HKU BUSINESS SCHOOL
港大經管學院

Proxy voting guidelines and director elections

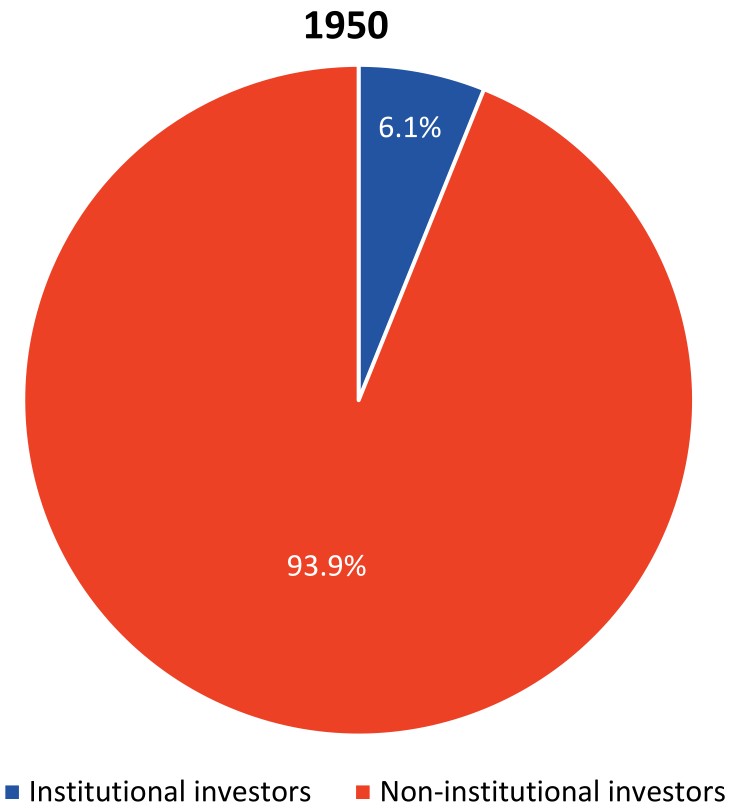
Maxime Couvert, Rüdiger Fahlenbrach, Zacharias Sautner

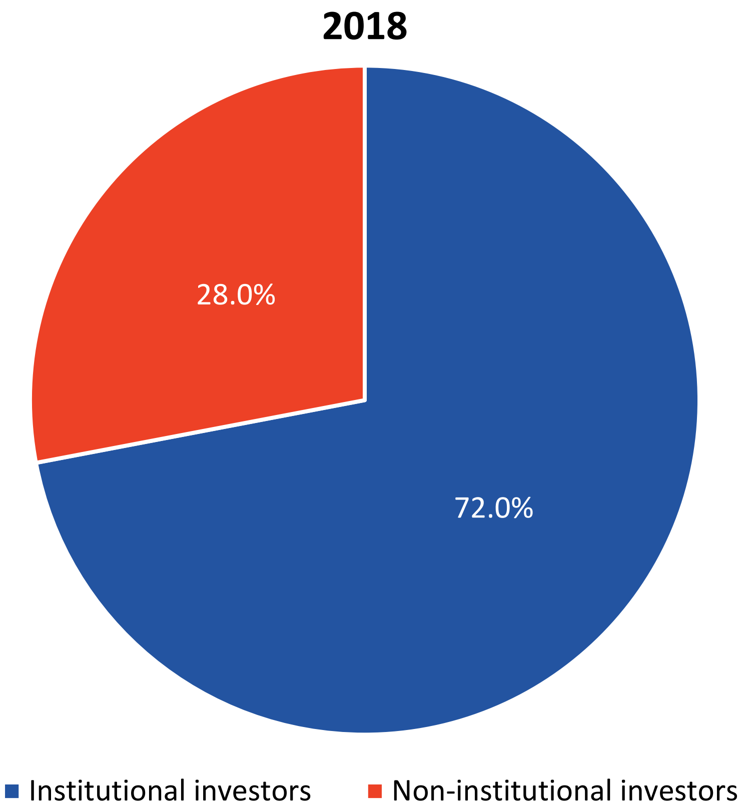
Zurich - October 1, 2024

Why study proxy voting guidelines?

