A DEFENSE OF PROXY ADVISORS

George W. Dent, Jr.[*]

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ABSTRACT

Proxy advisors have dramatically transformed shareholder voting. Traditionally, even large institutional investors tended to follow the Wall Street Rule—vote with management or sell your stock—because the economics did not justify incurring any expense in deciding how to vote. The emergence of proxy advisors who perform proxy research for a modest fee paid by each of thousands of institutions now enables these investors to vote intelligently. New laws and rules have also expanded the range of matters on which shareholders vote. Because of these developments, business managements can no longer ignore, but must cater to, shareholder interests.

However, corporate managers resent being dethroned. They have mounted a campaign to press the SEC to impose new regulations to hobble proxy advisors and, thereby, to neutralize institutional shareholders.

This Article reviews the charges leveled against proxy advisors and the new regulations proposed by their critics. It finds the complaints mostly unwarranted. Institutional investors are sophisticated and market forces minimize any problems with proxy advisors. With a few minor exceptions, new regulations are not needed and would be counterproductive.

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* Professor of Law, Case Western Reserve University School of Law.

INTRODUCTION

Proxy advisory services have transformed proxy voting by institutional investors. These investors traditionally followed the Wall Street Rule—vote with management or sell.[1] This practice made incumbent managers absolute monarchs of the companies. They could be challenged only in serious proxy fights, which insurgencies were (and still are) expensive and rare.[2]

Institutions followed the Wall Street Rule largely because they faced a collective action problem.[3] It is expensive for a shareholder to research the merits of every proxy issue on which it votes. This is especially true for mutual funds that typically hold stock in over 100 companies.[4] If an institution pays the costs of that research, votes for the "right" side, and by so doing causes the "right" side to win and

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1. *See* Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?*, 23 CARDOZO L. REV. 1419, 1430-31 (2002). For a discussion of the Wall Street Rule, see *id.* at 1430-34. *See also* Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 261 (1962) ("[T]he modern shareholder . . . always votes 'yes' on the proxy.").

2. One study a few years ago found that the average proxy fight costs the insurgent $10,710,000. Nikolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, J. FIN. ECON. (forthcoming) (manuscript at 26-27), *available at* http://www.ssrn.com/abstract=1646471. Proxy contests are rare. *See* Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 45-46 (2003) (empirical study finding that in a seven-year period from 1996-2002 only 215 proxy contests occurred). They seem to have increased more recently. *See* Warren S. de Wied, *Proxy Contests*, PRAC. L.J., Nov. 2010, at 32, 33. "[M]ore than two-thirds of activists quit before making formal demands to their targets. . . . [O]nly 7% of the activist campaigns end up in a proxy fight." Gantchev, *supra* (manuscript at 20).

3. Many institutional investors also have conflicts of interest that incline them to vote with management. *See infra* note 212 and accompanying text.

4. An inquiry in 2004 found that the average equity fund holds stock in 140 companies. Janice Revell, *The Power of Concentration: Mutual Funds That Buy Fewer Stocks and Hold Them Longer Beat the Competition*, FORTUNE (Aug. 23, 2004), http://archive.fortune.com/magazines/fortune/fortune_archive/2004/08/23/379390/index.htm. Many large mutual funds have over 100,000 proxy questions to vote on each year. *See* JAMES K. GLASSMAN & J.W. VERRET, HOW TO FIX OUR BROKEN PROXY ADVISORY SYSTEM 8 (Apr. 16, 2013), *available at* http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf.

enhances the value of the company's stock, other shareholders can "free-ride" on that effort; that is, the increase in value will be shared equally by stockholders who avoided the costs of the research.[5] Investment companies that eschew these research expenses will have a competitive cost advantage. Thus, most institutions saved costs by following the Wall Street Rule, even though the result was suboptimal corporate performance and stock price.

In the 1990s, however, Institutional Shareholder Services (ISS) and a few other organizations appeared, offering for a fee to perform the research that most institutions shunned and to advise their clients of their findings. These services dramatically changed the cost–benefit choices of institutional investors. At small cost they now could get objective, sophisticated, well-researched opinions about proxy issues. With most institutions using the service of a proxy advisor, votes against management became much more common.[6]

This change offends corporate executives; they want to seize back untrammeled power. They and their allies are waging a massive campaign to hobble the proxy advisors.[7] Offering several complaints, they persuaded the Securities and Exchange Commission (SEC) to

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5. *See* Ian D. Gow et al., *Sneak Preview: How ISS Dictates Equity Plan Design*, STAN. CLOSER LOOK SERIES (Stanford Graduate Sch. of Bus., Stanford, Cal.), Oct. 23, 2013, at 1, *available at* http://www.ssrn.com/abstract=2346401 ("In effect, proxy [voting] suffers from a 'free-rider' problem common to many voting situations.").

