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March 23, 2012

Whatever Happened to the Prudent Man? The Case for Limiting the Influence of Proxy Advisors through Fiduciary Duty Law

Jodi Slaght, Marquette University

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WHATEVER HAPPENED TO THE PRUDENT MAN? THE CASE FOR LIMITING THE INFLUENCE OF
PROXY ADVISORS THROUGH FIDUCIARY DUTY LAW

JODI SLAGHT*

I. INTRODUCTION

Proxy advisors exercise unrestrained influence over shareholder voting without an
economic interest in the companies they assess. Such unrestrained influence has the potential to
harm the company that is subject to the proxy advisor’s analysis. This Article identifies
regulation as the origin of the existence and influence of the proxy advising industry, and
attempts to provide a meaningful solution to its unrestrained influence in light of the current
climate of regulatory control.

Proxy advisors are third-party consultants that charge institutional investors for advice
about a specific company, and provide “for” or “against” recommendations on shareholder
voting issues.1 The proxy advisory industry is rooted in the shareholder rights movement that
began in the late 1960s.2 During this period, institutional investors typically voted
managements’ recommendations, or did not vote at all.3 Demand for information and an
informed voting mechanism sparked business ideas.

Today, institutional investors are allowed to consult with proxy advisors for direction in a
number of different areas. Such functions include: analyzing and making voting
recommendations on the matters presented for shareholder vote, executing votes on behalf of
institutional investors, assisting firms with administrative tasks such as vote tabulation, providing

2 Dean Starkman, A Proxy Advisor’s Two Sides, THE WASHINGTON POST, Jan. 23, 2006, available at
3 Id.
research and identifying risks, and eliminating conflicts of interest that may arise when the interest of an investment adviser conflicts with its client’s.⁴

Despite the best of intentions, the influence and lack of accountability of proxy advisors has become a cause for concern. In response, the Securities and Exchange Commission (“SEC”) issued a concept release in 2010 addressing possible regulation of proxy advisors. Several institutions, academics, and investors have responded to the SEC’s request for comment. Generally, comments response drafted by scholars, issuers, institutional investors, and industry professionals have suggested either (1) that proxy advisors register with the SEC under the Investment Advisers Act of 1940, or (2) that the SEC should promulgate rules to regulate proxy advisors that are similar to the current SEC rules regulating credit ratings agencies. This Article takes a critical look at the suggestions put forth and determines that neither approach would provide the needed oversight. A better solution would be to clarify existing SEC commentary so that fiduciary duties of investment advisers survive the advice of proxy advisors, thus limiting their influence. The implication of such a clarification would be that investment advisers would comply with their fiduciary obligation by advising their institutional investor client how to vote its shares, rather than advising the institutional investor to follow the advice of a proxy advisor. Additionally, this solution is more timely than formal rule promulgation, which is necessary because the implementation of “Say on Pay” increased proxy advisor’s power.

The Article begins by discussing the inception, growth, and influence of the proxy advising industry. Part III discusses the unrestricted influence of proxy advisors and the problems that arose from this lack of control. Part IV examines the current regulatory

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framework and cautions against formal rulemaking as an impulse reaction. Finally, Part V explores potential solutions to problems associated with the lack of regulation.

II. THE ONSET OF REGULATION, THE BIRTH OF PROXY ADVISORS, AND THE PROXY ADVISOR’S RISE TO INFLUENCE

The regulation of investment advisers\(^5\) created a need in the investment industry for efficient mechanisms for voting proxy shares in accordance with fiduciary duties.\(^6\) Rather than establish their own voting mechanisms, investment managers looked for a means to outsource fiduciary duties. The proxy advising industry arose in response to the needs of institutional investors to efficiently vote large numbers of share in accordance with their fiduciary obligations. Since its inception, the influence of the proxy advising industry has become quite significant; present indicators are that the industry’s growth and influence will increase in years to come. Proxy advisors offer three different services: (1) they rate corporate governance, (2) they offer a logistics platform that allows investors to automatically vote management’s proxy recommendation, and (3) they issue recommendations on how investors should vote their shares of firms included in their portfolio. This article will primarily focus on the third service—proxy voting recommendations.

A. Novel Government Regulation of Investment Advisers Created a Shift in Investment Philosophy

One of the most important aspects of stock ownership is the right to vote shares so that each stockholder may have a voice in the management of the companies they own. Important

\(^5\) An “investment adviser” is defined in Section 202(a)(11) of the Investment Adviser Act of 1940. To be considered an investment adviser an individual or firm must meet three qualifications: the investment adviser (1) for compensation is (2) engaged in the business of (3) providing advice, making recommendations, or issuing reports on securities. 15 U.S.C. §80b-2(11) (2011). Any firm or individual that meets this definition is required to register with the SEC as an investment adviser unless some other provision of the Act takes it outside of the definition. 15 U.S.C §801-3(a)(1)(c) (2011).

\(^6\) Both the Department of Labor and the Securities and Exchange Commission brought about regulation of investment advisers. The details of the investment adviser’s regulation will be outlined in the next section.
voting issues include the election of directors; changes to the articles of incorporation; and the sale, merger, or dissolution of the company.

Over the last 50 years\(^7\) stock ownership has shifted from typically being owned by individual shareholders, otherwise known as retail investors, to ownership by large organizations, also know as institutional investors. This shift in stock ownership has increased the popularity of proxy voting. Proxy voting allows a shareholder to appoint proxies to vote the shareholder’s stock on the shareholder’s behalf. SEC reports indicate that most investors now vote by proxy.\(^8\) While shifts in stock ownership altered the landscape of share ownership, government regulation spawned the birth of proxy advisors.

The “traditional philosophy” of the investment management industry was to follow one of two courses with regard to share voting: (1) the investment management firm would vote in accordance with management’s recommendations on its proxy statement so long as the firm had no concerns about management’s decision-making abilities, or (2) if there was concern with the management, the investment firm would simply sell its shares, and thus avoid voting altogether.\(^9\) The traditional philosophy of the investment management industry changed when regulators began imposing fiduciary duties on institutional investors. Beginning in the mid-1980s, the Department of Labor required any firm managing assets in ERISA-governed pension plans\(^10\) to


vote all shares in accordance with the prudent man standard\(^\text{11}\) (the duty of care).\(^\text{12}\) Following suit, the SEC mandated that all registered investment advisers vote all managed shares in compliance with the fiduciary duty of care and the fiduciary duty of loyalty in the best interest of the investment adviser’s beneficiary.\(^\text{13}\) The imposition of these two heightened standards created a void in the investment management industry: investment managers needed to obtain sufficient information to vote in accordance with their duties, but did not necessarily have the time or resources available to investigate the matter and thus comply with these fiduciary duties. Out of the void, the market developed several “outsourcing” strategies so that investment advisers could meet their obligations in an economically sound manner.\(^\text{14}\) Consulting proxy advisors has become chief among the outsourcing strategies.\(^\text{15}\) The services offered by proxy advisors range from making recommendations about how to vote shares, to creating mechanisms for voting shares, to actually exercising proxy votes on behalf of clients.\(^\text{16}\)

**B. The Spawning of a New Industry: The Rise & Continued Growth of Proxy Advisors**

The growth and influence of proxy advisors is largely affected by two recent trends in Corporate America: (1) the rise in recent corporate governance scandals,\(^\text{17}\) and (2) the increase in the number of shares held by institutional investors.\(^\text{18}\) First, corporate governance scandals (such

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\(^\text{11}\) The prudent man standard requires fiduciaries to make investment decisions in accordance with the fiduciary duty of care and the fiduciary duty of loyalty. *Harvard College v. Amroy*, 26 Mass. 446, 461 (1830). The fiduciary duty of care requires that the fiduciary discharge his or her duty with the care that a person in a like situation would “reasonably believe appropriate” under like circumstances. Model Business Corporation Act §8.30(a)(2).

\(^\text{12}\) Nathan, *supra* note 9, at 353.

\(^\text{13}\) The duty of loyalty is imposed on fiduciaries of a company to avoid conflicts of interest. Thus the fiduciary must place the interests of the organization above his or her own interest. This prevents fiduciaries from engaging in self-dealing and prevents them from taking opportunities away from the organization. Model Business Corporation Act §8.30(a)(3); Nathan, *supra* note 9, at 354; *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies*, 68 Fed. Reg. 6564 (Feb. 7, 2003).