Institutional ownership has increased greatly over the past decades.

Institutional ownership of US public equity





Most institutional investors have a fiduciary duty to vote at shareholder meetings.

Source: Bebchuk and Hirst (2019), OECD (2020).

Why study proxy voting guidelines?

Institutional investors must develop proxy voting guidelines (PVGs) describing how they generally vote at AGMs.

THE WALL STREET JOURNAL.

Vanguard to Take Tougher Stance Against Overextended Board Members

The index-fund giant is preparing to issue updated proxy-voting guidelines

Ontario Teachers' increases expectations on board diversity in 2023 Proxy Voting Guidelines

January 19, 2023 · 4 min read

March 25, 2022 10:19 AM

Goldman Sachs strengthens proxy-voting policies

By PALASH GHOSH

GSAM said it will vote against audit committees at companies that "do not disclose material greenhouse gas emissions data and have made insufficient progress in doing so,"

- Proxy voting guidelines (PVGs) have become an essential tool for institutional investors to perform their voting duty.
- Understanding the effectiveness and consequences of PVGs has therefore become critical.

Why study proxy voting guidelines?

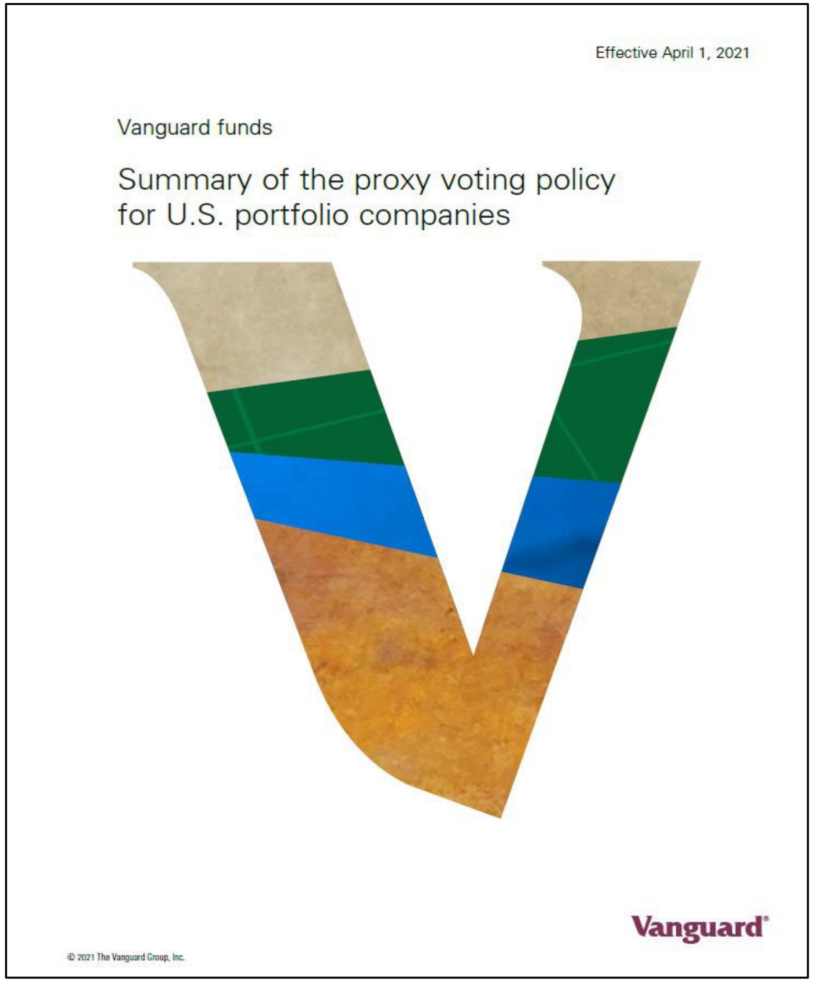
Debate in academia and industry about voting choice (Malenko and Malenko 2024) and custom proxy voting (Hu, Malenko, and Zytnick 2024).

- If effective governance can be achieved through PVGs, then why do we need to offer voting choice to final beneficiaries (pass-through voting)?