6. For example, support for shareholder proposals has increased. *See* Palmiter, *supra* note 1, at 1435.

7. The critics include SEC Commissioner Daniel Gallagher, *see SEC Commissioner Comments on Proxy Adviser Practices*, 16 Corp. Governance Rep. (BNA), at 19 (Feb. 4, 2013); Rep. Scott Garrett, Chairman of the House Financial Services Capital Markets Subcommittee, *see* Richard Hill, *Rep. Garrett Urges SEC to Act, in Limited Capacity, on Proxy Adviser Issues*, 45 Sec. Reg. & L. Rep. (BNA), at 1925 (Oct. 21, 2013); former SEC Chairman Harvey Pitt, *see* Yin Wilczek, *SEC, to Mitigate Proxy Advisers' Influence, Should Repeal 2004 No-Act Letters, Pitt Says*, 44 Sec. Reg. & L. Rep. (BNA), at 2277 (Dec. 17, 2012) [hereinafter Wilczek, *SEC to Mitigate*]; and the NASDAQ Stock Market, *see* Yin Wilczek, *Nasdaq Petitions SEC to Require Proxy Firms to Publicly Disclose Methodologies, Conflicts*, 45 Sec. Reg. & L. Rep. (BNA), at 1927 (Oct. 21, 2013) [hereinafter Wilczek, *Nasdaq Petitions SEC*].

Proxy advisors have also come under attack in Europe, *see* Nigel Banerjee, *Institutional Shareholders' Use of Proxy Advisers–Outsourcing Stewardship?*, 44 Sec. Reg. & L. Rep. (BNA), at 1646 (Sept. 3, 2012), and in Canada, *see* Yvan Allaire, *The Troubling Case of Proxy Advisors: Some Policy Recommendations* 11 (Inst. for Governance of Private & Pub. Orgs., Policy Paper No. 7, 2013), *available at* http://www.ssrn.com/abstract=2282617.

review the proxy advisory industry and consider new regulation.[8] One influential Congressman has said that if the SEC does not further regulate proxy advisors, Congress will.[9]

This Article analyzes the campaign against proxy advisors. Part I describes how proxy advisors work and how influential they are. Part II reviews charges that institutional investors have improperly delegated to proxy advisors their fiduciary duty to vote their shares with due care. Part III discusses the claim that ISS holds a damaging monopoly over proxy advisory services. Part IV considers the allegations that proxy advisors make many factual errors, that their activities lack transparency, and that their policies are misguided. Part V examines arguments that proxy advisors should be deemed fiduciaries for their clients and that they have conflicts of interest that should be regulated or prohibited. Part VI weighs other proposals to regulate proxy advisors.

I. THE FUNCTIONS AND INFLUENCE OF PROXY ADVISORY SERVICES

The biggest proxy advisor is Institutional Shareholder Services (ISS), which is owned by Vestar Capital Partners.[10] At the end of 2009, it had 2,970 clients,[11] more than all other proxy advisors combined.[12] ISS also performs two other services. It publishes corporate governance ratings for thousands of public companies that are used by some investors as indicia of the quality of a company's corporate governance.[13] Several other firms also issue corporate

8. *See generally* Proxy Advisory Firms Roundtable (Dec. 5, 2013) [hereinafter Proxy Roundtable], *available at* http://www.sec.gov/spotlight/proxy-advisory-services/proxy-advisory-services-transcript.txt.

9. *See* Hill, *supra* note 7, at 1925.

10. In 2014, Vestar purchased ISS from RiskMetrics, Inc. *See Vestar Capital Partners Completes Acquisition of Institutional Shareholder Services*, INSTITUTIONAL SHAREHOLDER SERVICES INC. (Apr. 30, 2014), http://www.issgovernance.com/vestar-capital-partners-completes-acquisition-of-institutional-shareholder-services/.

11. RiskMetrics Grp., Inc., Annual Report (Form 10-K) 3 (Feb. 24, 2010).

12. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 13 (2007) [hereinafter GAO REPORT].

