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HOW TO FIX OUR BROKEN PROXY ADVISORY SYSTEM

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ABSTRACT

A RULE ENACTED by the Securities and Exchange Commission in 2003 required institutions to adopt and disclose policies for proxy voting that were intended to minimize conflicts between the institutions' interests and those of their shareholders. An SEC staff interpretation of that rule led to a result almost the opposite of the ruling's intent. Institutions could easily protect themselves from legal liability by shifting responsibility to proxy advisory firms, which acquired increasing power over corporate governance, to the detriment of shareholders. The rule resulted in outsourcing decision making to advisors with little particularized knowledge and no incentive to maximize value. The proxy advisory firms themselves face the same conflicts of interest that the rule was intended to minimize. The problem is compounded by a market for proxy advice that is dominated by two firms. To fix this broken system, it is necessary to return the responsibility to determine the need for a vote to shareholders and directors.

JEL codes: G1, G2, G3 K2, and L2

Keywords: proxy advisory firms, shareholders, hedge funds, mutual funds, Institutional Shareholder Services, Securities and Exchange Commission

I. BACKGROUND

A DECADE AGO, the Securities and Exchange Commission (SEC) voted to require that every mutual fund and its investment adviser disclose "the policies and procedures that [they use] to determine how to vote proxies" —matters put to a vote by the public companies whose stock the fund holds—and to disclose votes annually.[1]

The idea behind Rule 206(4)-6 and Rule 30b1-4, which were enacted on August 6, 2003,[2] was to "encourage funds to vote their proxies in the best interests of shareholders" and to avoid conflicts of interest between those shareholders and the fund's "investment adviser, principal underwriter, or certain of their affiliates."[3]

The SEC rule followed changes at the US Department of Labor (DOL) in the 1980s mandating that ERISA pension plan fiduciaries—such as union, corporate, and other officials who control or manage a plan's assets—vote the plan's shares on the basis of active analysis, regardless of whether or not the fiduciary was certain that expending time and effort to analyze how to vote would create value for a fund.[4]

The vast majority of shareholder elections are uncontested, and the vast majority of shareholder proposals are unsuccessful. As a result, it has been argued that actively participating in shareholder elections, shareholder proposal votes, or other proxy votes may not be worth the effort for pension or mutual funds in lieu of other strategies (such as abstaining or passively voting in favor of management

1. SEC, "Securities and Exchange Commission Requires Proxy Voting Policies, Disclosure by Investment Companies and Investment Advisers," press release, January 1, 2003, http://www.sec.gov/news/press/2003-12.htm.
2. "SEC Brings Second Case Alleging Improper Proxy Voting by an Adviser," Ropes & Gray, May 20, 2009, http://www.ropesgray.com/intech/.
3. SEC, "Proxy Voting Policies."
4. "ERISA 3(16) Fiduciary Plan Administrator Overview," ING Financial Services, accessed April 4, 2013, ing.us/file.../5399/fiduciary_erisa_3_16__plan_admin_overview.pdf.

recommendations unless specific circumstances require more scrutiny).[5] But the Department of Labor ruled otherwise. In a key 1988 document called the "Avon Letter," DOL stated that "the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock."[6] The SEC eventually followed suit.

A few months after the adoption of the SEC's rule, one of the SEC commissioners, Paul Atkins, expressed his relief that "the rule did not impose a 'one-size-fits-all' requirement for the written proxy voting procedures. Instead, we left advisers with the flexibility to craft suitable procedures."[7]

Unfortunately, the rule became a classic case of unintended consequences. Many institutional investors largely outsourced their shareholder voting policies to a proxy advisory industry that relies on precisely the type of "one-size-fits-all" policies that were intentionally excluded from the original regulation because of objections by commissioners. The SEC staff interpretation of the rules on proxy voting have led to the opposite result of what many of its supporters intended. Instead of eliminating conflicts of interest, the rule simply shifted their source. Instead of encouraging funds to assume more responsibility for their proxy votes, the rule pushes them to assume less. Instead of providing informed, sensitive voting on proxies, the incentive has been to outsource decision making to two small organizations that most investors have never heard of. These two firms have emerged as the most powerful force in corporate governance in America today, shaping the way that mutual funds and other institutions cast votes on proxy questions posed by about 5,000 US public companies.

The larger of the firms, Institutional Shareholder Services (ISS), was founded in 1985. When the Department of Labor issued its new mandate a few years later, ISS made a specialty of advising institutional investors on how to comply with it,[8] and the firm has since profited from the demand created for its services by the government's requirements.

5. David Yermack, "Shareholder Voting and Corporate Governance," *Annual Review of Financial Economics* 2 (December 2010): 30, doi:10.1146/annurev-financial-073009-104034. Passive voting strategies are distinguished from abstentions. Companies need to obtain a quorum of shareholder participation even in an uncontested vote to have a successful board election, merger approval, etc., and so passively voting shares can still be a valuable exercise.

6. Allan Liebowitz, letter to Helmuth Fandl, February 23, 1988, cited in "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 17, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

7. "Speech by SEC Commissioner: Remarks at the Investment Counsel Association of America," Commissioner Paul S. Atkins, SEC, April 11, 2003, http://www.sec.gov/news/speech/spch041103psa.htm.

8. "25for25: Observations on the Past, Present, and Future of Corporate Governance In Celebration of ISS' 25th Anniversary," ISS (2011): iv, http://www.rhsmith.umd.edu/cfp/pdfs_docs/commentary/ISS.pdf.

Proxy season is now underway. More than half of US annual meetings, where proxies are tallied, take place in April, May, or June.[9] In 2010 the SEC issued a "concept release" that called for an examination of the entire US proxy system, including "the role and legal status of proxy advisory firms."[10] No action has been taken on the release, but with a new SEC chair moving into office a reexamination of the issue could be imminent. This report lays the groundwork for that consideration. What remains to be seen is whether the SEC will address a system that is badly broken and, most of all, hurts the small shareholders it is supposed to help.

The authors do not hastily rush for a regulatory solution to all corporate governance challenges. We recognize that on most issues shareholders have a plethora of nonregulatory tools available, including self-funded proxy fights, taking short positions, pricing corporate governance quality at firms into trading activity, and suing a company in state court for breach of fiduciary duty by a director or officer.

We want to be clear. Good corporate governance is crucial to the long-run success of any publicly traded company, and even the most aggressive defenders of capitalism agree that the participation of shareholders in proxy voting on governance issues can be an appropriate practice. In a recent report, the US Chamber of Commerce lauded "policies that promote effective shareholder participation in the corporate governance process. Strong governance is a critical cornerstone for the healthy long-term performance of public companies and their positive promotion of long-term shareholder value."[11]

But for the problem created by government rules that have enshrined two small proxy advisory firms, shareholders do not have a nonregulatory solution. We argue that as long as proxy advisors hold regulatory preferences and a regulatory mandate that funds purchase their services, more regulatory attention to the conflicts posed by these proxy advisors is wise. The remainder of this paper will sketch the specific problems that should be addressed and our approach to resolving them.

9. "A dialogue with Institutional Shareholder Services," Audit Committee Leadership Network in North America, ViewPoints, no. 139 (November 7, 2012): 3, https://webforms.ey.com/Publication/vwLUAssets/Proxy_advisory_firms/$FILE/ViewPoints_39_November_2012_Dialogue_with_ISS.pdf.
10. Concept Release on the U.S. Proxy System, SEC, 75 Fed. Reg. 42,981, 43,009 (July 22, 2010). Comments on the concept release can be found at http://www.sec.gov/comments/s7-14-10/s71410.shtml.
11. US Chamber's Center for Capital Markets Competitiveness, "Best Practices and Core Principles for the Development, Dispensation, and Receipt of Proxy Advice," March 2013, http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Best-Practices-and-Core-Principles-for-Proxy-Advisors.pdf.