- If institutional investors show sufficient heterogeneity in governance preferences as reflected in their PVGs (and act upon them), then do we need to worry about the power of proxy advisors?

- To address both questions, it is critical to understand the heterogeneity and effectiveness of PVGs.

What are proxy voting guidelines?



- SEC regulatory requirement.
- Designed at the fund family level.
- Non-binding.

- This paper: Describe and study criteria that funds monitor for director elections at portfolio firms.

We use these criteria to create a measure of funds' **"monitoring intensity of directors"**

Why director elections?

Director elections are a major tool for shareholders to exercise governance.

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or scan the QR code – login details are located in the shaded bar below.

Phone
Call toll free 1-800-652-VOTE (8683) within the USA, US territories and Canada

Save paper, time and money!
Sign up for electronic delivery at
www.investorvote.com/coca-cola

Using a **black ink** pen, mark your votes with an **X** as shown in this example.
Please do not write outside the designated areas. ☒

2022 Annual Meeting Proxy Card

▼ IF VOTING BY MAIL, SIGN, DETACH AND RETURN THE BOTTOM PORTION IN THE ENCLOSED ENVELOPE. ▼

A Proposals – The Board of Directors recommends a vote FOR all the nominees listed and FOR Proposals 2 and 3.

1. Election of Directors:

	For	Against	Abstain		For	Against	Abstain		For	Against	Abstain
01 - Herb Allen	☐	☐	☐	05 - Barry Diller	☐	☐	☐	09 - James Quincey	☐	☐	☐
02 - Marc Bolland	☐	☐	☐	06 - Helene D. Gayle	☐	☐	☐	10 - Caroline J. Tsay	☐	☐	☐
03 - Ana Botín	☐	☐	☐	07 - Alexis M. Herman	☐	☐	☐	11 - David B. Weinberg	☐	☐	☐
04 - Christopher C. Davis	☐	☐	☐	08 - Maria Elena Lagomasino	☐	☐	☐				

Do proxy voting guidelines matter for director elections? (1)

Voting outcomes rarely result in the rejection of board directors.

Consensual voting	Director elections are often consensual, with an average shareholder support of 95%.
Rare minority vote	It is rare that a director receives less than 50% shareholder support.
Plurality voting	It is common that directors do not need to receive a majority of the votes cast to be elected.
Rare proxy access	Often, shareholders do not have a say on who will be added as a director candidate to the proxy card.

Do proxy voting guidelines matter for director elections? (2)

Institutional investors may not have the incentives or tools to monitor directors through PVGs.

Lack of incentives

- Institutional investors only capture a small portion of the benefits from their stewardship activities.
- Passive investors are rarely compensated for performance and hence capture an even smaller portion of these benefits.
- Institutional investors may not vote against management when they have business ties (conflicts of interest).

Lack of tools

- Passive investors, such an index trackers, may not be able to use the threat of exit, limiting the effectiveness of the voice mechanism.

Do proxy voting guidelines matter for director elections? (3)

How can proxy voting guidelines be an effective tool for institutional investors to exercise governance?

- **Ex-ante channel**: PVGs may inform directors on how they should behave.

  Subsequently, directors behave better to avoid that institutional investors vote against them.

- **Ex-post channel**: Institutional investors monitor directors based on the criteria disclosed in their PVGs.

  Subsequently, they vote against directors which contravene PVGs criteria.

For both channels to be effective governance mechanisms:

1) Institutional investors need to follow the principles of the PVGs.

2) PVG-induced voting needs to have consequences for directors and firm valuations.

Goal of this paper

To study the effectiveness of proxy voting guidlines, we study the following specific questions:

- What director characteristics do mutual funds claim to monitor through their PVGs?
- Do mutual funds *actually* monitor the characteristics listed in their PVGs?
- Are they able to discipline directors through their PVGs?
- How does director monitoring via PVGs feed back into portfolio firm performance?

Data

Construction of the dataset

We hand-collect the guideline documents from 29 out of the largest 60 US mutual fund families, spanning the period from 2006 to 2018 and focus on the presence of 12 common director voting criteria.

Our sample therefore includes **377 guideline documents**.