\(^\text{14}\) *Id.* at 355.

\(^\text{15}\) *Id.*

\(^\text{16}\) *Id.* at 257-58.

\(^\text{17}\) R. Franklin Balotti et. al., *MEETINGS OF STOCKHOLDERS* §5.5 Players in the Corporate Governance Debate—The Three O’s (Aspen Publishers, 2009).

\(^\text{18}\) Rose, *supra* note 7, at 897.
as Worldcom, Enron, and Tyco)\(^{19}\) created a need for independent third party advisors to establish and ensure compliance with “best practices” standards.\(^{20}\) The commonality among these scandals was abusive decision-making by management and the board of directors.\(^{21}\) The best practices standard arose as a means to provide a benchmark for generally appropriate decision-making.

Standing alone, “best practices” standards can be beneficial. However, universal imposition across business models undermines management’s business judgment. Proxy advisors simply reward or penalize corporate governance policies enacted by the issuer.\(^{22}\) This unexamined imposition is especially dangerous when coupled with the size and influence of proxy advisors. The size and influence of proxy advisors force issuers to acknowledge the standards introduced by proxy advisors, essentially rendering issuers a captive audience. If a issuer simply ignores the “best practice” standard created by proxy advisors, the firm will risk negative votes from shareholders. The danger in this unchecked power is that issuers are either forced to comply with the “best practices” standards regardless of fit, or must submit to the mercy of the proxy advisor and seek pardon for its decision. This is the equivalent of giving proxy advisors regulatory authority without instilling any accountability measures for abuses of

\(^{19}\) The WorldCom scandal was an accounting fraud that originated with the CEO, Bernard Ebbers, and was perpetuated by corporate insiders known as “Bernie’s Boys.” James Fanto, Whistleblowing and the Public Director: Countering Corporate Inner Circles, 83 Or. L. Rev. 435, 449-53 (2004). Enron is a slightly more amorphous example because the blame for Enron’s failure has been widespread. Larry Ribstein, Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002, 28 J. Corp. L. 1, 5 (2003) However, it is uncontested the Enron’s board was responsible for the massive amounts of self-dealing and accounting fraud the company committed. Skilling v. United States, 130 S. Ct. 2896 (2010). The Sarbanes Oxley Act (SOX) was passed in 2002 in response to Enron and other corporate governance scandals. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 2(a), 116 Stat. 745, 746 (2002) (codified at 15 U.S.C. § 7201 (2009)). SOX was enacted to create greater independence and to enhance the standards of the board of directors, accounting firms, and management. Id.

\(^{20}\) See id. at 889 Rose believes this relationship is cyclical. The existing relationship between investment advisers and proxy advisors made proxy advisors a logical choice for ensuring “best practices” compliance. The need for independent assessment of corporate governance has furthered the intimacy of the relationship between investment advisers and proxy advisors, thereby making proxy advisors more influential.

\(^{21}\) See id.

\(^{22}\) Rose, supra note 7, at 898.
power or mistakes in judgment. The government made rules to alleviate corporate governance problems, and the method businesses choose to follow for compliance with government regulations should be the choice of management with the input of shareholders and not set arbitrarily by proxy advisors.

Secondly, the number of institutional investors, as well as the number of shares that are owned by institutional investors has increased. The increases contributed to the influence of proxy advisors because more shares now must be voted in accordance with fiduciary duties. From 1965 to 2001, the number of institutional investors rose by an estimated 50%.23 Likewise, the number of equities held by institutional investors rose by 45%.24 The increasing breadth in the investment portfolios held by institutional investors has made it impractical for institutional investors to investigate and vote its own shares. For example, TIAA-CREF, one of the largest institutional investors, estimates that it owns stock in over 7,000 companies and casts more than 80,000 proxy votes annually.25 Such large portfolios place heavy investigatory burdens on institutional investors. Without proxy advisors, financial burdens would likely have a crippling effect on the business model of institutional investors.

Without doubt, proxy advisors have become a necessary part of the modern investment landscape. However, unregulated, ever-growing influence is a cause for concern. Developments in the current corporate environment, such as increased SEC regulation26 and the recent

23 Id.
26 The enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 will create more voting issues for shareholders. Specifically, the enactment of the Say-on-Pay provision gives shareholder the right to vote on executive compensation, the right to vote on how often shareholders will vote on executive compensation, and the right to vote on golden parachutes. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L.
shareholders’ rights movement,\textsuperscript{27} will only strengthen the authority of proxy advisors. In fact, in its 2009 annual report, one proxy advisor stated: “In general, regulation has been a key driver to our business growth in the past. In the event that the recent financial crisis results in further regulation, we believe that such regulation could be a driver for growth in our business by increasing the demand for our existing products and services.”\textsuperscript{28}

Proxy advisors arose from gap in the market place, it is likely that its business model retains enough flexibility to adjust to opportunities provided by additional formal SEC rule promulgation. For example, in an attempt to gain greater transparency the SEC issued a ruling that requires mutual funds to disclose their voting records annually.\textsuperscript{29} In response to the vote disclosure requirements, Institutional Shareholder Services\textsuperscript{30} (ISS) began to offer new vote disclosure services so that its clients may comply with the law by outsourcing the disclosure function to ISS.\textsuperscript{31} Despite its intention, the ruling only caused the proxy advisor industry to grow faster.\textsuperscript{32} Additionally, the current financial crisis will likely bring more regulation of corporate governance.\textsuperscript{33} Based on past trends, we can expect that proxy advisors will respond to future regulations with new services that allow its clients to comply with the law without expending

\textsuperscript{27} Shareholders have “waged an aggressive campaign” aimed at making executives more accountable for the decisions they make on behalf of the corporation they serve. Shareholders want to enhance their voting power both by increasing the number of issues they vote on and the weight that is given to a shareholder’s vote. Lisa M. Fairfax, The Future of Shareholder Democracy, 84 IND. L. J. 1259, (2009).


\textsuperscript{30} ISS is the largest proxy advisor still in existence. ISS will be discussed in further detail in the next section.


\textsuperscript{32} Tamara Belinfanti, The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control, 14 STAN. J.L. BUS. & FIN. 384, 393 (2009).

\textsuperscript{33} Id.
much effort. Thus, additional regulation will only further drive the industry into the hands of ISS and other proxy advisors.  

Furthermore, the current shareholder rights campaign will only exacerbate the influence of proxy advisors: most shareholders are institutional investors that completely rely on proxy advisor services for share voting.  

As Chancellor Strine noted, “The influence of ISS and its competitors over institutional investor voting behavior is so considerable that … any initiative to increase stockholder power will simply shift more clout to firms of this kind—firms even more unaccountable than their institutional investor clients.” Increasing the number of proxy decisions only increases the likelihood that the institutional investors will solicit services from proxy advisors. While proxy advisors add value by gathering information and providing analysis, unrestricted influence is detrimental to the proper functioning of the market.

