive index providers are unable or unwilling to monitor, it can have a negative impact on corporate governance and firm performance. Proponent of the beneficial role of passive index providers tend to argue that **given an inherent inability to divest, passive index providers have enhanced incentives to properly monitor**, actively vote and engage. Moreover, as universal owners they bear the cost of

[8] *Investor horizon longer than 2 years.*

socially irresponsible firm behaviour that damages the performance of other portfolio firms. Passive funds can also be seen as a reliable partner in the eyes of other activists given their exogenous commitment to firm investments. In combination with their large ownership stake, this can reduce coordination costs during activist's campaigns and proxy solicitation (Appel, Gormley & Keim, 2017).

The key concern in identifying the effect of benchmark replicating investors on active ownership is omitted variable bias. Companies that exit an index due to poor performance will likely trigger both an activist campaign and the sale of shares by benchmark replicating investors. Appel, Gormley and Keim (2017) rely on the cut-off point[9] for index assignment as an exogenous shock to ownership in estimating the effect of benchmark replicating investors on active ownership. They show that higher ownership by benchmark replicating investors does not lead to higher likelihood of being targeted by activists. However, it does lead to **more ambitious activist resolutions**, such as board representation, and confrontational tactics, such as proxy fights. The switch to more ambitious tactics suggests that activist shareholders either perceive increased benefits from engagement (higher chances of success) or reduced costs associated with a large scale ambitious confrontation (improved odds of refunding campaign expenses from the company). Ownership by benchmark replicating funds is associated with a positive market response at activist announcement. Evidence on long run operating performance is inconclusive. Overall, the findings of Appel, Gormley and Keim's (2017) highlight the **beneficial role of benchmark replicating funds** as part of the 'wolf pack' of activist investors (Dimson, Karakas & Li, 2015).

Using a similar method, Schmidt & Fahlenbrach (2017) find that **CEO power and board tenure increase in firms with high ownership by passive investors**, and that firm value is reduced following increased accumulation of CEO power. In addition, they find evidence of a decrease in merger and acquisition announcement returns in firms with higher fraction of passive investors. This is in line with the view that uncontrolled managers, in firms with high ownership by passive investors, can extract private benefits though value reducing M&A activity (Jensen, 1986). Schmidt & Fahlenbrach (2017) findings also suggests that there are no differences in the incidence of shareholder proposals in firms with different levels of passive investors. Passive investors are not common initiators of shareholder proposals.

[9] *The 250 smallest US stocks from a sample of the 1000 largest tend to be a part of the Russel 1000 index and receive a low value weight in this index (0.014%); the next 250 stocks ranked by size will fall into the Russel 2000 index and will be assigned a much higher value weight (0.145%) (Appel, Gormley and Keim, 2017). Resultantly, passive funds on average tend to have higher institutional ownership in the top 250 stocks in Russel 2000 than in the bottom 250 of Russel 1000.*

To summarize, recent evidence suggests a non-trivial role of passive investors on active ownership. Their impact depends on the issue and engagement approach. Generally, it seems that passive investors help increasing the impact of cheap methods of engagement such as shareholder resolutions, but are detrimental to costly engagement methods such as monitoring CEO power accumulation and the assessment of M&A activity (Schmidt & Fahlenbrach, 2017).

Conflicts of interest

An issue that has received some attention recently, is the potential conflict of interest between portfolio managers who both manage company (pension) funds and own shares in the same company for other clients. How do funds vote on companies that are also their clients? Evidence points to an aggregate propensity to vote with management in mutual funds (Davis & Kim, 2005) (Ashraf, Jayaraman, & Ryan, 2012) that have strong business ties with the companies' pension funds. Davis and Kim (2005) hypothesize that funds with strong business ties adopt voting policies that are in broad support for all management proposals (both client and non-client) in order to avoid public scrutiny on the conflict of interest client votes.