Construction of the dataset

There is significant heterogeneity in the voting criteria mutual funds claim to monitor.

Example of voting policies – Fidelity 2018

A. Election of Directors

FMR will generally vote in favor of incumbent and nominee directors except where one or more such directors clearly appear to have failed to exercise reasonable judgment. FMR will also generally withhold authority for the election of all directors or directors on responsible committees if:

1. An Anti-Takeover Provision was introduced, an Anti-Takeover Provision was extended, or a new Anti-Takeover Provision was adopted upon the expiration of an existing Anti-Takeover Provision, without shareholder approval except as set forth below.

2. Within the last year and without shareholder approval, a company's board of directors or compensation committee has repriced outstanding options, exchanged outstanding options for equity, or tendered cash for outstanding options.

3. Within the last year and without shareholder approval, a company's board of directors or compensation committee has adopted or extended a Golden Parachute.

4. The company has not adequately addressed concerns communicated by FMR in the process of discussing executive compensation.

5. To gain FMR's support on a proposal, the company made a commitment to modify a proposal or practice to conform to the Guidelines and the company has failed to act on that commitment.

6. The director attended fewer than 75% of the aggregate number of meetings of the board and its committees on which the director served during the company's prior fiscal year, absent extenuating circumstances.

7. The board is not composed of a majority of independent directors.

Fidelity takes **7 dimensions** into consideration when voting on directors.

Example of voting policies – Harris 2018

Board of Directors Issues

Harris believes that boards should have a majority of independent directors and that audit, compensation and nominating committees should generally consist solely of independent directors.

- Harris will normally vote in favor of the directors recommended by the issuer's board provided that a majority of the board would be independent. If the board does not have a majority of independent directors, Harris will normally vote in favor of the independent directors and against the non-independent directors.
- Harris […] will vote against the election of non-independent directors who serve on those committees.

Harris takes **2 dimensions** into consideration when voting on directors.

Anatomy of director voting criteria in proxy voting guidelines

Descriptive statistics

We hand-collect data on the presence of 12 common voting criteria.