C. Rise to Influence: How the “Final Four” Proxy Advisors Dominate Shareholder Decision-Making

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34 Id.
35 Id. Professor Bebchuk argues that shareholders are the equitable owners of the companies in which they hold stock. Because the shareholder is the equity owner of the company, the shareholder should have power over the companies they own. In order for shareholder to exercise their power the should be able to adopt changes in the company’s basic corporate governance structure, elect and replace directors, and initiate and adopt amendment to the company’s corporate charter. See generally Lucian A. Bebchuk, The Case for Increasing Shareholder Power, 118 HARV. L. REV. 835, 836 (2005); Professor Bainbridge argues that the shareholder rights movement is unnecessary because the U.S. economy in its current state is outpacing the rest of the world economy, and any changes to corporate control balance could have detrimental effects on the U.S. economy’s growth and sustainability. But see Stephen M. Bainbridge, The Case for Limited Shareholder Voting Rights, 53 UCLA L. REV. 601, 623 (2006); Lipton & Rowe criticize Bebchuk and proxy advisors as being activist seeking to destroy the “director-centric” model of corporate governance in favor of maximizing shareholder value. Lipton and Rowe identify the major groups seeking to destroy the director-centric model as “for-profit corporate governance advisers” and “tenured academic” respectively and note that these groups have limited real-world experience. See also Martin Lipton & Paul K. Rowe, The Inconvenient Truth About Corporate Governance: Some Thoughts on Vice-Chancellor Strine’s Essay, 33 CORP. L. J. 63, 63-4 (2007).
36 Chancellor Leo E. Strine is the head of the Delaware Chancery Court. The Chancery Court hears cases involving Delaware corporations and other business entities. At the time of the writing Strine was Vice Chancellor. He became Chancellor in 2011. STATE OF DELAWARE, Delaware State Courts: Court of Chancery, http://courts.state.de.us/chancery/ (last visited Jan. 29, 2012).
According to a 2007 report by the Government Accountability Office (“GAO”), there were five major firms in the proxy-advising industry: Institutional Shareholder Services (ISS), Glass Lewis & Co. (Glass Lewis), PROXY Governance, Inc. (PGI), Egan-Jones Proxy Services (Egan-Jones), and Marco Consulting Group (MCG). The report indicated that market share was distributed as follows: ISS-61%, Glass Lewis-36%, and the remaining 3% was split among PGI, Egan-Jones, and MCG. PGI’s exit from the proxy advising industry in 2010 left 98% of market share in the hands of two players. Such dominance is likely the result of the reputation-based nature of the industry and high barriers to entry. ISS has been able to maintain its position because ISS primarily relies on its reputation, this reputation has caused issuers to comply with ISS’s best practice standards, because the issuers have complied ISS it is perceived as reliable and thus its reputation is boosted. Several firms that subscribe to ISS’s services stated they stay with ISS because it is the proxy advisor that they have relied on for many years. This gives no indication that the institutional investors have independently evaluated the proxy advisors; it appears the proxy advisors are flourishing primarily on reputation. Additionally, a

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39 Note that this estimation is not inconsistent with previously reported numbers. The GAO’s report indicates market share in 2007, which is 3 years before PGI transferred its clients to Glass Lewis. It is likely the Center for Executive Compensation’s current estimate that Glass Lewis controls 37% market share is accurate.
41 Although it is unclear why, PGI signed over all of its clients to Glass Lewis on December 20, 2010. According to its website, PGI has ceased operations as of 2011, leaving the majority of the proxy advisory market to its two major competitors. According to the Center on Executive Compensation, PGI’s exit from the proxy advising industry has further concentrated the market. This market concentration may raise antitrust concerns. Additionally, the GAO noted in its report that ISS’s dominant position in the proxy advising industry likely serves as a barrier to competition. Furthermore, as noted by the Center on Executive Compensation, ISS has become an “industry consolidator” in that it has participated in 11 consolidations within the proxy advising industry from June 1995 to June 2010. See Ctr. on Exec. Comp., A Call for Change in the Proxy Advisory Industry Status Quo: The Case for Greater Accountability and Oversight, 3 (2011), available at http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf. While antitrust concerns may be valid, any discussion of antitrust issues is outside the scope of this paper. Because PGI has ceased operations, any additional background on the company has been omitted.
43 Id.
market entrant would also have to provide comprehensive coverage of corporate proxies to compete against ISS, which would be particularly taxing for a start-up. Furthermore, new entrants would need to implement costly, sophisticated technology to provide the services institutional investors demand.

After noting the lack of competition in the industry and the increased use of proxy advisors, the SEC issued a concept release in July of 2010 on the U.S. proxy system. The concept release was aimed at the proxy advising industry generally and included requests for comment on: (1) the proxy voting process; (2) accuracy, transparency, and efficiency in the voting process; (3) communication and shareholder participation; and (4) the relationship between voting power and economic interest. The Article will primarily focus on (4) the relationship between voting power and economic interest. More specifically, this Article will focus on the relationship between institutional investors and the four largest proxy advisors. While market share is primarily divided among four firms, ISS and Glass Lewis are the by far the dominant firms in the proxy advising industry. Each of these proxy advisors will be discussed in turn in the following section.

1. Institutional Shareholder Services (ISS)

ISS was founded in 1985 with the intention of helping shareholders exercise more control over the direction of their companies. At the time ISS was founded, institutional investors controlled 46% of the U.S. stock market, valued at $2.2 trillion. ISS experienced tremendous

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44 Id.
45 Id.
47 Id.
49 Starkman, supra note 2.
50 Id.
growth in the mid-1990s, due in part to its electronic voting system.\textsuperscript{51} ISS’s electronic voting platform allows the investor to either: (1) provide guidelines to ISS to be executed by ISS or (2) defer to the voting guidelines developed by ISS without independent examination.\textsuperscript{52} This Article’s concern is with the second option. “ISS’[s] electronic voting system collects shareholder ballots, marks them with ISS recommendations, and delivers them to vote-tabulation companies without money managers having to see them.”\textsuperscript{53} This decoupling of voting rights and beneficial ownership\textsuperscript{54} is referred to as “empty voting.”\textsuperscript{55} Corporate law generally supports the coupling of votes and economic interest.\textsuperscript{56} Several researchers have found that, empirically, empty voting predicts reduced firm value.\textsuperscript{57}

Today, ISS is by far the largest proxy advisor with a client base of 1,600 institutions that own $23 trillion in stocks.\textsuperscript{58} This client roster contains about half the world’s stock market value.\textsuperscript{59} It is alarming that such a large volume of shares may be automatically voted according to ISS’s recommendations without consideration from managers of the investment account.

\textsuperscript{51} Id.
\textsuperscript{53} Starkman, \textit{supra} note 2.
\textsuperscript{54} The “beneficial owners” of a company are the persons or entity that own stock of that company. The beneficial owners are the persons or entities that would collect dividends from the company. The beneficial owner may appoint an “equity owner” which is a person or entity that would hold legal title to the stock and therefore be allowed to make voting decisions. A thorough discussion of empty voting is outside the scope of this paper. For an interesting discussion paralleling empty voting to short selling see, Michael C. Schouten, \textit{The Mechanisms of Voting Efficiency}, 2010 COLUM. BUS. L. REV. 763, 818 (2010).
\textsuperscript{56} Id. at 814.
\textsuperscript{58} Starkman, \textit{supra} note 2.
\textsuperscript{59} Id.
Because of its dominant influence, ISS is often regarded as the center of the proxy-advising universe.\(^{60}\)

Although little is known about the proxy advisors’ implementation of voting policies, several proxy advisors have disclosed basic snippets of voting policies to the public.\(^{61}\) ISS is among the few proxy advisors that chose to discuss voting policies with its peers and institutional investors at a February 2008 roundtable meeting.\(^{62}\) From that meeting, we have learned that ISS primarily relies on its executives to make final decisions about policy.\(^{63}\) To assist executives in making policy decisions, ISS has internal advisory subcommittees,\(^{64}\) which are each led by a specialist in the proxy issue subject matter (i.e., audit, board, compensation).\(^{65}\) Additionally, ISS annually solicits the opinions of current clients about the function of its voting matrix.\(^{66}\) ISS has also placed part of its voting policies on its website in an attempt to solicit public comment much in the same way the SEC provides concept releases and requests for public comment.\(^{67}\) Despite this facial attempt at transparency, ISS’s voting matrix remains proprietary without means of review for accuracy or reliability.


\(^{62}\) \textit{Id.} at 526.

\(^{63}\) \textit{Id.}

\(^{64}\) The internal advisory subcommittees are part of ISS’s larger steering committee, which helps determine voting policies as a whole.

\(^{65}\) For example, it is likely the compensation committee would examine executive compensation packages at each of the firms the committee is assigned to analyze. Issues with this voting system arise because it is believed that rather then tailoring its analysis to the specific industry, the committee would simply check the compensation figures against a proprietary voting matrix created by the proxy advisor. \textit{See CTR. ON EXEC. COMP., supra} note 41; Meagan Thompson-Mann, \textit{supra} note 61, at 528.