Joint initiatives to influence environmental and social issues

Institutional investors interested in influencing corporate environmental practices have recently joined forces via the Climate Action 100+ initiative. Their goal is to influence corporate accountability and oversight of climate change risk and greenhouse gas emissions across the value chain. Participants in the initiative also seek to increase corporate disclosure in a manner that would help investors better assess the robustness of enterprises to climate change scenarios. Cooperation on social and environmental issues is also undertaken though the principle for responsible investment (PRI) initiative. The mission of the initiative, representing the vision of signatories owning 59$ trillion assets, is to incorporate ESG issues into investment analysis and ownership policies. As active owners they also seek to increase corporate disclosure on ESG issues for their portfolio companies. The widespread popularity of these initiatives is consistent with the broad emergence of a new voluntary institutional Corporate Social Responsibility infrastructure that aims to put multi-bottom-line pressure on enterprises in the absence of a global governance (Waddock, 2008).

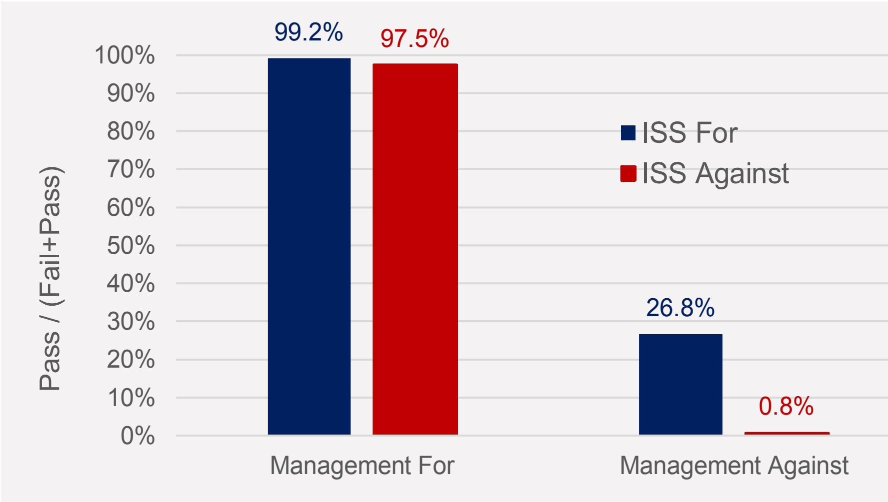
IV. The rising role of proxy advisory agencies

Researching the optimal way of voting across each company's agenda is costly. Investors face a classical free rider problem (Grossman & Heart, 1980) as the benefits of casting an informed vote are dispersed across the shareholder base while the costs of researching items subject to vote are borne fully by each investor. Institutional investors are large in terms of assets under management and have a fiduciary duty to vote. Nevertheless, even for institutional investors, the **free rider problem dilutes the benefits of engaging in costly active vote research given that the average institutional holding of a stock is only about 0.30%** (Larcker, McCall, & Ormazabal, 2015). The proxy advisory industry arose to meet these challenges, by developing **research expertise available to all their clients and thus reducing the per client costs of casting informed votes**. For mutual funds, the incentive to buy and follow proxy advisor's vote recommendations is even higher since the SEC's (2004a and b) interpretation that voting policies developed by independent third parties are free of conflict of interest and therefore in line with fund's voting obligations (Larcker, McCall, & Ormazabal, 2015).

The extent to which mutual funds rely on proxy advisory's vote recommendations varies extensively across funds. Overall, around **25% of funds follow ISS recommendations very closely** (Iliev & Lowry, 2014). Surprisingly, there seems to be significant divergence in voting practices even within fund families (Morgan, Poulsen, Wolf, & Yang, 2011). Overall, the evidence suggests that **funds with extensive benefits to active voting and low costs to information collection** (i.e. large family funds with large and concentrated equity stakes) tend to **vote more independently from proxy advisors' recommendations** (Iliev & Lowry, 2014).

More than 99% of resolutions supported by both management and ISS tend to pass. The role of proxy advisory agencies is particularly interesting when there is a conflict in recommendations. **Negative ISS recommendations are associated with a 1.7% drop in pass rates when management is in support of a recommendation**. However, when management is against a resolution, ISS support seems to be associated with a 26% percentage points increase in pass rates (Figure 2).