Voting criteria on director elections, 2006-2018

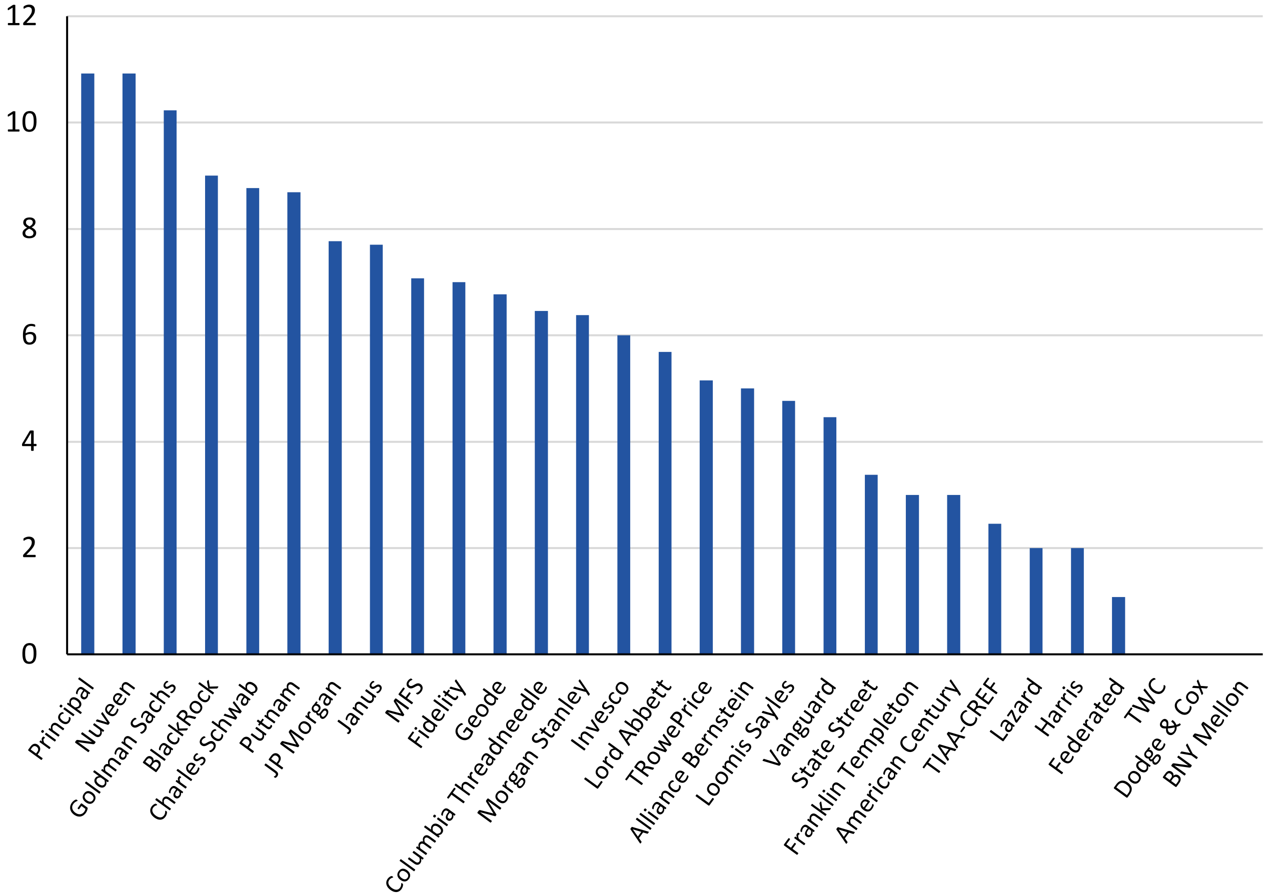
	Frequency (in %)
1. Director was absent for more than 25% of the meetings	75
2. Board does not have a majority of independent directors	84
3. An antitakeover provision was introduced/increased	31
4. Board introduced a poison pill	40
5. Board refused to remove a poison pill	13
6. Outstanding options were repriced	31
7. Board failed to act on shareholders' best interest when approving executive comp.	56
8. Non-independent directors serve on the audit, compensation or nominating cmt.	78
9. The company lacks an audit, compensation, or nominating committee	34
10. Director is overboarded	48
11. Board failed to act on a majority supported shareholder proposal	54
12. Director received less than 50% support in last election	19

Some criteria are more common than others.

Descriptive statistics

Some mutual fund families state that they monitor many criteria, while others do not mention any in their PVG.

Average number of criteria per fund family

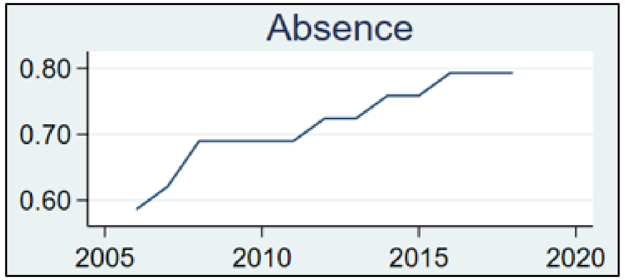


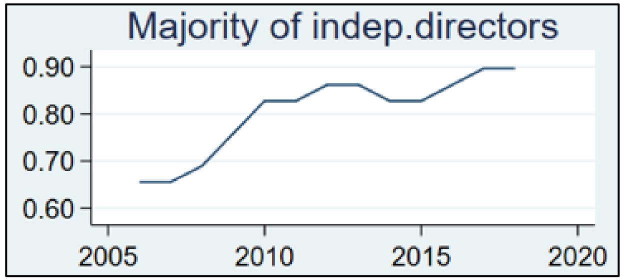
- Some fund families like Principal or BlackRock mention, on average, more than 10 criteria over the sample period.
- Other fund families like TWC do not mention any criteria for the election of board members.

Descriptive statistics

On average, the number of criteria that funds announce to monitor has significantly increased.