13. *See* RiskMetrics Grp., Inc., Annual Report (Form 10-K) 13 (Mar. 31, 2008).

governance ratings.[14] ISS also offers corporate governance advisory services to public companies.[15]

The second largest proxy advisor is Glass, Lewis & Co. ISS and Glass Lewis together have over 90% of the proxy advisor market.[16] Glass Lewis has grown and by 2011 had over 40% of the market.[17]

The potential influence of proxy advisors is considerable. As of 2007, investment funds alone owned about 24% of publicly traded American corporate stock, and this figure has been rising constantly for decades.[18] There is disagreement about how influential proxy advisors actually are. Some claim that ISS alone controls one-third or more of the shareholder votes of many issuers.[19] However, one study found that ISS recommendations swayed only 6% to 10% of the institutional votes.[20]

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14. *See* Tamara C. Belinfanti, *The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control*, 14 STAN. J.L. BUS. & FIN. 384, 391 (2009).

15. *Id.*

16. *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) [hereinafter CALL FOR CHANGE], *available at* http://www.execcomp.org/docs/c11-07a%20Proxy%20Advisory%20White%20Paper%20_FULL%20COLOR_.pdf (ISS "controls the market, with a 61% market share, and . . . Glass, Lewis & Co. controls approximately 37% of the market" (footnote omitted)).

17. *See* TAO LI, OUTSOURCING CORPORATE GOVERNANCE: CONFLICTS OF INTEREST AND COMPETITION IN THE PROXY ADVISORY INDUSTRY 4, 35 fig.1 (2013), *available at* http://www.columbia.edu/~tl2157/Tao_Li_Proxy_Advisors_Conflicts_Competition.pdf.

18. *See* INV. CO. INST., 2008 INVESTMENT COMPANY FACT BOOK 10 fig.1.2, 11 fig.1.4 (48th ed. 2008), *available at* http://www.ici.org/pdf/2008_factbook.pdf. Institutional investors now own over 70% of the stock of the largest 1,000 American corporations. Asaf Eckstein, *Great Expectations: The Peril of an Expectations Gap in Proxy Advisory Firm Regulation*, 40 DEL. J. CORP. L. (forthcoming 2014) (manuscript at 11), *available at* http://www.ssrn.com/abstract=2469158.

19. *See* Dean Starkman, *A Proxy Adviser's Two Sides: Some Question Work of ISS for Companies It Scrutinizes*, WASH. POST (Jan. 23, 2006), http://www.hrpolicy.org/downloads/2006/WashPost_ISS_ProxyAdvisor_012306.pdf (paraphrasing Susan E. Wolf, former Vice President and Corporate Secretary of Schering-Plough and former Chairman of the Society of Corporate Secretaries and Governance Professionals).

20. Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth Or Reality?*, 59 EMORY L.J. 869, 869, 906 (2010) [hereinafter Choi, Fisch & Kahan, *The Power of Proxy Advisors*]. A more recent study by the same authors also finds "a substantial degree of divergence [in voting by mutual funds] from ISS recommendations, refuting the claim that most funds follow ISS blindly." Stephen Choi, Jill Fisch & Marcel Kahan, *Who Calls the Shots? How Mutual Funds*

These widely divergent figures reflect the difficulty of distinguishing statistical correlation from causation. ISS is not the sole public voice on proxy issues.[21] Some institutions employ more than one proxy advisor.[22] Many large institutions rely more on their in-house proxy analysts than they do on ISS.[23] Some non-profit organizations offer proxy voting advice.[24] Shareholder proposals come with their own supporting statements by the proponent. And, of course, managements propagate their own views through the company proxy statement and other forms of proxy solicitation.

When ISS agrees with others, it is impossible to say that ISS "caused" the votes consistent with its advice. An institution may choose a proxy advisor whose philosophy it shares.[25] There is "a substantial correlation between proxy advisor recommendations and the factors that academics, policy makers, and the media have identified as important."[26] Thus, there are usually several vectors pushing in the same direction as proxy advisors' recommendations. Arguably, then, "the proxy firms' positions essentially mirror the

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Vote on Director Elections, 3 HARV. BUS. L. REV. 35, 39 (2013) [hereinafter Choi, Fisch & Kahan, *Who Calls the Shots?*]; *see also* Nadya Malenko & Yao Shen, *The Role of Proxy Advisory Firms: Evidence from a Regression-Continuity Design* 4 (Nov. 18, 2014), *available at* http://www.ssrn.com/abstract=2526799 (finding that "a negative recommendation from ISS leads to an about 25 percentage point decrease in voting support for say-on-pay proposals").