II. THE SOURCES OF ADVISORS' POWER

Of the two firms that dominate the proxy-advisory business, the larger by far is ISS with a 61 percent market share.[12] The second is Glass, Lewis & Co., LLC, with a market share of about 36 percent.[13] ISS is owned by MSCI Inc., a New York Stock Exchange–listed company that maintains dozens of stock and bond indices and provides portfolio management analytics for investment firms. Glass Lewis is owned by the Ontario Teachers' Pension Plan Board, which manages a fund with more than $100 billion in assets. These two principal proxy advisors have inherent conflicts not simply in their ownership but also in the services they provide to clients. Proxy advisors also have shown a tendency toward ideological bias in their recommendations, especially in areas that involve labor union power, executive compensation, and the environment.

The power of the two firms has increased in recent years for several reasons. First, mutual funds have become a larger force in investing, especially with the rise of defined-contribution pension plans. Institutional stock ownership has risen from 47 percent of assets of the 1,000 largest public corporations in 1987 to 76 percent just 20 years later.[14] Overall, mutual fund assets have risen nearly 30-fold since 1987, and total shareholder accounts have quintupled.[15]

Second, shareholder activism by well-connected groups—particularly unions and environmental organizations—has sharply increased. In addition, the Supreme Court's recent decision in *Citizens United v. FEC*[16] opened up new avenues for corporate spending in elections, spurring current debates about whether shareholders should be able to approve such expenditures and whether corporations should be

12. A study by the US Government Accountability Office in 2007, "Corporate Shareholder Meetings: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting," found that between them, ISS and Glass Lewis had more than 2,000 institutions (mutual funds and other financial firms) as clients, with $40.5 trillion in equity assets. Institutions served by the next three largest proxy-advisory firms had just $1.1 trillion in assets. See Government Accountability Office, *Corporate Shareholder Meetings: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting, a Report to Congressional Requesters*, GAO-07-765 (Washington, June 2007): 13, http://www.gao.gov/new.items/d07765.pdf.
13. Tamara C. Belinfanti, "The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight," *Stanford Journal of Law, Business & Finance* 14 (Spring 2009): 395. The author, an associate professor at New York Law School, attached the comment to a letter filed with the SEC on October 20, 2010. See http://www.sec.gov/comments/s7-14-10/s71410-183.pdf.
14. "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 15-16, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.
15. "2012 Investment Company Fact Book: A Review of Trends and Activity in the U.S. Investment Company Industry," Investment Company Institute (2012): 134, http://www.ici.org/pdf/2012_factbook.pdf.
16. 558 U.S. 310 (2010).
17. James R. Copland, Yevgeniy Feyman, and Margaret O'Keefe, "Proxy Monitor 2012: A Report on Corporate Governance and Shareholder Activism" (Fall 2012): 19, http://proxymonitor.org/pdf/pmr_04.pdf.

required to disclose them.[17] New rules either proposed or approved by the SEC are making it even easier for such measures to be added to proxy ballots by shareholders.[18]

As a result, proxy proposals by shareholders are on the rise, according to a November 2012 "Shareholder Activism Insight Report" from the law firm Schulte, Roth & Zabel, polling corporate executives and shareholder activists:

> Corporate executives should expect to see increasing opposition from shareholders during next spring's proxy season, according to the 78% majority of overall respondents. Using poor financial performance and the need for management or operational change as motivation, hedge funds, pensions and unions will continue the growth of shareholder activism. A significant increase in shareholder proposals will result, according to 84% of respondents.[19]

The principal legislation that resulted from the 2008–09 crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act,[20] adds to the importance of proxy voting by mandating that companies with a public float greater than $75 million conduct periodic (in most cases, annual) "Say-on-Pay" (SoP) votes.[21] While those votes are nonbinding, they are taken seriously by corporate directors, not least because lawsuits could ensue if shareholder preferences are ignored. The SoP mandate was expanded this year to include 1,500 smaller reporting companies.[22]

More institutional ownership, a trend toward activism, and the Dodd-Frank legislation have all enhanced the power of proxy advisors. But an even more important factor was how the original 2003 SEC rule was interpreted by SEC staff. In a staff letter responding to a request from Egan-Jones, a small proxy firm, the SEC advised on May 24, 2004:

> An investment adviser that votes client proxies in accordance with a pre-determined policy based on the recommendations of an

18. See Stephen Choi, Jill Fisch, and Marcel Kahan, "The Power of Proxy Advisors: Myth or Reality?," *Emory Law Journal* 59 (2010): 872–77, listing reasons for the increased in shareholder power, including the elimination of broker discretionary voting and the movement from plurality to majority and non-staggered boards; "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 5–6, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

19. Marc Weingarten, "2012 Shareholder Activism Insight Report," The Harvard Law School Forum on Corporate Governance and Financial Regulation (blog), November 26, 2012, https://blogs.law.harvard.edu/corpgov/2012/11/26/2012-shareholder-activism-insight-report/.

20. "Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act," SEC, last modified February 14, 2013, http://www.sec.gov/spotlight/dodd-frank.shtml.

21. SEC, "SEC Adopts Rules for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act," press release, January 25, 2011, http://www.sec.gov/news/press/2011/2011-25.htm.

22. "Proxy Advisory Business: Apotheosis or Apogee?," Corporate Governance Commentary, Latham & Watkins LLP (March 2011): 2–3, http://www.lw.com/upload/pubContent/_pdf/pub4042_1.pdf.

> independent third party will not necessarily breach its fiduciary duty of loyalty to its clients even though the recommendations may be consistent with the adviser's own interests. In essence, the recommendations of a third party that is in fact independent of an investment adviser may cleanse the vote of the adviser's conflict.[23]

In other words, if an independent proxy advisory firm recommends a proxy vote, then the mutual fund and its adviser can follow that recommendation and avoid a claim that it has a conflict of interest. A second important interpretation was that mutual funds and their advisers had to vote all their shares on all proxy issues on the basis of actively developed policies.[24] Overall, US issuers pose more than 250,000 proxy questions a year, and it is not unusual for large mutual funds and their advisers to be required to cast votes on more than 100,000 of them on the basis of actively developed voting policies.

By paying fees to proxy advisors, funds and their investment advisers could avoid being sanctioned by the SEC or being sued successfully by lawyers representing shareholders unhappy with particular proxy votes.[25] A 2011 study by the Center for Executive Compensation quotes Leo E. Strine Jr., vice chancellor of the Delaware Court of Chancery, saying, "Following ISS constitutes a form of insurance against regulatory criticism, and results in ISS have a large sway in the affairs of American corporations."[26] For the proxy advisors, the SEC's actions produced a bonanza of revenues—and of political power. Suddenly ISS became, as one recent report put it, "the de facto pay and governance police."[27]

The Egan-Jones letter helped ISS in another way. Part of ISS's business was advising listed firms ("issuers," in the parlance of regulators) on corporate governance, including recommendations on how to win proxy votes. While, on the face of it, this may seem to be a conflict, the SEC letter explicitly said that it was not.