\(^{66}\) For the purposes of this article “voting matrix” refers to the mix of standards the proxy advisor firm has put together to determine its voting recommendation. Although ISS solicits general comments for some of the standards it chooses to adhere to, the total mix of standards is proprietary and therefore not publically available or widely known. \textit{Id.}

\(^{67}\) \textit{Id.}
Additionally, ISS is one of two proxy advisors that voluntarily registered with the SEC under the Investment adviser Act, which brings ISS within current regulation by SEC.\textsuperscript{68} Despite widespread criticism, neither ISS nor Marco Consulting (discussed \textit{infra}) has been subject to any SEC enforcement actions.\textsuperscript{69}

2. Glass Lewis & Co.

Glass Lewis & Co. was founded in 2003 by Gregory P. Taxin, Lawrence M. Howell, and Kevin J. Cameron.\textsuperscript{70} Glass Lewis was likely founded in response to the great success ISS was experiencing as a proxy advisor.\textsuperscript{71} Glass Lewis has risen to become the second most influential proxy-advising firm.\textsuperscript{72} The company’s rapid growth was due to its relationship with a well-established corporate governance research firm, Investor Responsibility Research Center Institute (IRRC).\textsuperscript{73} The research firm negotiated an arrangement with Glass Lewis where Glass Lewis would make its proxy recommendations available to the IRRC’s clients.\textsuperscript{74} This gave the newly established Glass Lewis access to a large list of clients. IRRC was purchased by ISS in 2005, but many of IRRC’s clients chose to retain Glass Lewis for proxy advising services.\textsuperscript{75}

Glass Lewis currently provides proxy research and advice on over 16,000 public companies in 70 countries.\textsuperscript{76} Like ISS, Glass Lewis has developed an internal advisory board led by a specialist in the field to update voting policies on an annual basis.\textsuperscript{77} Additionally, Glass

\textsuperscript{68} Belinfanti, \textit{supra} note 32, at 432.
\textsuperscript{69} \textit{CTR. ON EXEC. COMP.}, \textit{supra} note 41, at 45.
\textsuperscript{70} \textit{CTR. ON EXEC. COMP.}, \textit{supra} note 41, at 33.
\textsuperscript{71} Leo E. Strine, \textit{The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (And Europe) Face}, 30 \textit{DEL. J. CORP.} 673, 688 (2005).
\textsuperscript{72} \textit{CTR. ON EXEC. COMP.}, \textit{supra} note 41, at 33.
\textsuperscript{73} \textit{Id.}
\textsuperscript{74} \textit{Id.}
\textsuperscript{75} \textit{Id.}
\textsuperscript{76} \textit{Id.} at 36.
\textsuperscript{77} Thompson-Mann, \textit{supra} note 61, at 527.
Lewis has developed an independent external advisory committee. Both committees place great emphasis on the on-going conversations with current clients as well as developments in the area of best practices. However, as with ISS, Glass Lewis’s voting matrix is proprietary and is undisclosed.

3. Egan-Jones Proxy Services

Egan-Jones incorporated its proxy-advising business in 2002. Unlike the other proxy advisors, Egan-Jones was born out of the credit ratings industry. Bruce Jones, one of the founding partners of the firm, was a credit rating analyst at Moody’s before he chose to join the firm in 1995. Egan-Jones claims that its foundation in the credit ratings industry gives it a “deep bench” and a competitive advantage when it comes to scrutinizing corporate finance issues. Egan-Jones, like Marco Consulting, has survived in the proxy advising industry by specializing despite its limited market share allocation.

4. Marco Consulting Group (MCG)

Marco Consulting Group is an Illinois corporation that was founded in 1988. Like Egan-Jones, MCG has survived in the concentrated proxy advising industry by carving out a small niche for itself. Marco Consulting primarily focuses on advising Taft-Hartley pension plans. The company claims to be the “largest consultant to jointly trusted benefit plans in the United

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78 Id.
79 Id.
80 CTR. ON EXEC. COMP., supra note 41, at 38.
83 CTR. ON EXEC. COMP., supra note 41, at 40.
84 Taft- Hartley Pension Funds are employer contribution retirement funds that are contractually negotiated between a company’s management and the employees’ union. In addition to employer contribution, the pension fund grows by investing its capital in the stock market. The management and the union equally appoint trustees to invest the funds money. See Labor Management Relations Act, 1947, PUB. L. NO. 80 -101, 61 Stat. 136 (1947) (codified as amended at 29 U.S.C. ss 141-97 (1988)). Although it is not clear, it is likely Marco Consulting has specialized in Taft-Hartley pension plans because the plan requires a fiduciary and Marco Consulting will contractually accept fiduciary duties.
85 Id. at 40.
States.” Like ISS, Marco Consulting has registered its proxy advising division with the SEC under the Investment Advisor Act.

III. THE PROBLEMS ARISING FROM THE UNRESTRICTED INFLUENCE OF PROXY ADVISORS

The influence of proxy advisors creates several problems because the advisory opinions are treated as determinative, rather than a single factor for consideration. As indicated by Chancellor Strine, many institutional investors have “little desire to do any thinking of their own.” CEOs recognize that institutional investors will likely defer to the recommendations made by proxy advisors. In response to such deference, CEOs alter corporate governance to ensure endorsement from ISS. As Chancellor Strine succinctly stated ISS’s influence in a recent article, “[P]owerful CEOs come on bended knee to Rockville, Maryland, where ISS resides, to persuade the managers of ISS of the merits of their views about issues like proposed mergers, executive compensation, and poison pills.” This section will discuss problems resulting from such domineering influence.

A. Proxy Advisors’ Recommendations are Outcome Determinative

At least one commentator has noted that the influence of proxy advisors is so substantial that it “cannot be overstated.” Its recommendations are typically “absolute and determinative, rather than merely advisory.” Quantifying just how influential the proxy advisors are has sparked some debate. On the high end, one study that analyzed data from 2003 to 2008 found that a negative recommendation from ISS reduced shareholder “for” votes by 28.8%.

87 Strine, supra note 71, at 688.
88 Id.
90 Id.
number rose to 53.1% when only the votes of mutual funds were considered. A study conducted in 2002 found that an unfavorable recommendation from ISS generated 13.6-20.6% fewer votes for management. On the lower end, a separate study that focused on uncontested director elections concluded that a recommendation by ISS shifts 6-10% of shareholder votes. The study ultimately concluded that many researchers grossly overestimate the influence of proxy advisors because they fail to consider company specific factors that investors deem important. However, even if we assume the influence of ISS is in the 6-10% range, it is still very significant because the sway from ISS is likely greater than the influence from the company’s largest shareholder.

In addition to scholarly work, the courts have taken notice of the influence proxy advisors have on its clients. In a decision dated August 12, 2010, the Delaware Chancery Court noted that a key factor in the outcome of a proxy contest is the recommendation of proxy advisor firms.

B. Proxy Advisors Create Agency Costs Because They Lack Fiduciary Obligations

Legal scholars define the agency relationship as a contract under which one or more persons engage another person to perform services on their behalf. In corporate law, the problem of agency is typically referred to as the separation of ownership and control. Shareholders of the corporation are widely regarded as the property owners of the corporation,

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92 *Id.*
95 *Id.* at 906.
96 *CTR. ON EXEC. COMP.*, *supra* note 41, at 20.
97 *Yucaipia American Alliance Fund II v. Riggio*, 1 A.3d 310, 357 (Del. Ch. 2010).
99 The theory of agency cost was originally introduced in 1976 by two prominent economists, Michael Jensen and William Meckling. *See id.*
while managers are deemed the party with control. This problem can be seen in the proxy advising industry. As previously noted, proxy advisors have significant power over the industry. Power alone is not indicative of a problem; however, the issue of agency costs arises because coupled with this power proxy advisors have virtually no accountability. Thus, proxy advisors have control beyond a typical shareholder. Yet proxy advisors are not shareholders and thus have no economic ownership interest in the firms they rate. Voting control absent economic ownership is referred to as “empty voting.” Such separation of ownership and control should not be tolerated in the absence of effective control procedures. Without an effective control procedure, the agency costs becomes disastrous.

Market forces cannot correct the separation of ownership and control because the principal has no means of checking the quality of the work the agent (PA firm) is putting forth. The principal is given only a recommendation with no supporting analysis, the analysis is the agent’s proprietary information. Market forces are not reliable absent notice that a decision is being made.

For example, in 2003 ISS was able to control the vote of the outstanding shares of 3M Corporation. In a letter to the SEC 3M wrote:

Approximately 55% of our top 50 institutional shareholders (representing about 50% of shares outstanding) follow ISS proxy voting guidelines. Neither the investors nor ISS or other such entities have the staff or resources to evaluate board-nominated director candidates on their individual merits. Instead they rely on a handful of litmus tests reflecting the policy decisions of ISS that are divorced from any one company's particular circumstances and, in most cases, have nothing to do with the company's "unresponsiveness" to shareholder concerns. The outcome of the elections that constitute the "trigger" mechanisms are controlled by these associations.