Percentage of criteria presence





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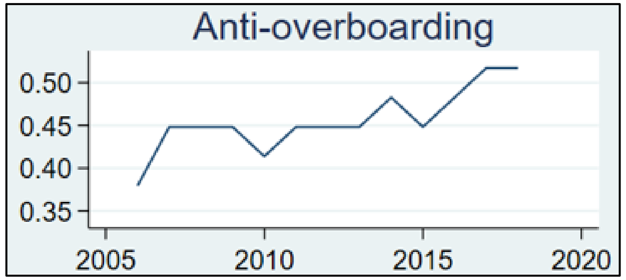
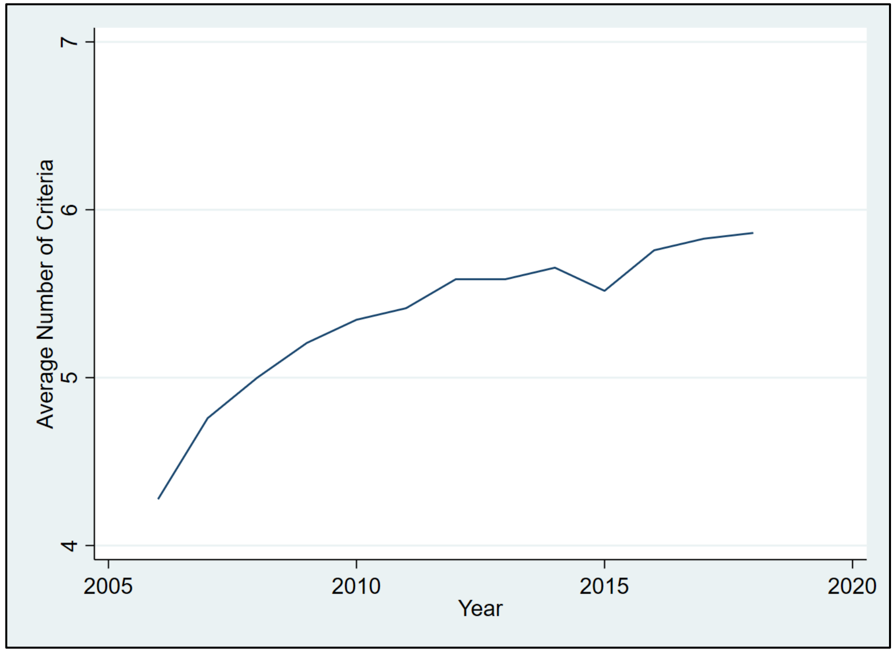


Average number of criteria for director elections



- Funds have significantly increased the number of criteria they monitor over time.
- Increase is present for almost all the criteria we study.

Do mutual funds monitor directors using the stated criteria?

Do mutual funds monitor directors using the stated criteria?

As proxy voting guidelines are non-binding and fund families may cover thousands of firms with small voting teams, it is not clear that funds make use of their criteria in practice.

Non-biding guidelines	Proxy voting guidelines are non-binding. Mutual funds may therefore present themselves as active monitors, while remaining passive in their votes.
Large portfolio	Mutual funds families may have thousands of companies across their portfolios.
Small stewardship teams	The voting and stewardship teams at large mutual fund families are often made up of a handful of people.
Proxy advisors	There is evidence that mutual funds use proxy advisors for voting recommendations on director elections.

We need to examine whether funds actually use their stated voting criteria.

Do mutual funds monitor directors using these stated criteria?

We investigate whether mutual funds use their stated criteria for director elections.

- Dependent variable: *Yes Vote* = 1 if a fund votes in favor of a director; = 0 otherwise.
- Variable of interest: *Criteria x Breach* = 1 when a director is in breach of a criterion; = 0 otherwise.

	Dependent variable: *Yes Vote*					
	Absence	Majority of Indep. Dir.	Non-indep. Dir. on ACN	Lacks ACN	Overboarded	All criteria
	(1)	(2)	(3)	(4)	(5)	(6)
Criteria x Breach	-0.173**	-0.251***	-0.012**	-0.022***	-0.038***	-0.140***
	(-2.21)	(-12.19)	(-2.40)	(-4.86)	(-9.64)	(-7.55)
Criteria	-0.004	0.013***	-0.005*	-0.016***	-0.002***	-0.006***
	(-1.16)	(4.06)	(-1.94)	(-6.34)	(-5.35)	(-3.42)
Breach	0.142**	0.103***	-0.009*	-0.017***	-0.008***	-0.018
	(1.99)	(6.56)	(-1.95)	(-5.50)	(-3.63)	(-1.20)
Observations	5,125,979	5,125,979	5,125,979	5,125,979	5,125,979	5,125,979
R-squared	0.192	0.194	0.192	0.193	0.195	0.194
Controls	YES	YES	YES	YES	YES	YES
Year FE	YES	YES	YES	YES	YES	YES
Company FE	YES	YES	YES	YES	YES	YES
Fund FE	YES	YES	YES	YES	YES	YES