23. "Investment Advisers Act of 1940—Rule 206(4)-6: Egan-Jones Proxy Services," SEC letter to Kent S. Hughes, May 27, 2004, http://www.sec.gov/divisions/investment/noaction/egan052704.htm.
24. The SEC's proxy policy rules have been interpreted to include a mandate to vote shares on the basis of actively developed policies. See Concept Release on the U.S. Proxy System, SEC, 75 Fed. Reg. 42,981, 43,009 (July 22, 2010).
25. There are exceptions. In 2009, the SEC brought a complaint against INTECH Investment Management, LLC, alleging that the firm tried to curry favor with the AFL-CIO by adopting an ISS proxy-voting platform that followed the voting recommendations of the union. INTECH's aim, according to the SEC, was to improve its score on an annual AFL-CIO survey ranking investment advisers. A total of $350,000 in fines was assessed. See Order Instituting Administrative Cease-and-Desist Proceedings Pursuant to Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order, File No. 3-13463 (May 7, 2009), available at http://www.sec.gov/litigation/admin/2009/ia-2872.pdf.
26. Leo E. Strine, Jr., "The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (And Europe) Face," *Delaware Journal of Corporate Law* 30 (2005): 688.
27. "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 15–16, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

> In your letter, you ask whether a proxy voting firm would be considered to be an independent third party if the firm receives compensation from an issuer ('Issuer') for providing advice on corporate governance issues. We believe that the mere fact that the proxy voting firm provides advice on corporate governance issues and receives compensation from the Issuer for these services generally would not affect the firm's independence from an investment adviser.[28]

III. THE DEPTH AND BREADTH OF ADVISORS' INFLUENCE

In 2003, W. James McNerney Jr., then chairman of 3M Corporation, stated in a letter to the SEC that ISS controlled the proxy votes of half of his company's shares and that "many of the top 30 institutional shareholders we contacted in each of the past two years to discuss our position would not engage in any meaningful discussions, often citing adherence to ISS proxy voting guidelines."[29]

The McNerney letter was referenced in a study of proxy advisors published in the *Stanford Journal of Law, Business, and Finance*.[30] The study also cited Lynn Stout of Cornell, who wrote, "When institutional investors follow ISS [proxy recommendations] en masse, directors of public corporations can expect to see 20%, 30% even 50% of their company's shares being voted not as the directors recommend, but as ISS recommends."[31]

Of course, no single institution determines the outcome of every proxy vote, but, according to a study by David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, opposition by a proxy advisor results in a "20% increase in negative votes cast."[32] That figure underestimates the power of ISS and Glass Lewis since corporations trying to avoid a negative recommendation from a proxy advisory firm will shape their policies accordingly. Another study, published by researchers Jennifer E. Bethel and Stuart L. Gillan in the journal *Financial Management*, found that when ISS

28. "Investment Advisers Act of 1940—Rule 206(4)-6: Egan-Jones Proxy Services," SEC letter to Kent S. Hughes, May 27, 2004, http://www.sec.gov/divisions/investment/noaction/egan052704.htm.
29. "Comment from W. James McNery, Jr. on SEC Proposed Rule," SEC, December 5, 2003, http://www.sec.gov/rules/proposed/s71903/3m120503.htm.
30. Tamara C. Belinfanti, "The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight," *Stanford Journal of Law, Business, and Finance* 14 (Spring 2009): 386–87n14.
31. Ibid.
32. David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policy" (Rock Center for Corporate Governance at Stanford University Working Paper No. 119, Stanford, CA, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2101453.

recommends a "no" vote on a management proposal, affirmative votes decline by 13.6 percent to 20.6 percent.[33]

Between them, ISS and Glass Lewis clients control 25 percent to 50 percent of the typical mid-cap or large-cap company's shares, according to a study by a proxy solicitation firm.[34] Members of the Society of Corporate Secretaries and Governance Professionals "think that ISS alone controls one-third or more of their shareholders' votes."[35]

Last year a survey conducted by the Conference Board, NASDAQ, and the Stanford University Rock Center for Corporate Governance reported research demonstrating the influence that proxy advisory firms have over the design of corporate governance policies. Over 70 percent of directors and executive officers reported that their compensation programs were influenced by the policies or guidelines of proxy advisory firms.[36]

To a large degree, corporate directors and executives are now subject to decision making on critical issues by organizations that have no direct stake in corporate performance and make poor decisions as a result. Conscientious shareholders, who do have such a stake, also suffer because their votes are usurped or overwhelmed by these same organizations. The SEC's proxy policy rules have led to results unimagined by their original advocates.

Instead of mutual funds assuming more responsibility for their proxy votes, they have assumed less. Instead of providing more incentive for informed, sensitive voting on proxies, the incentive has been to outsource decision making to firms that, for understandable business reasons, make their recommendations using one-size-fits-all standards.

The problem is compounded because, as a result of the financial crisis, Congress and the president have decided to give shareholders more authority over directors—and that means more authority for proxy advisors, who play a key role in determining how shareholders vote. As Strine wrote, "The influence of ISS and its competitors over institutional investor behavior is so considerable that traditionalists will be

33. Stuart Gillan and Jennifer E. Bethel, "The Impact of the Institutional and Regulatory Environment on Shareholder Voting," University of Delaware Working Paper No. 2002-002, Newark, DE, 2002. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=354820.

34. Yin Wilczek, "Bounty Program to Cramp Corporate Boards: ABA Speakers Discuss Governance Provisions," Daily Report for Executives, *Bloomberg BNA*, Aug. 10, 2010, cited in "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 20, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

35. Quote from Susan E. Wolf, former chair of the Society, cited in "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 20, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

36. The Conference Board, NASDAQ, and Stanford Rock Center for Corporate Governance, "The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions," (March 2012), http://www.gsb.stanford.edu/cldr/research/surveys/proxy.html.

concerned that any initiative to increase stockholder power will simply shift more clout to firms of this kind."[37]

The victims of the unintended consequences are America's investors. As we shall see, research shows that rather than being enhanced, shareholder value is being depleted by the recommendations of proxy advisors because of inadequate professional standards, conflicts of interest, a lack of properly aligned incentives, ideological bias, or some combination of factors.

IV. SUSPECT ADVICE AND SHAREHOLDER VALUE

Regulators have handed a valuable franchise, a franchise that lets them determine the shape of corporate governance in America, to two proxy advisory firms. If the decisions these firms make are good ones—that is, if they promote good governance and thus enhance shareholder value—the concentration of power might not be so troublesome. In that case, even in the absence of a regulatory mandate, institutions might want to make use of proxy firms. The key question is, How good is the firms' advice?

The objective of strong corporate governance is to enhance shareholder value, but it is by no means clear that ISS and Glass Lewis have achieved this objective with their recommendations. In fact, two serious studies found the contrary.

A July 2012 Stanford study titled "The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policies" looked at ISS and Glass Lewis recommendations on compensation policies and issued these stark conclusions:

> First, proxy advisory firm recommendations have a substantive impact on say-on-pay voting outcomes. Second, a significant number of firms change their compensation programs in the time period before the formal shareholder vote in a manner consistent with the features known to be favored by proxy advisory firms apparently in an effort to avoid a negative recommendation. Third, the stock market reaction to these compensation program changes is statistically negative. Thus, the proprietary models used by proxy advisory firms for say-on-pay recommendations appear to induce boards of directors to make choices that decrease shareholder value.[38]

37. Leo E. Strine Jr., "Toward a True Corporate Republic: A Traditional Response to Lucian's Solutions for Improving Corporate America," (John M. Olin Center for Law, Economics and Business Discussion Paper Series, Paper 541, Harvard Law School, Cambridge, MA, 2006), http://lsr.nellco.org/harvard_olin/541.

38. David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policy" (working paper, Rock Center for Corporate Governance at Stanford University Working Paper No. 119, Stanford, CA, 2012): Abstract, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2101453.

Specifically, the researchers found that, in their study of a total of more than 2000 firms, the "average risk-adjusted return" on the implementation of the recommendations "is a statistically significant −0.42%."[39]

In another Stanford study, in 2011, researchers looked at exchange offers—that is, transactions in which executives holding stock options are allowed to trade them in for new options. These offers (also called "re-pricing") typically occur when the original options the executives were granted are trading far out of the money and are unlikely to be worth much, if anything, in the future, thus destroying the incentive that options are supposed to produce.

Certainly, exchange offers can be abused, but whether to issue them is a subtle question that has no simple, uniform solution. Still, ISS has taken a strong stand on limiting exchanges. For example, it issues negative recommendations on exchanges in which executive officers or directors can participate or when new options vest in six months or less.

The study looked at 272 exchange offers and found that only 23 percent were compliant with ISS guidelines. This was a rare instance in which ISS's policies were not particularly influential, but it turned out better for shareholders that ISS was ignored. The researchers observed "a positive price reaction to [all] exchange offers, suggesting that shareholders view these proposals as value-increasing." In addition, "the stock price reaction is significantly less positive when the exchange offer is constrained to meet ISS guidelines." The authors also found that "future operating performance is lower and executive turnover is higher when the exchange program is constrained in the manner recommended by ISS."[40] Thus, the authors found that shareholders experienced better returns if they ignored ISS.