100 Id., at 310. But see Lipton & Rowe, supra note 35, at 66 (arguing against “ownership” language because the whole point of the corporate form is to make clear that shareholders are not owner).
101 Belinfanti, supra note 32, at 407.
In response to a similar stockholder proposal in the previous year, 3M's board resolved not to adopt a poison pill without stockholder approval, unless exigent circumstances led a majority of the independent directors to conclude that their fiduciary duties required them to act without the delay attendant on submission to stockholders. Despite this reasonable implementing resolution, which adopted the proposal to the extent permitted by the directors' fiduciary duties, ISS recommended that 3M stockholders approve this year's inapposite shareholder proposal, despite its inconsistency with fundamental notions of lawful corporate governance, and it won 58.9% of the vote. 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 that called for support of the shareholder proposal.\footnote{Letter from W. James McNerney, Jr., Chairman of the Board and CEO, 3M Corp., to Jonathan G. Katz, Sec'y, U.S. Sec. & Ex. Comm'n, (Dec. 5, 2003), available at http://www.sec.gov/rules/proposed/s71903/3m120503.htm.}

With regard to proxy advisors, the problem of agency arises because proxy advisors do not have an interest in the firms they advise: the intention of the proxy advisor is to make a profit selling the research and opinions it has developed. While ISS and other proxy advisors should take steps to ensure the information it sells to clients is accurate, several companies that have been subject to evaluation suggest that it does not.\footnote{Belinfanti, supra note 32, at 386; See also Peter Burrows & Andrew Park, Compaq and HP: What's an Investor to Do?, BUS.WEEK, Mar. 18, 2002, at 62. (“If [ISS] had gone the other way, the deal would have been dead.”)}

As a result of fiduciary duty mandates for share voting, investors have turned to proxy advisors as a means to maximize resources: they comply with fiduciary duties without incurring costly investigation.\footnote{Thompson-Mann, supra note 61.} Additionally, it appears that deferring to the advice of proxy advisors insulates investment advisers from liability. Chancellor Strine states that following a recommendation from ISS “constitutes a form of insurance against regulatory criticism, and results in ISS having a large sway in the affairs of American corporations.”\footnote{Strine, supra note 71, at 688.} Commentators are also concerned that institutional investors “rely so heavily on proxy advisors that they have...
essentially abdicated their role as manages, leaving proxy advisors with inordinate power.”\[107\]

Such inordinate power coupled with lack of accountability is a recipe for disaster from a traditional agency cost perspective. Advisors should not shed fiduciary duties by shifting share-voting decisions to proxy advisors.

**C. Proxy Advisors Recommendations May Contain Material Inaccuracies**

Proxy advisors’ use of unskilled labor,\[108\] rather than skilled analysts,\[109\] has likely led to material inaccuracies in voting recommendations. For example, in response to the SEC’s concept release,\[110\] Pfizer noted that a recommendation about its company from a proxy advisor contained a material inaccuracy.\[111\] A proxy advisor stated in its recommendation that Pfizer required a supermajority shareholder vote on certain shareholder matters; this requirement had been eliminated in 2006.\[112\] It was apparent to the corporation that the analyst reviewing the company’s information “did not understand the various documents filed under the Delaware General Corporation Law to delete those requirements.”\[113\] Frustration inevitably develops from

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\[108\] Rose *supra* note 7, at 897; see also Eleanor Laise, *Is This the Most Influential Man on Wall Street?*, SMARTMONEY MAG., Oct. 16, 2002, available at http://www.smartmoney.com/mag/index.cfm?story=oct02-influential. Rose notes that ISS uses “relatively unskilled temporary employees” to conduct corporate governance reviews based primarily on required disclosures filed with the SEC.

\[109\] Skilled labor generates the proprietary metric, but unskilled labor inputs the data. In security disclosure documents, it is not always easy to decipher what information to use.

\[110\] A concept release is the first part in a three-part process used by the SEC to promulgate a rule under its rule-making power within the Administrative Procedures Act. The SEC issues a concept release on the state of the proxy advising industry in July of 2010. The SEC issues a concept release as a means of soliciting comment from those in the industry on their thoughts about a specific issue, typically to determine whether it should move forward with promulgating a rule. In the second step of the rule promulgating process, the SEC will take the information it receives from a concept release into consideration as it drafts a proposed rule. After the rule is drafted, the SEC will once again make the rule available on its website and solicit comment from the industry. In the third step the SEC finalizes the rule by making any changes it deems necessary based on industry reaction to the rule. Once the rule is finalized the SEC can begin enforcing the rule. See Paul S. Atkins, Commissioner, Remarks as Prepared: American Society and the SEC’s Mission (Oct. 15, 2007), available at http://www.sec.gov/news/speech/2007/spch101507psa.htm.


\[112\] Id.

\[113\] Id.
such misstatements because the company has no effective recourse against the proxy advisor’s mistakes. Some companies, such as Target Corporation, have sought to eliminate the impact of the material inaccuracies and misstatements by publishing white papers on its website.\(^\text{114}\)

However, it is not likely the information released in the white paper can effectively combat the negative effects of ISS’s incomplete analysis because it is unlikely investors will see it or know to look for it.

**D. Proxy Advisors’ Voting Matrices Are Based on Flawed “Best Practices” Standards**

To help assist with affordable decision-making, proxy advisors have created a one-size-fits-all structure that does not consider all of the issues facing a particular company in a given industry.\(^\text{115}\) Rather than consider the structure of each business it rates individually, ISS has developed a set of arbitrary “best practices” for corporate governance.\(^\text{116}\) Furthermore, ISS dominates the proxy advising industry, and the resulting lack of competition has eliminated thoughtful evaluation of “best practices” for corporate governance.\(^\text{117}\) The result is that other proxy advisors adhere to ISS’s standard of best practices and expect the businesses it evaluates to comply with these standards.\(^\text{118}\) The illusion of a one-size-fits-all best practices regime may damage a company by limiting the number of shareholders willing to invest in a company that

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114 A company issues a “white paper” as an authoritative document to educate the reader about matters relevant to the company. Target’s white paper identified eight material inaccuracies or misstatements contained in ISS’s analysis. The tone of the paper conveys the authors’ frustration with ISS’s analysis; accusations include “failed to provide”, “mischaracterizes”, and “lacks any critical analysis.”


116 *See* RiskMetrics Group Inc., Annual Report (Form 10K), at 9, (Nov. 30, 2010), *available at* [http://files.shareholder.com/downloads/MSCI/1734003786x0x453382/FE6B916-392F-417A-9A64-00D82DCCFF76/123837_017_BMK.PDF](http://files.shareholder.com/downloads/MSCI/1734003786x0x453382/FE6B916-392F-417A-9A64-00D82DCCFF76/123837_017_BMK.PDF)*.


118 *Id.*
does not fit the standards. Limited capital may then force a company to adopt a set of “best practices” governance principles despite its inefficiencies for the particular company. Thus, through proxy recommendations, ISS and other proxy advisors can impose “best practices” corporate governance standards without evidentiary support for its efficiency in a given company.

E. Proxy Advisors Largely Ignore Conflicts of Interest

The SEC, as well as academic scholars and shareholder advocates, are taking notice of perceived conflicts of interest in the business model of some proxy advisors, specifically ISS. The concern is likely twofold.

On one hand, concerns arise from the fact that ISS is selling corporate governance services to the same companies it scrutinizes. ISS’s perceived conflicts of interest have not gone unnoticed by its clients. In 2004, Missouri’s public pension fund (valued at $8 billion) dropped ISS over concerns that ISS “couldn’t provide enough assurance that its loyalty was solely with shareholders.” Shortly thereafter, the $69 billion Ohio public employees retirement fund and $34 billion Colorado public employees retirement fund followed suit, also citing conflicts of interest. Both retirement funds subsequently hired Glass Lewis. To combat conflicts of interest, ISS has created a physical “firewall” separating its shareholder research division from its corporate services division. In addition to physical separation, the

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119 Rose, supra note 7, at 891.
120 Id. at 892.
121 Id. at 906.
122 Starkman, supra note 2.
123 Rose, supra note 7, at 906.
124 Starkman, supra note 2.
125 Id.
126 Id.
127 Id.
128 Starkman, supra note 2.
two sides have separate office equipment and computer databases.\textsuperscript{129} Responses to ISS’s claim that it has effectively managed any potential conflicts of interest have not been positive. Ira Millstein, a leading corporate lawyer, stated, “Anyone who can’t see a conflict between consulting and standards-setting has a problem with their eyesight.”\textsuperscript{130}

On the other hand, concern arises that ISS may give preferential treatment in its proxy analysis to companies that also purchase corporate governance advice.\textsuperscript{131} ISS attempted to ease concerns about such maltreatment by publishing a proxy-voting manual that outlined a skeletal framework of its processes.\textsuperscript{132} Despite this attempt at transparency, most of the metric ISS uses to arrive at a “for” or “against” conclusion is proprietary, which makes it impossible for anyone outside of the company to determine whether the proxy-voting standards are as objective as ISS claims them to be.