Note: ACN refers to the Audit, Compensation, and Nomination committees. The analysis is conducted at the fund-vote level, for the criteria for which we can test whether directors are in breach.

- Funds are more likely to vote against a director when this director is in breach with one of the funds' criteria.
- Breaching a criterion decreases the probability that a fund supports a director by 14% (Column 6).
- Similar results when using the new adoption of voting criteria (not in the table).

Do directors care?

What are the implications of this monitoring on directors?

- **Challenge:** Firms have many mutual fund shareholders with different voting criteria.
- **Solution:** Create a measure of the average presence of criteria at the firm level
- **Measure:** $\textit{Weighted criteria}_{i,c,t}$ is the weighted sum of the presence of criterion *c* among firm *i*'s mutual funds shareholders in year *t*, standardized by the total ownership of the mutual funds for which we have PVG.

Example - construction of *Weighted Criteria*

Firm *i*'s shareholders (year *t*)

	BlackRock (1)	Vanguard (2)	State Street (3)
Criterion *c*'s presence	1	0	0
Funds' holdings in firm *i*	16%	12%	6%

$$\textit{Weighted Criteria}_{i,c,t} = \frac{1 \times 16\% + 0 \times 12\% + 0 \times 6\%}{16\% + 12\% + 16\%} = 47\%$$

What are the implications of this monitoring on directors?

Directors serving at firms where a large portion of shareholders have adopted criteria are less likely to serve for another term.

- Dependent variable: *No Director Turnover* = 1 if a director serves in the next term; = 0 otherwise.
- Variable of interest: *Weighted Criteria* (from previous slide).

	Dependent variable: *No Director Turnover*					
	Absence	Majority of Indep. Dir.	Non-indep Dir. on CAN	Lacks CAN	Overboarded	All Criteria
	(1)	(2)	(3)	(4)	(5)	(6)
Weighted Criteria	-0.015**	-0.019***	-0.013**	0.001	-0.028**	-0.004***
	(-2.29)	(-2.74)	(-2.04)	(0.16)	(-2.54)	(-3.70)
Observations	138,364	138,364	138,364	138,364	138,364	138,364
R-squared	0.431	0.431	0.431	0.431	0.431	0.431
Controls	YES	YES	YES	YES	YES	YES
Year FE	YES	YES	YES	YES	YES	YES
Company FE	YES	YES	YES	YES	YES	YES
Director FE	YES	YES	YES	YES	YES	YES

Note: ACN refers to the Audit, Compensation, and Nomination committees. The analysis is conducted at the director level.

- We find that it is especially true when directors are in breach of the criteria.

Do firms care?

What are the implications of this monitoring on portfolio firms?

- **Challenge:** Mutual funds may select firms whose directors correspond to their preferences.
- **Solution:** Exploit changes in criteria to analyze the impact of these criteria on firms that were already in the mutual funds' portfolio before the change.
- **Measure:** $\textit{Weighted Criteria Change}_{i,c,t}$ is the weighted sum of the changes in the presence of criterion *c* among firm *i*'s mutual funds shareholders between year *t* and year *t+1*, standardized by the total ownership of the mutual funds for which we have PVG.

Example - construction of *Weighted Criteria Change*

Suppose Vanguard adopts criterion *c* in year *t*.

Firm i's shareholders (Year *t* -> *t+1*)

	BlackRock (1)	Vanguard (2)	State Street (3)
Criterion *c*'s presence	1	0->1	0
Funds' holdings in firm *i*	16%	12%	6%

The change of our measure due to this adoption is:

$$\textit{Weighted Criteria Change}_{i,c,t+1} = \frac{(1-1)\times 16\% + (1-0)\times 12\% + (0-0)\times 6\%}{16\% + 12\% + 6\%} = 35.3\%$$

What are the implications of this monitoring on portfolio firms?