Shareholders do not always ignore ISS's policies in instances where they harm companies. An example is ISS's policies concerning the new Say-on-Pay voting mandate. SoP was immensely popular among state pension and union pension funds. Notably, no representatives from the mutual fund or hedge fund community were active in the debate over SoP, which one would expect if the practice created value for shareholders.[41] The focus that proxy advisors place on SoP votes may stem

39. Ibid, 4.

40. David Larcker, "Do ISS Voting Recommendations Create Shareholder Value?" (Rock Center for Corporate Governance at Stanford University, Closer Look Series: Topics, Issues and Controversies in Corporate Governance and Leadership No. CGRP-13, Stanford, CA, April 19, 2011): 2, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1816543##.

41. At a Senate hearing at which one of the authors testified on this issue, the five-person panel included a representative from the American Federation of State, County and Municipal Employees, a powerful union, and one from the Council of Institutional Investors, a pension fund group controlled by state and union pension funds. Notably, no representatives from the hedge fund or mutual fund lobby were present or particularly supportive of pushing the rule forward at the SEC. The absence of hedge fund or mutual fund support indicates that SoP may be about political issues rather than a focus on shareholder returns. See *Hearing on Protecting Shareholders and Enhancing Public Confidence by Improving Corporate Governance Before the Senate Committee on Banking, Housing, & Urban Affairs*, 111th Cong. (July 29, 2009), http://www.banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Hearing&Hearing_ID=c754606c-0b95-4139-a38a-63e63b4b3fa9.

more from conflicted interests in pleasing particular types of clients than in recommending value-enhancing voting policies.

ISS requires that the board obtain the votes of at least 70 percent of shareholders for its compensation plan, but the proxy advisor provides no evidence to support that arbitrary requirement. Nor does ISS show how SoP votes themselves encourage more efficient compensation policies. ISS also universally recommends annual say-on-pay votes—again, with no empirical support. What SoP votes do encourage (despite the fact that they are not technically binding) are lawsuits.[42]

ISS also backs other corporate governance policies for which the empirical evidence is mixed, at best, but which nevertheless enjoy support among politically motivated institutional investors. Current ISS policies indicate support for independent directors,[43] and the firm indicates it will support, on a case-by-case basis, proposals to give shareholders the right to nominate director candidates to the corporate proxy, despite evidence suggesting that proxy access generally fails to add value.[44] ISS guidelines also indicate opposition to options repricing, as we noted.[45] The evidence on all of these issues is mixed, at best.

ISS supports independent chairs,[46] but the literature is unclear on whether having a chairperson separate from the CEO correlates with increased returns.[47] Golden parachute agreements, which ISS opposes, are actually associated with increases in stock prices.[48] Similar critiques have been raised with respect to independent

42. Sarah A. Good, Cindy V. Schlaefer, and Ana N. Damonte, "Proxy Season Brings Third Wave of 'Gotcha' Shareholder Litigation," PillsburyLaw.com, February 21, 2013, http://www.pillsburylaw.com/publications/proxy-season-brings-a-third-wave-of-gotcha-shareholder-litigation.

43. This paragraph describes policies contained in ISS's most recent policy statement for the 2013 proxy season. See "2013 U.S. Proxy Voting Concise Guidelines," ISS (December 19, 2012), http://www.issgovernance.com/files/ISS2013USConciseGuidelines.pdf.

44. See Thomas Stratmann and J.W. Verret, "Does Shareholder Proxy Access Damage Share Value in Small Publicly Traded Companies?," *Stanford Law Review* 64 (2011): 1431–68.

45. The debate over whether options repricing is material to executive compensation packages is explored in Brian J. Hall and Thomas A. Knox, "Underwater Options and the Dynamics of Executive Pay-to-Performance Sensitivities," *Journal of Accounting Research* 42, no. 2 (May 2004): 365–412.

46. See generally Roberta Romano, *Foundations of Corporate Law*, 2nd ed. (New York: Thomson Reuters/Foundation Press, 2010) 410–25.

47. See, e.g., Paula L. Rechner and Dan R. Dalton, "CEO Duality and Organizational Performance: A Longitudinal Analysis," *Strategic Management Journal* 12, no. 2 (February 1991): 157. See also Audra L. Boone et al., "The Determinants of Corporate Board Size and Composition: An Empirical Analysis," AFA 2005 Philadelphia Meetings, Philadelphia, PA, March 2006. http://dx.doi.org/10.2139/ssrn.605762. See also "Comment from Fidelity Investments on SEC Proposed Rule," SEC, March 18, 2004, http://www.sec.gov/rules/proposed/s70304/fidelity031804.htm.

48. See generally Richard A. Lambert and David F. Larcker, "Golden Parachutes, Executive Decision Making and Shareholder Wealth," *Journal of Accounting and Economics* 7 (1985).

directors.[49] The jury is also still out on takeover protections that have been consistently opposed by ISS and Glass Lewis.[50]

More research is needed to establish with a strong degree of certainty whether proxy advisory recommendations consistently increase shareholder value. A problem with conducting such research is the lack of transparency on the part of the proxy advisors. A Conference Board survey related to advisory firm SoP recommendations concluded:

> While the evidence suggests that companies are aware of and react to proxy advisory policies as they relate to SOP, the evidence does not speak to whether these changes are positive or negative for shareholders. Until proxy advisory firm methodologies are vetted by third-party examiners, it cannot be determined whether these changes are beneficial to companies and their shareholders.[51]

Such third-party examinations will be difficult, if not impossible. As a Rock Center commentary stated:

> Ultimately, the accuracy of a recommendation can only be determined by rigorous statistical analysis showing positive impact of a governance choice on shareholder value. What rigorous empirical research supports each of the voting recommendations promulgated by proxy advisers? Why don't ISS and Glass Lewis disclose the specific research (either that they have conducted or conducted by third parties) that justifies each of their recommendations?[52]

49. Sanjai Bhagat and Bernard S. Black, "The Uncertain Relationship Between Board Composition and Firm Performance," *Business Law* 54, no. 3 (May 1999): 932.
50. Barry Baysinger and Henry Butler, "Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation," *Virginia Law Review* 71 (1985): 1302–3. See also Marcel Kahan and Edward Rock, "Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment," *Pennsylvania Law Review* 152 (2003): 516.
51. The Conference Board, NASDAQ, and Stanford Rock Center for Corporate Governance, "The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions" (March 2012): 6, http://www.gsb.stanford.edu/cldr/research/surveys/proxy.html.
52. David F. Larcker, Allan L. McCall, and Brian Tayan, "And Then a Miracle Happens! How Do Proxy Advisory Firms Develop Their Voting Recommendations?" (Rock Center for Corporate Governance at Stanford University Closer Look Series: Topics, Issues and Controversies in Corporate Governance and Leadership No. CGRP-31, Stanford, CA, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2224329.

V. TWO SOURCES OF LOW-QUALITY ADVICE

The evidence strongly suggests that proxy advisors do not enhance shareholder value with their recommendations. It is time to examine why. The problem begins with a simple fact: proxy advisors lack the resources to make adequate judgments. Currently, ISS has 1,300 clients and covers more than 40,000 meetings and every holding within client portfolios in more than 100 developed and emerging markets worldwide.[53] ISS does all this with a research staff of fewer than 200 persons.[54] The other major advisor, Glass Lewis, says that it "empower[s] institutional investors to make sound decisions by uncovering and assessing governance, business, legal, political and accounting risks at more than 23,000 companies in 100+ countries" with a total of just 300 employees, only 200 of whom are involved in research.[55] In addition, more than half of company shareholder meetings occur in a three-month span (April to June),[56] and this concentration makes thoughtful evaluations even more difficult.