IV. CURRENT PITFALLS: THE SHORTCOMINGS OF CURRENT REGULATION, THE DANGER OF FUTURE REGULATION, AND THE PRESSING NEED FOR ACTION

The SEC has taken notice of the problems arising from the proxy advisory industry, and in response issued a concept release in July 2010. In its discussion of proxy advisors, the SEC noted the industry experienced tremendous growth and that part of this growth is attributable to the fiduciary obligations placed on institutional investors.\textsuperscript{133} In response, the SEC has received almost 300 discussion papers,\textsuperscript{134} most of which seem to suggest one of two solutions\textsuperscript{135} with

\textsuperscript{129} Id.
\textsuperscript{131} Rose, supra note 7, at 906.
\textsuperscript{132} Id. at 921.
\textsuperscript{133} Concept Release on the U.S. Proxy System, 75 Fed. Reg. 430009.
\textsuperscript{135} Additionally, the U.S. Department of Labor has proposed amending ERISA to give the Secretary of Labor the ability to monitor proxy voting decisions and assess fines against fiduciaries for failure to comply with proxy-voting requirements. While this suggestion may affect for institutional investors subject to ERISA regulation, namely Pension Plans, institutional investor that are not subject to ERISA regulation, such as mutual funds and hedge funds, would not be subject to this proposed rule. Further, the Comment address neither proxy-voting requirements for
regard to proxy advisor regulation: (1) regulate proxy advisors under the Investment Adviser Act, or (2) create formal regulations specifically for proxy advisors that parallel the regulations imposed on credit ratings agencies. First, commentators would like to see proxy advisors registered under the Investment Adviser Act of 1940 so that proxy advisors are subject to the SEC’s oversight, and the SEC’s antifraud rules. However, two of the four major proxy advisors, including ISS, are already registered with the SEC under the Act and all proxy advisors are subject to common law fraud rules. Second, some commentators have noted the similarities between the proxy advising industry and the credit ratings industry and suggested the SEC simply mimic credit ratings agency regulation. However, commentators who suggest this solution tend to focus on the theory and intent of the rules in place for regulating credit ratings agencies and do not provide any solutions for the shortcomings of such regulation. Section A and Section B will argue against both suggestions respectively, and propose an alternative solution.

Commentators asked for greater transparency in a variety of different ways. The American Business Conference suggested that proxy advisors should be required to disclose the name, position, and responsibilities of its clients, as well as provide a draft of the proxy advisors’ recommendations before they are given to clients. In its own comment letter, Egan-Jones directly addressed the issue of submitting draft recommendations to issuers. Egan-Jones


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argued that contacting issuers prior to publication of its recommendation would undermine the independence of proxy advisors.\textsuperscript{140} Egan-Jones noted that it has its own mechanism in place for correcting errors in its proxy vote recommendation.\textsuperscript{141} These suggestions present a dichotomy: on one side, disclosure would undermine independence and potentially harm the proxy advisor’s business if disputes are not timely resolved; on the other side, inaccurate voting\textsuperscript{142} results from a purely reactive corrective system. This Article strikes a middle ground between the suggestions provided and calls for proxy advisors to submit the raw data it will analyze to the issuer before a recommendation is generated. In this manner, issuers can ensure the information used by proxy advisors is accurate and proxy advisors may avoid compromising independent decision-making. Any proxy advisor recommendations that are not in line with management would likely be disputed and would prevent the proxy advisor from issuing a recommendation altogether.

Additionally, this solution addresses the aspect of timeliness. Proxy advisors must provide its recommendations during proxy season, this is a relatively short window to generate recommendations, resolve disputes about the recommendation, correct and publish recommendations. Proxy advisors could disclose raw data to issuers outside of the proxy season window. Furthermore, it is important to bear in mind that proxy advisors are businesses, not regulators; forced draft disclosure and appeals would strengthen proxy advisors’ stance as a corporate governance regulator and still allow institutional investors to evade fiduciary duties by defaulting to the recommendation of proxy advisors.

\textsuperscript{140} Id.
\textsuperscript{141} Id.
\textsuperscript{142} For example, in its Comment, National Fuel explained that ISS recommended that shareholders vote “against” management for National Fuel’s executive compensation package. ISS’s recommendation was based on data not relevant to National Fuel’s business. National Fuel contacted ISS to correct the recommendation and learned that ISS was aware of its “apples to oranges” comparison, yet had no intention of disclosing this fact in its analysis. National Fuel, Response to SEC Concept Release S7-4-10, Mar. 5, 2012, http://www.sec.gov/comments/s7-14-10/s71410-309.pdf.
A. The Shortcomings of the Current Regulatory Regime: SEC Regulation Does Not Restrain Proxy Advisors

The proxy advisor industry exemplifies a significant hole in the regulation of the markets by the SEC. As noted in the SEC concept release, the proxy advisor industry could be subject to SEC regulation in two limited contexts: (1) the proxy solicitation rules under the Securities Exchange Act Rule 14a, or (2) the Investment Advisor Act. Yet, proxy advisors have generally escaped both.

Initially, the proxy advisor industry could have been subject to the SEC’s proxy rules. However, in 1979 the SEC adopted Exchange Act Rule 14a-2(b)(3), which exempted filing and informational requirements for proxy advisors. The only meaningful provision of the proxy rules that survived this exemption is the antifraud rule contained in Rule 14a-9. The antifraud rule prohibits false and misleading statements by proxy advisors. Notwithstanding the antifraud protections, several companies have come forward with material misrepresentations and misstatement made by proxy advisors; however, the SEC found no major violations of securities laws in its investigations of proxy advisors.

Secondly, the Investment Advisers Act (“IAA”) may bring a proxy advisor firm within the regulation of the SEC if it meets the definition of an investment adviser. ISS and Marco Consulting are already registered as investment advisers with the SEC, and therefore subject to

\footnotesize{143} Id. at 108. Certain conditions apply.
\footnotesize{144} Id. at 109.
\footnotesize{145} The SEC’s Office of Compliance, Inspections, and Examinations (OCIE) investigated the issue and reported that there are no major violations stemming from the activities of proxy advisors. However, OCIE is notoriously understaffed, and has on occasion missed clear violations of the securities law, e.g., the Madoff Ponzi scheme. See Sara Hansard, More Funding Won’t Boost SEC’s Exams, INVESTMENT NEWS, available at http://www.investmentnews.com/article/20100214/REG/302149982; Michelle Samaad, SEC Struggles with Surge of Investment Advisors, CREDIT UNION TIMES, Feb. 9, 2011, available at http://www.cutimes.com/2011/02/09/sec-struggles-with-surge-of-advisers; GAO Report: PA Issues, supra note 38, at 12.
\footnotesize{146} The Investment Advisers Act of 1940 requires that anyone who for compensation is engaged in the business of providing advice about securities register with the SEC. 15 U.S.C. § 80b-1, §203(a). The rule was promulgated to protect investors and prevent advisers from colluding and acting in any way other than in the client’s best interest. See SEC v. Capital Gains Research Bureau et. al., 375 U.S. 180 (1963).
SEC regulation via the IAA. This voluntary registration subjects over 61% of the market share of the proxy advising industry to SEC regulation. Even with voluntary registration, there is no indication such regulation has reduced or eliminated any of the problems surrounding the industry. For example, under the IAA and related rules, the SEC is charged with ensuring that investment advisers identify, disclose, and mitigate all potential conflicts of interest to its clients and potential clients.\textsuperscript{148} Despite criticism, the SEC has found no major violations of potential conflicts of interest in these regulated firms.\textsuperscript{149} Affirmatively, in a No-Action Letter issued to Egan-Jones, the SEC explained that the mere fact that a proxy advisor firm provided voting recommendations, as well as advice on corporate governance issues, did not create a conflict of interest.\textsuperscript{150}

Additionally, in 2004 the SEC issued a No-Action Letter to Egan-Jones in which the Commission stated that following the recommendation of an independent third party may cleanse the vote of the advisor’s conflict of interest.\textsuperscript{151} The context of this discussion is Rule 206(4)-6, which allows an Investment adviser to defend against a potential conflict of interest by voting proxies in accordance with a pre-determined policy.\textsuperscript{152} The Commission states that an investment adviser who votes clients’ proxies in accordance with a pre-determined policy will not be deemed to have violated the fiduciary duty of loyalty even if the vote is consistent with the adviser’s own interests.\textsuperscript{153} While this discussion does help clarify Rule 206(4)-6, it is not clear that the Commission’s statements are limited to that discussion.