We analyze whether firms adopt the characteristics put forward by mutual funds in their PVGs.

- Dependent variable: Three measures of board independence.
- Variable of interest: *Weighted Criteria Change x Post* where *Post* = 1 after a change in voting criteria; = 0 otherwise.

Dependent variable:	**Pct. Indep. Directors** (1)	**Non-Indep. Directors on ACN** (2)	**All ACN Committees** (3)
Weighted Criteria Change x Post	0.009**	0.011	0.011
	(2.12)	(0.71)	(0.83)
Observations	13,464	13,464	13,464
R-squared	0.769	0.484	0.810
Controls	YES	YES	YES
Year FE	YES	YES	YES
Company FE	YES	YES	YES

Note: ACN refers to the Audit, Compensation, and Nomination committees. The analysis is conducted at the firm level.

- Adoption of a majority criterion by a mutual fund family leads to more independent boards.
- No significant implications for audit, compensation, or nomination committees.

What are the implications of this monitoring on portfolio firms?

We investigate the value implications of board monitoring through PVGs for portfolio firms.

- Dependent variable: *Tobin's q*.
- Variable of interest: *Weighted Criteria Change x Post* where *Post* = 1 after a change in voting criteria, and = 0 otherwise.

Impact on firm value

Dependent variable:	***Tobin's q*** (1)	***Tobin's q*** (2)	***Tobin's q (growth)*** (3)	***Tobin's q (growth)*** (4)
Weighted Criteria Change x Post	0.056***	0.074**	0.012*	0.022*
	(2.82)	(2.31)	(1.70)	(1.87)
Observations	12,684	6,262	12,475	6,123
R-squared	0.787	0.745	0.250	0.267
Controls	NO	YES	NO	YES
Year FE	YES	YES	YES	YES
Company FE	YES	YES	YES	YES

Note: ACN refers to the Audit, Compensation, and Nomination committees. The analysis is conducted at the firm level.

- Changes in voting criteria by mutual fund shareholders lead to higher portfolio firm valuations.

Conclusion

Conclusion

- New measure of mutual funds' monitoring intensity of board directors from PVGs.
- Significant heterogeneity in mutual funds' stated monitoring criteria.
- Mutual funds vote against directors that do not meet their criteria through voting.
- More against vote lead to higher director turnover, more independent boards, and higher firm value.

Thank you!

Appendix

What are the implications of this monitoring on directors?

Directors serving at firms where a large portion of shareholders have adopted criteria are less likely to serve for another term, especially when they are in breach of these criteria.

- Dependent variable: = 1 if a director serves in the next term; = 0 otherwise.
- Main variable of interest, *Weighted criteria x Breach*: the weighted average number of funds which mention a specific criterion when a director is in breach of the criterion, and zero otherwise.

Impact on breaching director

	Absence	**Majority of Indep. Dir.**	**Non-indep dir. on ACN**	**Lacks ACN**	**Overboarded**
	(1)	(2)	(3)	(4)	(5)
Weighted criteria x Breach	-0.024	-0.010	-0.045*	-0.009	-0.078**
	(-0.61)	(-0.21)	(-1.71)	(-0.20)	(-2.07)
Breach	-0.026	-0.001	0.056***	0.025	-0.039***
	(-0.82)	(-0.01)	(2.78)	(0.62)	(-4.28)
Weighted criteria	-0.015**	-0.019***	-0.012*	0.001	-0.026**
	(-2.26)	(-2.73)	(-1.93)	(0.19)	(-2.29)
Observations	138,364	138,364	138,364	138,364	138,364
R-squared	0.431	0.431	0.431	0.431	0.431
Controls	YES	YES	YES	YES	YES
Year FE	YES	YES	YES	YES	YES
Company FE	YES	YES	YES	YES	YES
Director FE	YES	YES	YES	YES	YES

Note: ACN refers to the Audit, Compensation, and Nomination committees. The analysis is conducted at the director level.