A perverse outcome of the current system is that regulators are effectively separating the evaluation of corporate governance from investment analysis by driving funds to use crude alternatives to assess proxies, rather than the analytic expertise that they tout as their comparative advantage. A 2010 report published on the Harvard Law School forum found that

> at best, they may rely on statistical modeling in an effort to sort portfolio companies by performance, such as grading a company against a peer group determined by SIC codes or the like. . . . Voting decision makers do not and cannot utilize the tools of investment decision makers because it is simply not feasible to do so in the cost environment in which proxy advisors and internal corporate governance staffs are required to operate.[57]

53. "Proxy Advisory Services," ISS, accessed April 4, 2013, http://www.issgovernance.com/proxy/advisory.
54. "A dialogue with Institutional Shareholder Services," Audit Committee Leadership Network in North America, ViewPoints, no. 139 (November 7, 2012): 6, https://webforms.ey.com/Publication/vwLUAssets/Proxy_advisory_firms/$FILE/ViewPoints_39_November_2012_Dialogue_with_ISS.pdf.
55. "About Glass Lewis," GlassLewis.com, accessed April 4, 2013, http://www.glasslewis.com/about-glass-lewis/.
56. "A dialogue with Institutional Shareholder Services," Audit Committee Leadership Network in North America, ViewPoints, no. 139 (November 7, 2012): 6, https://webforms.ey.com/Publication/vwLUAssets/Proxy_advisory_firms/$FILE/ViewPoints_39_November_2012_Dialogue_with_ISS.pdf.
57. Charles Nathan, "The Parallel Universes of Institutional Investing and Institutional Voting," *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, April 6, 2010, http://blogs.law.harvard.edu/corpgov/2010/04/06/the-parallel-universes-of-institutional-investing-and-institutional-voting/.

On February 19 of this year, the Norges Bank Investment Fund (NBIF), the world's largest sovereign wealth fund ($650 billion), released a report questioning the application of one-size-fits-all universal codes for evaluating corporate governance.[58] The NBIF report concluded that "principles should be seen as best practices and that considered deviation must be expected and welcomed." The implication is that the models used by proxy advisors are no substitute for informed analysis that considers the mission and background of each individual fund and looks carefully not just at rules and guidelines but also at the real-life nature of each proxy question.

An especially egregious example of the current reliance on guidelines and models involves Warren Buffett, perhaps the most respected investor and corporate leader of the past 40 years, a man brimming with experience and integrity. His company, Berkshire Hathaway, first bought Coca-Cola shares in 1988 and had amassed $10 billion worth of stock, making Coke at the time its largest single investment. Buffett had long served on the audit committee of the board.

But in April 2004, ISS opposed Buffett's reelection because some of Berkshire's companies, like Dairy Queen, sell Coke products, thus creating what ISS saw as a conflict. According to an ISS press release, "The recommendation is based on ISS's best practice corporate governance guidelines that call for completely independent audit committees."[59]

Buffett was reelected to the board anyway, and he commented, "I think it's absolutely silly. . . . Checklists are no substitute for thinking."[60] We do not suggest that it is necessarily wrong to focus on conflicts of interest on audit committees or otherwise; however, we do suggest that ISS's failure to consider Buffett's history with the company, his stature, and the firm's own compliance with rigid New York Stock Exchange listing rules for audit committee membership indicate a recommendation process that is unsophisticated and "one size fits all."

Checklists are precisely what the regulators have encouraged. For example, ISS guidelines state that the firm will recommend voting against directors of a company that does not act on a shareholder proposal that received a majority of votes in the previous year.[61] This sort of checklist item, of course, means that SoP "precatory," or advisory, votes actually carry the authority of being nearly mandatory. More importantly, the checklist item fails to take into account the possibility that directors may

58. Norges Bank Investment Management, NBIM Discussion Note: Corporate governance, November 19, 2012, http://www.nbim.no/Global/Documents/Dicussion%20Paper/2012/DiscussionNote_14.pdf.

59. ISS, "Institutional Shareholder Services' Response to Coca-Cola Director: Herbert Allen's April 15 Wall Street Journal Op-Ed Misses Point on Audit Panel Independence at Coke," PR Newswire, April 15, 2004, http://www.prnewswire.com/news-releases/institutional-shareholder-services-response-to-coca-cola-director-72496527.html.

60. David Larcker and Brian Tayan, *Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences* (New Jersey: FT Press, 2011), 403.

61. See ISS guidelines referenced in note 43 on page 15.

have more information or wisdom than shareholders, or that events have occurred in the intervening year that supersede the original vote. It is telling that ISS is willing to make that generalized recommendation in the absence of clear evidence whether the underlying successful shareholder proposal will add value at the company.

In addition, ISS toughened some of its standards in 2013, giving shareholder votes even more weight. According to an article in a trade publication, "The firm will now consider a proposal to have gained majority support if it wins a majority of shares cast, not just a majority of shares outstanding. That's a significant change, since many shareholders never cast their votes."[62]

The problem with checklists is that they simplify the complexities of business reality. Consider the matter of ISS's reliance on determining appropriate compensation by linking it to what a company's peer group members are paying. Company A may be on the ropes because a CEO just died or the company is simply performing poorly. The pool of top CEOs in the industry may be tiny, and competitors may be grabbing market share. Company A's directors may believe that hiring away Company B's CEO will both hurt a competitor and help Company A in a time of dire need, and to get B's CEO to move may require doubling his or her salary and offering substantial stock options. Such nuances occur in real life but not on the checklists of ISS and Glass Lewis.

Besides a lack of resources, proxy advisory firms lack the right incentives to make decisions that meet the interests of shareholders. As a working paper from the University of Pennsylvania School of Law states,

> Proxy advisors do not have a financial stake in the companies about which they provide voting advice; they owe no fiduciary duties to the shareholders of these companies; and they are not subject to any meaningful regulation. Moreover, it is not clear that the proxy advisory industry is sufficiently competitive and transparent to subject advisory firms—ISS in particular—to substantial market discipline.[63]

By contrast, the same paper points out that directors have powerful incentives to make the right decisions. They own shares in their companies, they are subject to lawsuits, and they risk their personal reputations. The danger is that "boards may do what they believe ISS wants them to in order to keep their seats, whether or not their belief is justified."[64]

62. Joseph McCafferty, "Proxy Advisers Make Changes to Voting Guidelines for 2013," *Compliance Week,* December 7, 2012, http://www.complianceweek.com/proxy-advisers-make-changes-to-voting-guidelines-for-2013/article/271784/.
63. See Stephen Choi, Jill Fisch, and Marcel Kahan, "The Power of Proxy Advisors: Myth or Reality?," *Emory Law Journal* 59 (2010): 872.
64. Ibid.

VI. THE ADDITIONAL PROBLEM OF CONFLICTS OF INTEREST

When the SEC adopted its rule requiring mutual funds to disclose their proxy voting policies, Chairman Harvey Pitt emphasized that the principal motivation for the new rule was his concern about potential conflicts of interest that mutual fund advisors face in voting their shares. He noted: "Because the securities are held for the benefit of the investors, they deserve to know the fund's proxy voting policies and whether they were in fact followed. Many wield voting power in the face of conflicts; they may cast votes furthering their own interests rather than those for whom they vote."[65]

Conflicts of interest deserve considerable discussion. Let's begin by looking at the results of poor advice under similar circumstances at credit-rating agencies.[66]

Federal regulators have designated nine firms as "nationally recognized statistical rating organizations."[67] One of the key functions of these NRSROs is to determine the creditworthiness of corporate and government borrowers and of specific bond issues. Two private firms dominate the market, though not quite as thoroughly as ISS and Glass Lewis dominate proxy advice. The two are Standard & Poor's, which according to the most recent SEC survey accounted for 44,500 of the 99,286 ratings of corporate issuers in 2010, and Moody's, which accounted for 30,285. Between them, the two firms accounted for 75 percent of the market for corporate bonds; a third firm, Fitch, added another 14 percent. S&P and Moody's had an even larger share—83 percent—of the market for rating government securities, with Fitch accounting for nearly all the rest.[68]

An array of financial regulations requires banks, insurance companies, and other institutions "to use credit ratings to establish investment risk standards for their portfolio holdings,"[69] for example, to meet capital requirements. After the financial crisis of 2008–09, credit-rating agencies, with conflicts of interest similar to proxy advisory firms, came under criticism for underestimating the risk involved in asset-backed securities, which they also rate (S&P and Moody's controlled 73 percent of that market in 2010; Fitch, another 21 percent). On February 5 of this year, the

65. "Speech by SEC Chairman: Remarks at the Commission Open Meeting," Chairman Harvey L. Pitt, SEC, January 23, 2003, http://www.sec.gov/news/speech/spch012303hlp.htm.
66. Editorial, "Standard & Poor's Stands Accused," *New York Times*, February 5, 2013, http://www.nytimes.com/2013/02/06/opinion/standard-poors-stands-accused.html.
67. "Annual Report on Nationally Recognized Statistical Rating Organizations," SEC (March 2012): 6–7, https://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0312.pdf.
68. Ibid., 9–10
69. Ibid., 15.