2 - Management-ISS disagreement



Displays the percent of resolutions that pass. Management recommendation is the board of director's vote recommendation disclosed in the proxy card. ISS recommendation is from ISS's proxy research report. Based on a sample of 424360 votes on management and shareholder (governance) proposals in the period covering 2003-2016. Data comes from the 'Company vote result' database (ISS Voting Analytics).

Source: Amundi Reseach

Do proxy advisors have an impact on voting outcome?

When it comes to the impact of recommendations on voter support, early empirical research was able to establish a positive correlation (Ertimur, Ferri & Oesch, 2012; Li, 2013). More recently, Malenko and Shen (2016) rely on regression discontinuity design[10] and the arbitrary nature in which ISS used to decide whether to scrutinize compensation packages as a method to estimate the causal effect of ISS recommendations. **Companies that pass ISS's arbitrary scrutiny threshold** were analysed extensively by ISS and **were found to have a 15% higher probability of receiving a negative recommendation** on their say-on-pay proposal (that is, on votes for executive remuneration). The effect is economically meaningful given an 12.7% average probability of a negative recommendation. Say-

[10] *Regression discontinuity is a popular method in the voting literature. When applied to voting, the method relies only on close call votes to estimate the causal effects of voter support. The intuition is that agents cannot predict whether a proposal will pass or fail by a small margin and are therefore unable to take actions ahead of the vote. Moreover, the underlying characteristics of firms that pass and fail by a small margin tend to be similar (Cuñat, Gine, & Guadalupe, 2012). This allows for causal inference of the effect of proposal adoption on the variable of interest (stock returns for example).*

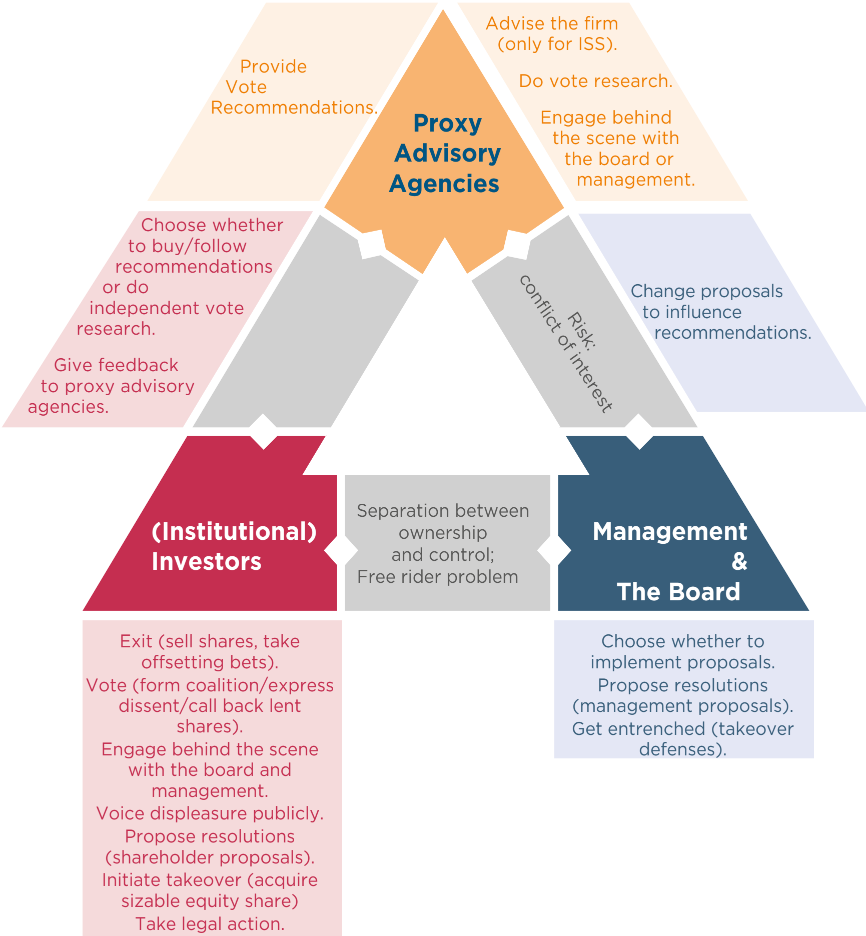
on-pay proposals with negative recommendations were found to have a 25-percentage point drop in support.