21. *See infra* notes 70-77 and accompanying text.

22. *See* Letter from Jonathan Feigelson, Senior Vice President, Gen. Counsel & Head of Corporate Governance, Teachers Ins. & Annuity Ass'n of Am. & Coll. Ret. Equities Fund (TIAA-CREF), to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Nov. 8, 2010) [hereinafter Letter from TIAA-CREF], *available at* http://www.sec.gov/comments/s7-14-10/s71410-263.pdf ("TIAA-CREF subscribes to the corporate governance research publications of several firms . . . .").

23. *See infra* note 67 and accompanying text.

24. For example, the Sustainable Investments Institute is a non-profit organization that offers advice on proxy resolutions concerning "social and environmental issues." *See Mission*, SUSTAINABLE INVESTMENTS INST., http://www.siinstitute.org/ (last visited Nov. 22, 2014).

25. *See* Choi, Fisch & Kahan, *The Power of Proxy Advisors*, *supra* note 20, at 879.

26. *Id.* at 881. Similarly, in 2010 ISS recommended "'against'" "28 out of 136 management-sponsored say-on-pay proposals[,] . . . [but o]nly three of the 28 . . . failed to pass." E-mail from Glenn Davis, Senior Research Assoc., Council of Institutional Investors, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Oct. 14, 2010) [hereinafter E-mail from Council of Institutional Investors], *available at* http://www.sec.gov/comments/s7-14-10/s71410-80.pdf.

current consensus on good governance."[27] Not surprisingly, mutual funds "tend to support proposals which are likely to positively impact shareholder wealth."[28] In recent years the influence of proxy advisors seems to have declined.[29]

Also, altering some shareholders' votes does not mean that proxy advisors dictate the success or failure of a resolution. In 2012, ISS and Glass Lewis recommended voting against about 14% of say-on-pay resolutions, but just 2.7% of say-on-pay votes failed.[30] And these votes are only precatory. If a board likes its pay plan despite a negative shareholder vote, it can still implement the plan and explain its decision to the world.[31]

Moreover, statistical analyses do not distinguish between important and minor proxy issues. Because of the huge volume of issues on which institutions vote, some institutions use proxy advisors primarily to identify issues that deserve special attention.[32]

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27. ROBYN BEW & RICHARD FIELDS, TAPESTRY NETWORKS, VOTING DECISIONS AT U.S. MUTUAL FUNDS: HOW INVESTORS REALLY USE PROXY ADVISERS 9 (2012), *available at* http://www.irrcinstitute.org/pdf/Voting_Decisions_at%20US_ Mutual_Funds.pdf; *see also* Yonca Ertimur, Fabrizio Ferri & David Oesch, *Understanding Director Elections: Determinants and Consequences* 3-4, 35 (June 9, 2014), *available at* http://www.ssrn.com/abstract=2447920 (study finding "substantial variations" in "withhold" votes in board elections "conditional on the underlying reason" for ISS's "withhold" recommendation).

28. Angela Morgan et al., *Mutual Funds as Monitors: Evidence from Mutual Fund Voting*, 17 J. CORP. FIN. 914, 927 (2011).

29. Reena Aggarwal, Isil Erel & Laura Starks, *Influence of Public Opinion on Investor Voting and Proxy Advisors* 4-5, 13-14 (Georgetown Univ. McDonough Sch. of Bus., Research Paper No. 2447012, 2014), *available at* http://www.ssrn.com/abstract=2447012.

30. *See* Stephen Joyce, *Say-on-Pay Votes Change, Enhance Role of Proxy Advisory Firms, Many Agree*, 44 Sec. Reg. & L. Rep. (BNA), at 1305 (July 2, 2012) [hereinafter Joyce, *Say-on-Pay Votes Change Role*] (citing data from Semler Brossy Consulting Group LLC). Similar figures have been observed for 2011. *See* BEW & FIELDS, *supra* note 27, at 10. A say-on-pay vote is a vote by shareholders of a public company on whether to approve the company's executive compensation plan. This vote is required by the Dodd–Frank Wall Street Reform and Consumer Protection Act § 951. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899-1900 (2010) (codified as amended at 15 U.S.C. § 78n-1 (2012)). This law stipulates that the shareholder vote is only advisory. *Id.*

31. Dodd–Frank Wall Street Reform and Consumer Protection Act § 951. However, even a substantial minority vote may influence a board to make changes. *See* Ertimur et al., *supra* note 27, at 5-6, 35 (study finding that boards often make changes in response to a high "withhold" vote in director elections).

