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Highlights

Highlights of GAO-07-765, a report to congressional requesters

June 2007

CORPORATE SHAREHOLDER MEETINGS

Issues Relating to Firms That Advise Institutional Investors on Proxy Voting

Why GAO Did This Study

At annual meetings, shareholders of public corporations can vote on various issues (e.g., mergers and acquisitions) through a process called proxy voting. Institutional investors (e.g., mutual funds and pension funds) cast the majority of proxy votes due to their large stock holdings. In recent years, concerns have been raised about a group of about five firms that provide research and recommendations on proxy votes to their institutional investor clients.

GAO was asked to report on (1) potential conflicts of interest that may exist with proxy advisory firms and the steps that the Securities and Exchange Commission (SEC) has taken to oversee these firms; (2) the factors that may impede or promote competition within the proxy advisory industry; and (3) institutional investors' use of the firms' services and the firms' potential influence on proxy vote outcomes.

GAO reviewed SEC examinations of proxy advisory firms, spoke with industry professionals, and conducted structured interviews with 31 randomly selected institutional investors.

GAO is not making any recommendations.

GAO provided a draft of this report to SEC for its review and comment. SEC provided technical comments, which GAO incorporated, as appropriate.

www.gao.gov/cgi-bin/getrpt?GAO-07-765.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Yvonne Jones at (202) 512-8678 or jonesy@gao.gov.

What GAO Found

Various potential conflicts of interest can arise at proxy advisory firms that could affect vote recommendations, but SEC has not identified any major violations in its examinations of such firms. In particular, the business model of the dominant proxy advisory firm—Institutional Shareholder Services (ISS)—has been the most commonly cited potential conflict. Specifically, ISS advises institutional investors how to vote proxies and provides consulting services to corporations seeking to improve their corporate governance. Critics contend that corporations could feel obligated to retain ISS's consulting services in order to obtain favorable vote recommendations. However, ISS officials said they have disclosed and taken steps to mitigate this potential conflict. For example, ISS discloses the potential conflict on its Web site and the firm's policy is to advise clients of relevant business practices in all proxy vote analyses. ISS also maintains separate staff who are located in separate buildings for the two businesses. While all institutional investors GAO spoke with that use ISS's services said they are satisfied with its mitigation procedures, some industry analysts continue to question their effectiveness. SEC conducts examinations of advisory firms that are registered as investment advisers and has not identified any major violations.

Although new firms have entered the market, ISS's long-standing position has been cited by industry analysts as a barrier to competition. ISS has gained a reputation for providing comprehensive services, and as a result, other firms may have difficulty attracting clients. Proxy advisory firms must offer comprehensive coverage to compete and need sophisticated systems to provide the services clients demand. But firms interested in entering the market do have access to much of the information needed to make recommendations, such as publicly available documents filed with SEC. Competitors have attempted to differentiate themselves from ISS by, for example, providing only proxy advisory services and not corporate consulting services. While these firms have attracted clients, it is too soon to tell what their ultimate effect on enhancing competition will be.

Among the 31 institutional investors GAO spoke with, large institutions reportedly rely less than small institutions on the research and recommendations offered by proxy advisory firms. Large institutional investors said that their reliance on proxy advisory firms is limited because, for example, they have in-house staff to assess proxy vote issues and only use the research and recommendations offered by proxy advisory firms to supplement such research. In contrast, small institutional investors have limited resources to conduct their own research and tend to rely more heavily on the research and recommendations offered by proxy advisory firms. The fact that large institutional investors cast the great majority of proxy votes made by institutional investors and reportedly place relatively less emphasis on advisory firm research and recommendations could serve to limit the firms' overall influence on proxy voting results.