Given the strong impact of proxy advisory firms on voting outcomes, it is not surprising to find that **firms change proposals before shareholder meetings in an attempt to appease proxy advisors and avoid negative recommendations** (Larcker, McCall, & Ormazabal, 2015). The market reaction to such modifications is negative and statistically significant. Larcker, McCall, & Ormazabal (2015) interpret this finding as evidence that attempts to comply with proxy advisory recommendations are value reducing.

Competition among proxy advisors and conflicts of interest

Currently, the proxy advisory business is **dominated by two large players: (1) Institutional shareholder services (ISS) and (2) Glass Lewis**. ISS used to have a dominant position in the market, but the role of Glass Lewis has increased in the past couple of years. McCahery, Sautner and Starks (2015) find that 60% of institutional investors use at least one proxy advisory vote recommendation service. About 50% of participants also indicated using recommendations from multiple sources (McCahery, Sautner & Starks, 2015). Generally, the correlation between ISS and Glass Lewis recommendations tends to be relatively high (Larcker, McCall, & Ormazabal, 2015). Glass Lewis recommendations seem to be more aggressive (against management) on say on pay proposals relative to ISS recommendations (Larcker, McCall, & Ormazabal, 2015).

3 - The role of proxy advisory agencies and their connections with key actors



Source: Amundi Reseach

Recently, more attention has been placed on the effects of **proxy advisory competition**. The problem with competition in the proxy advisory business is closely linked to the free rider problem between shareholders. More specifically, institutional investors have a limited incentive to bear the cost of informed voting and would **attempt to select proxy advisory agencies mainly on the basis of costs**. This in turn incentivises proxy agencies to **avoid firms specific research in an attempt to minimize costs**. In other words, pure price competition detrimentally affects vote quality as the best way to be competitive is to reduce costs. For example, **ISS tends to issue uniform recommendations on certain policies across all companies** (for example, right to call special meeting or require majority vote for directors) (Iliev & Lowry, 2014). The practice has not gone unnoticed by regulators. **SEC Commissioner Gallagher raised concerns in 2013 as to whether voting according to proxy advisory recommendations is in line with a fund's fiduciary duty to vote shares in the best interest of shareholders** (Iliev & Lowry, 2014).

The European Securities and Markets Authority (ESMA) finds no clear evidence of market failure in the way proxy advisors interact with investors; however, ESMA recommends improvements in transparency and disclosure (ESMA, 2013). More specifically, ESMA recommends that proxy advisory agencies disclose: (1) the methodology and sources of information used to derive recommendation, (2) the way local conditions and regulations influence recommendations, (3) the nature in which proxy advisory agencies engage with issuers and (4) any potential conflicts of interest. ESMA concludes that an authorization regime for proxy advisory agencies is not necessary; rather, they suggest that it is sufficient for the industry to adopt a Code of Conduct and to observe minimum standards (ESMA, 2013).

Concerns have also been raised about **potential conflicts of interest in the proxy advisory industry**. For example, ISS is known to provide **advisory services to companies** and recommendations to funds on the same governance issues (see Figure 3); this creates an environment where ISS could have incentives to give biased recommendations (Li, 2015). In this respect, competition can help. Increased competition leads to reduced support for management proposals and reduced conflicts of interest through the existence of an outside recommendation option (Li, 2015).

V. Impact of shareholder activism

There is a vast literature investigating the impact of shareholder activism on the performance and ESG rating of targeted firms. A related question of interest is whether active ownership can be profitable to active owners after costs. Some forms of active engagement can be costly; and this cost accrues wholly to the activist shareholder. Finally, some studies also examine the potential beneficial signalling effect on non-targeted firms. Following an engagement, other mismanaged enterprises may make voluntary corrections in order to pre-empt engagements by activist investors.