Department of Justice brought suit against S&P, charging that severe harm was inflicted on investors.[70]

The problem was not simply that credit-rating firms misjudged risk (either innocently or because of conflicts of interest) but that—just as with proxy advisory firms—regulators conferred substantial evaluative powers on a few firms, thus enabling institutions that engaged those firms to pass off responsibility for exercising their own fiduciary duty to conduct an informed analysis of the suitability of securities held in client accounts.

Proxy advisors don't literally or legally have the same license as credit-rating agencies, but their oligopoly is eerily similar. The fear now is that the regulations that have empowered a few proxy advisers are leading to the same adverse results as the rules that have empowered a few rating agencies.[71]

Remember that the main purpose of the 2003 SEC rule on proxies was to address problems caused by conflicts of interest between institutions and the shareholders whose assets they manage. In fact, the conflicts have merely been shifted to different firms. The conflicts have actually been exacerbated by the rule, since their regulatory mandate gives proxy advisors substantial market power. Before the 2003 rule, competitive pressures were already encouraging some mutual funds to disclose information about their proxy voting policies to customers.[72] Now those competitive pressures are less effective.

There are two major kinds of conflicts of interest that afflict proxy advisors. The first is that advisors may beinfluenced by some of their largest clients to make recommendations that serve those clients' social and political interests. As James R. Copland of the Manhattan Institute wrote in a *Wall Street Journal* op-ed: "ISS receives a substantial amount of income from labor-union pension funds and 'socially responsible' investing funds, which gives the company an incentive to favor proposals that are backed by these clients."[73] As a result, the behaviors of proxy advisors "deviate from concern over share value, [suggesting] that this process may be oriented toward influencing corporate behavior in a manner that generates private

70. "Department of Justice Sues Standard & Poor's for Fraud in Rating Mortgage-Backed Securities in the Years Leading Up to the Financial Crisis," United States Department of Justice (February 5, 2013), http://www.justice.gov/opa/pr/2013/February/13-ag-156.html. To be clear, the authors doubt that this particular lawsuit has merit. See "Payback for a Downgrade? The Feds Sue S&P but not Moody's for Pre-crisis Credit Ratings," *Wall Street Journal*, February 5, 2013, http://online.wsj.com/article/SB100014240 53111903596904576518460162935404.html.

71. Charles M. Nathan and Parul Mehta, *The Parallel Universes of Institutional Investing and Institutional Voting* (Rochester, NY: Social Science Research Network, 2010), 3.

72. See "Comment from Franklin Tempelton Fund on SEC Proposed Rule," SEC, December 9, 2002, http://www.sec.gov/rules/proposed/s73602/mlsimpson1.htm.

73. Opinion, "Politicized Proxy Advisers vs. Individual Investors," *Wall Street Journal*, October 7, 2012, http://online.wsj.com/article/SB10000872396390444620104578012252125632908.html.

returns to a subset of investors while harming the average diversified investor."[74] The legacy of the SEC's proxy policy rules appears to have encouraged a focus, in the words of SEC Commissioner Daniel Gallagher, on "social and political issues rather than issues that would be material to investors."[75]

The second variety of conflict that taints advisors is that they provide consulting services to the issuers about whom they make voting recommendations to mutual funds. These consulting services are designed precisely to facilitate managers' obtaining favorable recommendations. Copland writes about ISS:

> About 20% of its revenues also come from consulting contracts with companies about corporate governance issues and executive compensation, according to MSCI's 2011 annual report. Shareholder proposals that increase corporate sensitivity to ISS preferences would have the effect of increasing the incentive for public companies to enter into such consulting contracts with ISS. . . . From 2006 to 2012, ISS supported 35% of shareholder proposals related to environmental issues such as global warming or natural-gas hydraulic fracturing, and 70% of proposals seeking to increase disclosure of or to limit corporate political spending. Only one such proposal has received the support of a majority of shareholders.[76]

The SEC's Egan-Jones Letter, issued by the SEC shortly after its proxy advisor rule was enacted, addressed this potential conflict:

> An investment adviser could breach its fiduciary duty of care to its clients by voting its clients' proxies based upon the proxy voting firm's recommendations with respect to an Issuer because the proxy voting firm could recommend that the adviser vote the proxies in the firm's own interests, to further its relationship with the Issuer and its business of providing corporate governance advice,

74. James R. Copland, Yevgeniy Feyman, and Margaret O'Keefe, "Proxy Monitor 2012: A Report on Corporate Governance and Shareholder Activism" (Fall 2012): 3, http://proxymonitor.org/pdf/pmr_04.pdf.

75. Ning Chiu, "SEC Commissioners take divergent views on corporate governance and related disclosure regulations," *Lexology,* February 26, 2013, http://www.lexology.com/library/detail.aspx?g=d121d7fb-a090-4338-aff7-55d8b5fe13c1.

76. Opinion, "Politicized Proxy Advisers vs. Individual Investors," *Wall Street Journal,* October 7, 2012, http://online.wsj.com/article/SB10000872396390444620104578012252125632908.html.

> rather than in the interests of the adviser's clients. The proxy voting firm's relationship with an Issuer thus may present a conflict of interest that is in addition to any conflict of interest that the investment adviser may have.[77]

While the SEC staff clearly recognized the potential for conflict, the letter then took a turn that was surprisingly deferential to the proxy advisory firms by suggesting that disclosure would be sufficient to relieve the problem:

> Accordingly, an investment adviser should obtain information from any prospective independent third party to enable the adviser to determine that the third party is in fact independent, and can make recommendations for voting proxies in an impartial manner and in the best interests of the adviser's clients. . . . For instance, under the circumstances that you describe in your letter, the procedures should require a proxy voting firm that is called upon to make a recommendation to an investment adviser regarding the voting of an Issuer's proxies to disclose to the adviser any relevant facts concerning the firm's relationship with an Issuer, such as the amount of the compensation that the firm has received or will receive from an Issuer.[78]

This approach stands in stark contrast to other situations in which the SEC has issued regulations motivated by conflict-of-interest concerns in the arena of corporate governance. In cases involving investment analysts, for instance, the SEC has been quite aggressive. In its regulation of some non-audit advisory services offered by firms that conduct financial audits, the SEC was similarly dismissive of arguments that conflicts of interest could be managed merely through disclosure.[79] (Debates over the advisability of the SEC's approach to potential conflicts of interest involving investment advisers or auditors are beyond the scope of this paper. The examples suggest that the SEC's soft approach to proxy advisory firm conflicts of interest has been uncharacteristic.)