\textsuperscript{149} \textit{Id.} at 4.
\textsuperscript{152} \textit{Id.}
\textsuperscript{153} \textit{Id.}
In addition, prior scholarship has not discussed development of proxy advisor regulation in light of the recent D.C. Circuit condemnation of SEC rules. Since 2005, the D.C. Circuit has struck down three different rules promulgated by the SEC.\textsuperscript{154} In 1998, the D.C. Circuit noted that agencies are entitled to particularly deferential review so long as the agency is acting reasonably and the subject matter is within the agency’s field of discretion and expertise.\textsuperscript{155} In contrast, in its 2011 opinion, the D.C. Circuit Court was particularly critical of the SEC, and at one point referred to the agency’s explanation of its economic analysis as “unutterably mindless.”\textsuperscript{156} Such a hostile opinion from the court should not be overlooked when a similarly situated rule is being considered.

The most recent decision is noteworthy, especially in light of prior D.C. Circuit SEC rulemaking opinions. In its 2011 decision, the D.C. Circuit vacated the SEC’s ‘proxy access’ rule.\textsuperscript{157} The proxy access rule allowed a shareholder who has held at least 3\% of the share of a company for the last 3 years to nominate candidates for the company’s board of directors.\textsuperscript{158} The intent of the rule was to give shareholders a voice in the nomination of directors.\textsuperscript{159} The SEC was charged with the difficult task of quantifying the economic value of providing shareholders with a voice so that its proxy access rule could survive judicial scrutiny. Ultimately, the SEC was not able to convince the court that its proxy access rule was economically sound.\textsuperscript{160} Like the

\textsuperscript{154} Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005); American Equity Investment Life Insurance Co. v. SEC, 613 F.3d 166 (D.C. Cir. 2010); Business Roundtable v. SEC, 647 F.3d 1144, (D.C. Cir. 2011).
\textsuperscript{156} Business Roundtable v. SEC, 647 F.3d 1144, at 1156.
\textsuperscript{157} Id. at 1156.
\textsuperscript{158} Id. at 1147.
\textsuperscript{160} Business Roundtable v. SEC, 647 F.3d 1144, at 1156.
proxy access rule, quantifying the economic value of accuracy in voting recommendations would prove extraordinarily difficult.

B. The Case Against Formal Regulation Parallel to that of the Credit Ratings Industry

The analogy between credit rating and proxy advising services with respect to conflicts of interest, direct market influence, and business operation is so close that all you would have to do is change the names to see the parallel of the industries.\(^{161}\) The proxy advising industry is similar to the credit ratings industry because each takes a set of complicated data and, through an undisclosed methodology, reduces the information to a single indicator.\(^{162}\) As described above, the metric used in the proxy advising industry is typically not transparent and may be based on inaccurate information. Likewise, the methods employed by credit rating agencies have been criticized as flawed and misleading.\(^{163}\) Although in both industries the advice offered by the advisor merely represents one company’s opinion about the health of another firm, both have proven to be very influential.\(^{164}\) While many commentators believe the parallels in these two industries signify the need for formal regulation of the proxy advisory industry similar to that of the credit ratings agencies,\(^{165}\) the converse is likely the most cogent.\(^{166}\)

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\(^{162}\) Belinfanti, *supra* note 32, at 431.

\(^{163}\) Id. at 433.

\(^{164}\) Id.


\(^{166}\) Additionally, credit rating agencies and proxy advisors both quantify known unknowns on behalf of investors. Credit ratings agencies quantify risk by offering a ‘AAA – D’ rating, while proxy advisors quantify corporate governance and management decisions through ‘for’ or ‘against’ recommendations.
The recent history surrounding regulation of credit rating agencies has not proven such regulation to be easy to implement or effective. Although subject to SEC regulation for almost eight years, it is believed that the credit rating agencies have largely avoided regulation and this avoidance contributed to the recent economic recession. Furthermore, some scholars raise concern that the SEC is unable to enforce formal regulation due to the complex nature of the credit rating agencies.

To date, regulation of the credit ratings agencies has been unwieldy. The SEC issued a concept release for regulation of credit ratings industry in 2003, Congress passed the Credit Agency Reform Act in 2006, which conferred authority on the SEC to oversee the regulation of credit ratings agencies. Despite two years of regulation, in July 2008 the SEC issued a report disclosing its shortcomings in regulating credit ratings agencies and the impact these companies had on the subprime mortgage crisis. The SEC issued additional rules in 2008 and 2009, which were aimed at enhancing disclosure, strengthening the integrity of the ratings process, and addressing conflicts of interest. Finally, further steps were taken to enhance disclosure and controls over the credit ratings agencies under Dodd-Frank in 2010. Dodd-Frank eliminates the requirement that federal agencies use credit rating agencies when assessing the credit

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worthiness of an entity.\textsuperscript{175} It appears this requirement is aimed at limiting the influence of credit ratings agencies organically. Some commentators believe\textsuperscript{176} that the SEC is not enforcing its regulations of the credit rating agencies because it has a long-term strategy of eliminating investor reliance on the decisions of credit raters.\textsuperscript{177}

Because of the significant timeline and lack of effect in regulating credit rating agencies, the SEC should exercise caution before attempting to impose formal regulation on proxy advisors. The SEC can glean understanding from the attempts to regulate credit rating agencies and apply this newfound knowledge to regulating proxy advisors. Any regulation should include a careful analysis of unintended consequences and resources necessary for regulatory enforcement. Therefore, the SEC should begin by generating simple, easy to implement guidelines in an attempt to limit the influence of proxy advisors before formal rulemaking takes place.

\textit{C. The Need for Meaningful, Timely Regulation in the Shadow of “Say on Pay”}

The implementation of Say on Pay was expected increase the number of proxy votes by 16,000.\textsuperscript{178} Because investment advisers are not equipped to manage this great influx of proxy votes, the practical effect of the additional proxy votes will only serve to exacerbate the influence

\textsuperscript{176} Despite criticism of the SEC, some state Attorneys General have brought state actions against the credit rating agencies under state fraud and deceptive practices laws. It is noteworthy that states Attorneys General have begun to file claims against credit ratings agencies because typically states do not get involved in securities issues. \textit{See} Jim Scalzi\textquoteleft ti, Lisa Madigan Sues S&P for Role in Housing Market Meltdown, \textit{CHICAGO SUNTI MES}, Jan. 26, 2012 (noting that internal emails at Standard & Poors stated investments “could be structured by cows and we would rate it”) ; \textit{See also} State of Connecticut, \textit{Attorney General Sues Credit Agencies for Tainted Ratings that Enabled Financial Meltdown}, OFF. OF THE ATTORNEY GEN., Mar. 10, 2010; David Segal, \textit{Ohio Sues Rating Firms for Losses in Funds}, N.Y. TIMES, Nov. 20, 2009.
\textsuperscript{177} Gretchen Morgenson, \textit{Hey, S.E.C., That Escape Hatch Is Still Open}, N.Y. TIMES, Mar. 5, 2011. Morgensen explains that the SEC has protected now existing credit ratings agencies from competition because the SEC must approve any new market entrant. Thus limiting the number of credit rating agencies and subjecting all credit rating agencies to oversight by the SEC. Additionally, the Dodd-Frank Act eliminated all references to credit ratings agencies in government statutes. One may infer from the Dodd-Frank Act that the legislature is signaling that the business of credit ratings agencies are questionable.
\textsuperscript{178} CTR. ON EXEC. COMP., \textit{supra} note 41, at 25.
of the proxy advising industry. It is necessary for the SEC to step in and limit this influence before investment companies become so overwhelmed with the sheer number of proxy issues that they all defer to the recommendations of proxy advisors as a Pavlovian response to handling proxy votes.