In general, voting and shareholder proposals are a cheap engagement tool. The early empirical literature was skeptical of the view that investor voting can serve as an effective monitoring tool (Black, 1998; Romano, 2001; Gillan & Starks, 2007). For example, Karpoff, Malatesta, & Walkling (1996) find that proposals have negligible effects on stock performance and firm operations. The common view used to be that low-cost activism is also low impact (Ferri, 2012). Wohlstetter (1993) even argued that shareholder proposals are value reducing because activists do not have the skills and information needed to guide management towards improved decision making. Instead of enhancing performance they distract management and hinder their ability to execute effectively (Lipton & Rosenblum, 1991). Proposal submission can even be viewed negatively by the market if it is taken as a signal that behind the scene engagement, which usually precedes the submission of a proposal, has been unsuccessful (Prevost & Rao, 2000).

Recent work is more supportive of the beneficial role of voting. **Vote outcomes on specific issues, such as the adoption of governance proposals, have been shown to affect firm valuations, with an increase in shareholder value by 2.8% on average** (Cuñat, Gine, & Guadalupe, 2012). The beneficial impact of the successful implementation of such proposals tends to be higher for firms with stronger anti-takeover provisions.

Activist shareholders can also choose to do independent vote specific research or try to actively influence vote outcomes (though proxy fights or by borrowing shares for the purpose of voting). In such instances, the cost of activism can be meaningful. Gantchev (2013) models activism as a sequential process consisting of demand negotiations, board representation, and proxy contest and he estimates the costs of each activism stage. He finds that a campaign ending in a proxy fight has an average cost of $10.71 million and that monitoring costs reduce activist returns by more than two-thirds.

Doing independent vote research, even if costlier than following proxy voting recommendations, can still be profitable for active owners. Iliev & Lowry (2014) analyse the effect of independent vote research on fund performance. Funds with high benefits to active voting, such as larger funds with low turnover ratios and concentrated equity positions, are less likely to follow ISS recommendations and tend to earn higher risk adjusted returns (Iliev & Lowry, 2014). This suggests that doing independent vote research can be profitable for active owners.

Interesting evidence on the value of votes comes from the equity lending market. Equity lending transfers the right to cast a vote to the borrower. This gives researchers a unique opportunity to examine investors' behaviour in the lending market before relevant votes. The evidence suggests that investors tend to recall loaned shares prior to a proxy record date to be able to exercise their voting rights (Aggarwal, Saffi, & Sturgess, 2015). When the share is recalled, the **lending fee serves as a lower bound on the value of voting**

to the fund. If investors believed that voting does not increase valuations, they would not recall shares and forgo borrowing fees. The recall rate of lent shares tends to be higher for investors with greater benefits of active voting and proposals for firms with poor governance and financial performance (Aggarwal, Saffi, & Sturgess, 2015). This suggests that the value associated with the right to vote is positive and larger for poorly performing firms.

Early studies find a small impact of behind the scene engagement on target firms' governance structures, and a negligible impact on the firm's value or earnings. This early evidence is based on the analysis of the engagements of large pension funds, such as CalPERS (Nesbitt, 1994; Smith, 1996; Anson, White, and Ho, 2004; English, Smythe, and McNeil, 2004), mutual funds (Davis & Kim, 2005) or shareholders associations, like the Council of Institutional Investors (Opler & Sokobin, 1995), and the United Shareholders Association (Strickland, Wiles, & Zenner, 1996). The **absence of impact was mainly attributed to inadequate monitoring (due to free riding), ownership dispersion (small ownership stakes of large institutions)**[11] **and an inability to spend sufficient resources on activism**. There are also legal and institutional obstacles to activism, especially in the US where the anti-director rights of shareholders are particularly restricted, which limits their ability to nominate and elect directors.[12] Finally, institutional investors' incentives might be distorted. Private pension funds are not run independently of corporate management and public pension funds might be influenced by politicians whose interests might diverge from the interests of pension fund beneficiaries.