The Department of Labor, which regulates pension plans under ERISA (Employee Retirement Income Security Act of 1974, the main law regulating pension plans), has taken a more forceful stand against conflicts of interest in voting proxies. DOL's Advisory Opinion 2007-07A expressed "strong concern about the

77. SEC to Hughes, May 27, 2004.

78. Ibid.

79. See, e.g., Strengthening the Commission's Requirements Regarding Author Independence, 68 Fed. Reg. 6006 (February 5, 2003) (to be codified at 17 C.F.R. pts. 210, 240, 249, and 274).

use of plan assets to promote particular legislative, regulatory or public policy positions that have no connection to the payment of benefits or plan administrative expenses."[80] The letter used this example:

> The likelihood that the adoption of a proxy resolution or proposal requiring corporate directors and officers to disclose their personal political contributions would enhance the value of a plan's investment in the corporation appears sufficiently remote that the expenditure of plan assets to further such a resolution or proposal clearly raises compliance issues under [ERISA].[81]

In March 2011, the DOL's inspector general issued a report warning that unions may be using "plan assets to support or pursue proxy proposals for personal, social, legislative, regulatory, or public policy agendas."[82] The inspector general noted that the Employee Benefits Security Administration (ESBA), the division of DOL that enforces ERISA, often lacked adequate assurances that plan fiduciaries or third parties like proxy advisory firms base their votes or recommendations for votes on actual economic benefit.[83] It appears that the Labor Department's Inspector General shares our concern that corporate voting policies by some politically active funds may be conflicted.

It is possible that conflicts of interest posed by proxy advisory firms accepting consulting fees from issuers may already be prohibited under ERISA—or expose plan fiduciaries or proxy advisors to liability under the law. DOL has contemplated designating proxy advisors as fiduciaries under ERISA, a question beyond the scope of our analysis.[84] Even in the absence of such a rule, reliance on proxy advisors who provide consulting services may be prohibited.

When an ERISA fiduciary (that is, an official or firm with influence over pension plan investments) appoints others to fulfill its obligations—such as when it gives voting power to a proxy advisor—the ERISA fiduciary also has an obligation to monitor those appointees.[85] If relying on an expert that also receives fees from those whom the expert is assessing—fees that relate to the very matters in question—is deemed unreasonable, then ERISA fiduciaries may not meet their obligations for prudence.

Also, under ERISA, when a fiduciary acts to the benefit of a third party, even if

80. See 29 C.F.R. § 2509.94-2 (2008).
81. Ibid.
82. "Proxy-voting May Not be Solely for the Economic Benefit of Retirement Plans," Department of Labor, Office of Inspector General—Office of Audit, Employee Benefits Security Administration, Report No. 09-11-001-12-121 (March 31, 2011): 4–8, http://www.oig.dol.gov/public/reports/oa/2011/09-11-001-12-121.pdf.
83. Ibid.
84. Definition of the Term "Fiduciary," SEC, 75 Fed. Reg. 65,263, (October 22, 2010).
85. See Shirk v. Fifth Third Bancorp, No. 05-cv-49, 2007 WL 1100429, at *16 (S.D. Ohio April 10, 2007).

the fiduciary's own interest is not implicated, the fiduciary may violate its duty.[86] In addition, the lack of company-specific recommendations by proxy advisors and the limited empirical evidence supporting those recommendations call into question whether ERISA fiduciaries are fulfilling their obligations.

While the SEC's fiduciary rules for investment advisers are less developed than the Department of Labor's, many of the same principles could also inform interpretive guidance from the SEC to regulate the role of conflicts of interest faced by proxy advisors in corporate governance.

Some proxy advisors or ERISA fiduciaries might provide boilerplate disclosure about the possibility of conflicts stemming from consulting fees, yet in analogous contexts, like those involving auditors whose firms offer consulting services, institutional investor groups have been highly suspicious and have found disclosure or firewalls to be insufficient remedies.

For instance, the California Public Employees' Retirement System (CalPERS) advocates the following clear principle on auditor independence: "The external auditor should not provide internal audit services to the company."[87] Consulting services provided by the same entity that provides the external assessment represent an unavoidable conflict of interest in the view of CalPERS, which, with $254 billion in assets, serves 1.6 million members. It would seem that a similar problem is present when the same proxy advisory firm may be called upon to provide an external rating of a corporate governance proposal or mechanism it helped design.

In addition, the Council of Institutional Investors advocates that "a company's external auditor should not perform any non-audit services for the company, except those, such as attest services, that are required by statute or regulation to be performed by the company's external auditor."[88] Some proxy advisors have attempted to keep their work in proxy recommendations separate from their consulting work for issuers.[89] Still, it would seem inconsistent to argue that auditors providing tax structuring advice or internal audit consulting to the issuers they audit represent such an obtrusive conflict of interest that the practice must be banned outright, and at the same time argue that proxy advisors can successfully avoid the conflicts posed by providing consulting services to the issuers about whom they make voting recommendations.[90]

Indeed, the analogy to auditing fees actually *understates* the conflict involved. To be fully analogous, we would have to consider a situation where auditors provided issuers with consulting services about how to navigate successfully an outside audit (and by the same firm).

86. See Bevel v. Higgonbotham, Civ.-98-474-X, 2001 WL 1352896, at *14 (E.D. Okla. Oct. 4, 2001).
87. See Global Principles of Accountable Corporate Governance, CalPERS, November 14, 2011 at 27.
88. See Global Principles of Accountable Corporate Governance, CalPERS, November 14, 2011.
89. See Concept Release on the U.S. Proxy System, SEC, 75 Fed. Reg. 42,981, 43,009 (July 22, 2010).
90. See "Comment from Council of Institutional Investors on SEC Proposed Rule," SEC, January 10, 2003, http://www.sec.gov/rules/proposed/s74902/sabteslik1.htm.

Courts have held that obligations imposed by ERISA should be construed consistently with those of the federal securities laws.[91] Thus, to the extent that these principles cross over to the fiduciary obligations owed by proxy advisors and the investment advisers who rely on them, similar restrictions and liability risks from proxy advisor consulting fees may be present.

We have now examined three sources of low-quality advice: lack of resources, misaligned incentives, and conflicts of interest. Conflicts may already violate DOL regulations, which in turn provide guidelines for the SEC to follow. We have other recommendations as well to fix the current broken system.

VII. RECOMMENDATIONS

THE PROXY ADVISORY industry was principally created by regulation. Without regulatory mandates requiring active participation in proxy votes, and without interpretative releases giving preferential treatment to investment managers who use proxy advisors, a profitable proxy advisory industry might not exist.

There are legitimate concerns about merely adding more regulations, such as requirements that proxy advisors further "professionalize" their staffs or that a mandatory disclosure regime be created to solve a problem caused by regulation. The result of additional rules, as with credit-rating agencies, is often to make the regulated institutions less open to competition and closer to their regulators, a phenomenon known as "regulatory capture." Also, as we have seen, regulations often produce unintended consequences. It was no surprise that the US Chamber of Commerce, in a set of proposals in March for repairing the proxy advisory system, rejected the regulatory approach.[92]

On the other hand, replacing poor regulations with well-designed regulations can render businesses more exposed to the normal market forces that produce good outcomes.

The Egan-Jones letter shifted fiduciary responsibility for proxy decisions from mutual funds to third parties while simultaneously limiting the fiduciary exposure of those third parties. In the end, except in extraordinary cases, no one is responsible for representing the interests of shareholders. As a remedy, the law firm Wachtell, Lipton, Rosen & Katz argued, according to a piece in the *New York Times*, "that proxy advisory services should be subject to the proxy solicitation rules. If these rules applied, shareholders and public companies could sue the advisory services over disclosure lapses in their recommendation reports."[93] It is possible, of course,

91. *Shirk*, 2007 WL 1100429, at *15.

92. Ross Kerber, "Chamber of Commerce wants more proxy advisor disclosures," Reuters, March 20, 2013, http://www.reuters.com/article/2013/03/20/us-proxy-advisors-chamber-idUSBRE92J0S120130320.