The implementation of Say on Pay echoes the ghost of credit ratings past. In its examination, the SEC placed great emphasis on the diminished quality of credit ratings caused by the significant increase in number and complexity of subprime residential mortgage-backed securities and collateralized debt obligations. Likewise, the proxy advising industry will experience an increase in the number and complexity of proxy statements with implementation of Say on Pay.

V. MOVING FORWARD BY LIMITING THE INFLUENCE OF PROXY ADVISORS, DISCLOSING PERTINENT INFORMATION, & REPORTING POTENTIAL CONFLICTS OF INTEREST

Enacting additional legislation will not resolve the dangers posed by proxy advisors. The initial regulations enacted by the SEC and DOL birthed the unintended rise of the proxy advisors. While this proposal does not purport to foreclose formal regulation, there is a pressing need for meaningful oversight that could be easily enacted and carried forward. This recommendation is meant to provide flexibility and foresight to specifically tailor any necessary formal regulation to the proxy advising industry. The parallels between the credit ratings industry and the proxy advising industry are uncanny; the enactment of legislation should not

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179 One early review of the 2011 proxy season indicates that, as expected, proxy advisors were able to successfully handle the increased number of votes through one-size-fits-all voting policies coupled with simple metrics. This approach again forces issuers to either comply with the one-size-fits-all voting policies enforced by proxy advisors, or expend time and resources trying to convince proxy advisors of the merits of the firm’s compensation package. It seems our fears have been confirmed, “the outcome of mandatory Say on Pay advisory votes will be the ascendency of the proxy advisory firms’ executive compensation voting policies and associated metrics…” Charles Nathan, et. al. Say on Pay 2011: Proxy Advisors on Course for Hegemony, N.Y. L. J., Nov. 28, 2011, available at http://www.lw.com/upload/pubContent/_pdf/pub4467_1.pdf.

180 U.S. SEC. & EXCH. COMM’N, supra note 172.
be—there is a lot that can be learned from the mistakes of our recent past. This is a specific area of need and timely limitations of influence are of the utmost importance.

A. The First Step: Limiting Influence to Eliminate Outcome Determinative Recommendations & Limit Agency Costs

Initially, the SEC should clarify the No-Action Letter it issued to Egan-Jones in which it determined that investment advisers could enlist the services of proxy advisors to avoid conflicts of interest between the investment adviser and its client.\textsuperscript{181} The SEC should clarify its 2004 letter to state that while the advice of proxy advisors is a means of limiting a conflict of interest, it does not relieve an investment adviser of its fiduciary duties. In this manner, an institutional investor has not met the prudent investor standard\textsuperscript{182} if it blindly follows the recommendations of a proxy advisor. Rather, to comply with its fiduciary duty, an institutional investor should vote its shares in a manner that will allow the issuer to be profitable. Institutional investors should consider the recommendation of a proxy advisor as simply one factor in its analysis for determining how to vote to in its clients’ best interest.\textsuperscript{183} Clarification of the No-Action Letter would limit the influence of proxy advisors and thus resolve two issues: (1) it would limit the outcome determinative effect of proxy advisors’ recommendations, and (2) it would place fiduciary duties back on investment advisers and thus limit agency costs because control of proxy voting would be back in the hands of the owner of the stock.

The survival of fiduciary duties would likely limit the influence of proxy advisors and thus combat the problem of outcome determinative recommendations. If a recommendation is

\begin{footnotesize}
\begin{enumerate}
\item Egan-Jones Proxy Services, SEC No-Action Letter, \textit{supra} note 151.
\item Investment advisers are charged with fiduciary duties of loyalty and care, as well as an affirmative duty of the "utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading clients." \cite{SECvCapitalGainsResearchBureau}
\item There is likely also a need for the SEC to refine what it means by voting shares in the clients’ “best interest.” \cite{Belinfanti}
\end{enumerate}
\end{footnotesize}
only a factor for consideration, institutional investors would have a legal obligation to expend more time and resources to ensure its vote complied with its fiduciary requirement. This would force institutional investors to be more attentive when determining how to vote proxy statements. Such attention would likely shed light on the flawed methodologies imposed by proxy advisors because it is unlikely a good faith investigation would yield the same outcome as the proxy advisor’s recommendation in every case. This realization would force the investment adviser to reassess the methodology of the proxy advisor. Forcing institutional investors to independently spend time looking into the proxy of a company may limit the desire to use the proxy advisor at all. However, institutional investors would still be allowed to benefit from the services of proxy advisors. Institutional investors would review proxy advisors’ recommendation in the same manner that an appellate court reviews cases involving an exercise of discretion. The institutional investor would not conduct a de novo review, but rather would review the factual basis for the proxy advisor’s recommendation.

The SEC should limit the influence of proxy advisors to address the issue of agency cost. Limiting the influence of proxy advisors would likely combat the outcome determinative problem because institutional investors could no longer blindly rely on the recommendations of proxy advisors. The elimination of blind reliance on proxy advisors would force institutional investors make its own determination about proxy voting and thus eliminate the gap between ownership (institutional investor) and control (proxy voting). The survival of fiduciary duties would force institutional investors to consider proxy advisors’ recommendations as only a factor in their own analysis, effectively shifting control over voting mechanism from proxy advisors back to institutional investors—thus narrowing separation of ownership and control. Limiting influence would also reduce the issues that occur with the value of the proxy advisor’s advice. If
the issuer is no longer in the grip of a proxy advisor, it may structure its corporate governance in the way it determines is best suited for the company rather than structuring to satisfy the demands of a proxy advisor.

B. The Second Step: Ensuring Accuracy in Voting Matrices through Disclosure

Secondly, the SEC should require proxy advisors to disclose the raw data used in its analysis to each individual issuer it evaluates. In addition to disclosure of information, proxy advisors should allow issuers sufficient time to review the information for accuracy and make objections. The opportunity to object provides the subject of the evaluation with meaningful recourse against the proxy advisor’s inaccurate information. Through this procedure, the SEC may eliminate the problem of material inaccuracies. This solution provides meaningful control to the subject of the evaluation without burdening the SEC with litigation for inaccurate information. Furthermore, disclosure of underlying information will also benefit the proxy advising industry because its clients will know what was examined when arriving at a conclusion. Such transparency and thorough analysis will likely make the recommendation more valuable to the client.

Additionally, disclosure would likely slow the analysis of proxy advisors. Disclosure of the research will force the proxy advisor to take more time and ensure the information collected is accurate before including the information in its voting matrix. This would ensure those analyzing information for the proxy advisors are not simply taking available information and absentmindedly placing it into a voting matrix, but are attentive and actively evaluating the information they are collecting and relying on to make recommendations.

Further, proxy advisors should present any objections made by the issuers to their clients. This will provide the clients with greater transparency into the accuracy of proxy advisor’s investigation without disclosing the proxy advisor’s proprietary voting matrix. This solution
would ensure accuracy of information without compromising the independence of proxy advisors.

C. The Third Step: Limiting Conflicts of Interest through Disclosure to the SEC

Lastly, the SEC should require proxy advisors to specifically disclose any potential conflicts of interest to the SEC for independent examination. The disclosure would require the proxy advisor to notify the SEC when it provides corporate governance advice for a company it currently makes proxy recommendations about. This requirement would ensure the judge is not its own jury. Proxy advisors would no longer be allowed to simply make a blanket disclosure, but would have to take the time to actually evaluate whether there may be potential for a conflict of interest.

Additionally, the requirement may cause the proxy advisor to exercise discretion when determining to whom it will offer corporate governance advice. If the proxy advisor must make a determination about whether it would be forced to disclose this advice to the SEC, it is more likely that the proxy advisor would pause to consider whether the advice it is giving is potentially a conflict of interest. Disclosure should be made to the SEC because the SEC is most properly suited for examination. This solution would also mandate that proxy advisors provide explanation and justification of its internal processes to ensure there is no maltreatment in its assessments.

VI. CONCLUSION

Regulation spawned the proxy advising industry. Lack of oversight permitted imprudent growth and influence with unintended negative consequences. In light of the current regulatory environment, the SEC should exercise caution in its oversight of proxy advisors to ensure any

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184 A “blanket disclosure” is a form document given by the proxy advisor to its clients that informs the client in very broad language that using a proxy advisor may create a conflict of interest.
regulation imposed will be effective. The final objective should be to limit the influence of proxy advisors and ensure investment advisers are accountable for the portfolios they manage.