The debate concerning the effect of behind the scene engagements has been revived more recently by Becht, Franks, Mayer, & Rossi (2008), who studied the governance engagements of the Hermes Focus Fund, a UK fund owned by the British Telecom Pension Scheme. The fund used mostly private engagements with mainly demands of restructuring to provide more focus (by selling non-core divisions for example). The study found that this **engagement strategy led to an abnormal return of 4.9% net of fees** against the FTSE All-Share index, which cannot be attributed to stock picking.

Dimson, Karakas & Li (2015) also provide **favourable results on the effects of ESG behind the scene activism of a large institutional investor with a major commitment to responsible investment**. Successful engagement was followed by a yearly abnormal return of 4.4% and led to improved accounting performance and superior governance of the targeted companies. The most successful engagements target firms with reputation concerns and a higher

[11] *Investors have limited incentives to actively engage and monitor the effect of engagements if they have a small ownership stake.*

[12] *The development of majority voting and proxy access is however changing the situation.*

capacity to implement corporate social responsibility changes. Barko, Cremers & Renneboog (2017) study investor activism on ESG issues with a proprietary database. They find that **firms with lower ESG ratings are more likely to be engaged and experience an improvement in their independent ratings during the engagement period.** Activism was more successful for companies with a favourable ESG track record and more dispersed ownership. The effect of successful engagements on financial performance is positive.

When it comes to pension fund activism, Barber (2007) finds significant positive short run returns for CalPERS' (California Public Employees' Retirement System) activism through their use of a public focus list of target companies. However, the long term positive effects of CalPERS activism are difficult to measure and tend to be statistically insignificant (Barber, 2007).

Though the acquisition of a large equity stake, hedge fund activism plays a middle role between internal monitoring by large shareholders and external discipline by corporate raiders. Evidence suggests that **hedge fund intervention is beneficial for both accounting and stock performance** (Brav, Jiang, Partnoy, & Thomas, 2008). Revealing an active engagement leads to a 7% increase in the performance of the target firm around the 20-day announcement period (Brav, Jiang, Partnoy, & Thomas, 2008). The announcement is also followed by favourable developments in payout ratios and returns on assets.

Active hedge funds seem to have a beneficial role that goes beyond the effects on the target firm. The perceived threat of takeover motivates similarly ranked firms to reduce agency costs and improve performance, leading to a rise in their valuation that tend to be anticipated by the market (Gantchev, Gredil, & Jotikasthira, 2016). All in all, **smaller and less regulated funds, like for example hedge funds, who hold large equity stakes in smaller companies, using also leverage and derivatives to extend their reach, seem to be better able to influence corporate boards and achieve high performance.**

Overall, recent studies suggest that the market reaction to activism is positive, consistent with the view that activism creates shareholder value. ESG ratings tend to improve following engagements which suggests that shareholders can influence corporate decision making though active engagements. Studies tend to support the view that active investors can make a profit from their engagements. Cheap methods, such as voting, can have a beneficial impact on performance. Moreover, investigations that focus on the returns of activist funds suggest that their after-cost performance is positive when adjusted for risk or relative to the appropriate benchmark (Becht, Franks, Mayer, & Rossi, 2008; Iliev & Lowry, 2014).

Conclusion

Supervision is key to the proper functioning of modern corporations. Shareholders may want to challenge social and environmental corporate policies in order to bring them closer in line to their objectives. Shareholders should specifically battle for control over corporate decision making in firms with high agency costs (Harris & Raviv, 2010).

There are many effective tools in the active shareholders' toolbox. Large shareholders with high benefits of active ownership can consider costly methods, such as independent vote research, behind the scene engagement and takeover. Small shareholders with high information collection costs on the other hand, can rely on exit, vote recommendations and shareholder proposals as activist tools.

Overall, recent empirical findings are supportive of the view that active ownership is beneficial. The successful use of the activist toolbox tends to raise market values. Moreover, both accounting and ESG performance of target firms tends to improve after successful engagement. The empirical evidence is also consistent with the view that active ownership, even if leading to substantial costs in some cases, can be profitable to active owners.

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