93. Steven M. Davidoff, "Proxy Firms Need More Rules, Companies Say," DealBook, November 30, 2010, http://dealbook.nytimes.com/2010/11/30/in-one-area-companies-want-more-regulation/.

that "by imposing this liability, the ability of proxy advisors to make recommendations would be chilled, if not killed."[94] This paper does not suggest either a mandatory disclosure regime or the Lipton proposal, though both are valid options that deserve a place in the debate.

At a bare minimum, regulators must act to end to proxy advisor services' conflicts of interest, actual and potential. The firms must choose their clients: either corporate share issuers or investment institutions such as mutual funds—but not both. Even if this conflict were eliminated, the change would not remove that possibility that ISS would favor the ideological and political views of large proxy-advisory clients. That bias can't be removed through oversight, only through competition. In other words, if it were more broadly known that ISS recommendations diminished shareholder value, both kinds of potential clients might look elsewhere for advisory services.

Knowledge about shareholder value depends on research, and this sort of research is difficult to design because the advisory firms lack transparency. If regulators eliminate rules that offer preferential treatment to proxy advisors and the firms that use them, and eliminate the regulatory mandate for active voting policies, disclosure will occur voluntarily through market forces. This voluntary disclosure can occur along the lines recently suggested by the US Chamber, asking that proxy advisors

> review the effects of their recommendations six months, or as practicable, after relevant proxy votes, and publish those results (with other necessary data) to permit interested persons to assess the accuracy, validity, and appropriateness of the PA Firm's recommendations. . . . These reviews should permit regularly revisiting and, if appropriate, modifying, proxy voting policies to ensure that they have a positive—or at a minimum no negative—effect on shareholder value.[95]

Unfortunately, ISS issued a response to the Chamber's suggestion that illustrates the extensive buffer it enjoys from market competition:

> We take exception with the Chamber's misinformed characterization of the proxy advisory industry and with their disrespect for the financial institutions that are our clients and, ironically, some of the Chamber's own members. . . . We are accountable to our

94. Ibid.
95. "Best Practices and Core Principles for the Development, Dispensation, and Receipt of Proxy Advice," Center for Capital Markets Competitiveness, Chamber of Commerce (March 2013): 7, http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Best-Practices-and-Core-Principles-for-Proxy-Advisors.pdf.

> clients who place their confidence in our service, to the companies we analyze and to the regulators that set the real guidelines for fiduciary responsibility. The Chamber should take its own advice by grounding its "Principles" in actual facts rather than its own self-serving interests.[96]

Fixing the current system also requires that we acknowledge that mutual funds can't possibly make considered judgments about tens of thousands of proxies, and that it is not in their best interest to do so. "Institutional investors like mutual funds and pension funds do not have the resources to analyze and consider all these proposals," as Steven Davidoff, a law school professor, wrote in the *New York Times*.[97] TIAA-CREF, for instance, holds stock in 7,000 companies and must cast more than 100,000 votes a year. Instead of requiring mutual funds to engage in active analysis of tens of thousands of votes, the SEC could allow funds and their advisers to determine when such analysis would be in their fund's best interest. This approach recognizes that the ultimate source of the problem is not the way ISS conducts its business but the burden the SEC has imposed on mutual funds that made them turn to ISS in the first place.

That burden is compounded by Dodd-Frank's insistence that shareholders cast certain votes, such as Say-on-Pay. We believe such proxy requirements are unnecessary. If issuers ignore the wishes of shareholders, then shareholders will take appropriate action through self-funded proxy fights, filing civil lawsuits, taking short positions, or simply voting with their feet by selling shares, thereby sending the powerful signal of a falling stock price.

In the absence of such a policy shift, many institutional investors cannot or will not dedicate sufficient resources to develop individual assessments of all proxies. And, since the SEC has provided them with what appears to be a legal "safe haven," these mutual funds will continue to turn to firms like ISS, firms that cannot adequately evaluate all the companies in the investment universe.

On the other hand, if the SEC recognized the limitations of the current policy, investors would benefit from lower costs and a decrease in the risk associated with centralized decision making. This change would not necessarily eliminate the role of proxy advisors but would reduce it to its proper weight in the scheme of corporate governance. Holly Gregory of the law firm Weill, Gotshal & Manges recently wrote on the blog of the Harvard Law School Forum on Corporate Governance

96. "ISS Response to the U.S. Chamber of Commerce's Guidelines for Proxy Advisory Firms," ISS, accessed April 4, 2013, http://www.issgovernance.com/press/issreponsechamberofcommerce.
97. Davidoff, "Proxy Firms Need More Rules, Companies Say."

and Financial Regulation, "Decisions to utilize the services that proxy advisors offer should be made on an informed basis after appropriate due diligence, especially if the shareholder is an institutional investor that owes fiduciary duties to beneficiaries."[98]

Those fiduciary duties include serious considerations of costs versus benefits. A perverse result of mandating that institutions vote all matters on a company proxy is that the SEC is essentially saying all issues are important to all shareholders. In fact, the potential benefits realized by voting on certain items, as required by SEC regulations, are outweighed by the cost to the fund of conducting a proper evaluation—a cost ultimately absorbed by the shareholders. In other words, the cost of, say, deciding how to vote proxies on 1,000 shares of a stock owned by a mutual fund with high turnover *subtracts* from shareholder value.

A report by the law firm Latham & Watkins, LLP, cites a 2008 interpretation by the Department of Labor, which found

> that an investment adviser's fiduciary duty requires it first affirmatively to conclude that the potential economic benefits to share value arising from the act of voting outweighs [*sic*] the costs of voting (including the risk that the vote could decrease share value), with voting being appropriate only for those matters at a particular company that are determined to have greater benefit than cost.[99]

So far, neither the Department of Labor nor the SEC has reconciled this need for benefit-cost analysis with universal active proxy voting policy requirements. While the 2008 DOL interpretation tried to address the universal active voting mandate, a shift in priorities and a lack of enforcement at the DOL has since undercut the 2008 interpretive letter.

The SEC also has yet to address the responses to its 2010 concept release on proxy voting. When it does, it must recognize that its own interpretation of the original 2003 rule is at the root of the trouble—and the trouble is that two small firms, and one in particular, have become the central arbiters of corporate governance in America, and those firms are not equipped or incentivized to make value-enhancing decisions.

98. Holly Gregory, "Preserving Balance in Corporate Governance," *The Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), February 1, 2013, http://blogs.law.harvard.edu/corpgov/2013/02/01/preserving-balance-in-corporate-governance/.

99. "Proxy Advisory Business: Apotheosis or Apogee?," *Corporate Governance Commentary*, Latham & Watkins LLP (March 2011): 2, citing 29 C.F.R. § 2509 (2008).

Three steps are needed to fix the problem:

1. Limit proxy voting requirements of mutual funds and pension funds so that those institutions will be the sole arbiters of when it makes sense to vote using active analysis of the question at hand. The test should be whether the vote enhances the value of an investment to a significant degree and whether the benefits of the voting process exceed the costs.
2. End the preferential regulatory treatment that proxy advisors currently enjoy in the law. That process must start by rescinding the Egan-Jones letter issued by the SEC staff. Institutional investors would remain free to purchase proxy advisory services if those services are valued for their own merit. Continued resistance by proxy advisors to sharing the empirical foundation for their recommendations suggests demand for their services may decline in the absence of their regulatory advantages.
3. End extraneous proxy requirements, such as Say-on-Pay votes. Let shareholders and directors decide the matters that should be put to votes, if any, beyond those already required under state corporate law.

All three steps are reasonable, nonideological, and address a pressing problem. They should be relatively easy to accomplish. However, if step 2 is not enacted, we would advocate as an alternative limiting proxy advisors to a single business in order to mitigate conflicts of interest. They can advise issuers on corporate governance and getting proxy proposals passed, or they can advise mutual funds and other financial institutions on how to vote—but not both. As we noted in the previous section, such a conflict may already subject ERISA plans relying on proxy advisors to potential liability. The SEC's rules for mutual funds and their advisers recognize this conflict.

The time for reform is now. The regulatory advantages proxy advisory firms enjoy should be curtailed in the interest of America's shareholders.