32. *See* Susanne Craig, *The Giant of Shareholders, Quietly Stirring*, N.Y. TIMES (May 18, 2013), http://www.nytimes.com/2013/05/19/business/blackrock-a-

Institutions rely less on proxy advisors with respect to "certain high-profile or controversial proxy issues, such as mergers and acquisitions or executive compensation."[33] Thus, the influence of proxy advisors seems to be greatest where it is least important.

Several independent outside observers have found that the overall influence of proxy advisors is not great. A General Accountability Office (GAO) report concluded "that the overall influence of advisory firms on proxy vote outcomes may be limited."[34] An empirical study found that the influence of ISS is exaggerated and that "proxy advisors act primarily as agents or intermediaries which aggregate information that investors find important in determining how to vote in director elections rather than as independent power centers."[35] Another study found that "reliance on management appears to be more significant than reliance on ISS."[36]

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shareholding-giant-is-quietly-stirring.html?pagewanted-all&_r=0 (stating that BlackRock "uses the advisory services I.S.S. and Glass, Lewis & Company to help summarize proxy statements. Once those services have identified an issue, BlackRock assigns an analyst to it").

33. GAO REPORT, *supra* note 12, at 17; *see also infra* notes 79-82 and accompanying text.

34. GAO REPORT, *supra* note 12, at 17.

35. Stephen J. Choi, Jill E. Fisch & Marcel Kahan, *Director Elections and the Influence of Proxy Advisors* 51-52 (N.Y. Univ. Ctr. for Law, Econ. & Org., Working Paper No. 08-22, 2008), *available at* http://ssrn.com/abstract=1127282; *see also* BEW & FIELDS, *supra* note 27, at 2, 13 (stating that proxy advisors are valued by institutions as "data aggregators"). A proxy advisor also makes information easier for the investor to absorb by presenting it in a common format for all issuers. *See* Proxy Roundtable, *supra* note 8, at 150 (citing remarks of Michael Ryan, Vice President, Business Roundtable, stating that proxy advisors "take and distill the information" and "standardize the ability to read" it); *see also id.* at 63 (citing remarks of Damon Silvers, Director of Policy and Special Counsel, AFL-CIO, stating that proxy advisors "produce extremely detailed analyses of things that in many cases have been essentially rendered intentionally obscure in the proxy process").

36. Choi, Fisch & Kahan, *Who Calls the Shots?*, *supra* note 20, at 67; *see also* Randall S. Thomas, Alan R. Palmiter & James F. Cotter, *Dodd–Frank's Say on Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance?*, 97 CORNELL L. REV. 1213, 1247 (2012) ("For management-sponsored say-on-pay proposals, what is striking is that shareholders are more than twice as likely to follow management's recommendation than they are ISS's recommendation when the two recommendations differ."). Another study found that the "against" vote in say-on-pay resolutions averaged 6.7% when ISS recommended a vote for the resolution and 34.9% when ISS recommended a "no" vote. James F. Cotter, Alan R. Palmiter & Randall S. Thomas, *The First Year of Say-on-Pay Under Dodd–Frank: An Empirical Analysis and Look Forward*, 81 GEO. WASH. L. REV. 967, 983 (2013).

However, the influence of proxy advisors may extend beyond their impact on proxy votes. In order to get favorable recommendations on proxy votes and positive corporate governance ratings, many public companies tailor their executive compensation schemes, responses to shareholder proposals, and corporate governance practices to the standards of the leading proxy advisors.[37] This influence cannot be measured precisely, but it may be largely the result of a self-fulfilling prophecy. In an effort to convince the SEC to hobble proxy advisors with regulation, corporate executives and their minions have trafficked inflated estimates of the advisors' influence. Ironically, many of these people seem to have been fooled by their own propaganda and kowtow to ISS more than they need to.[38]

That may not be a bad thing. Corporations may improve their performance by adopting the views of proxy advisors even if they need not do so to gain shareholder approval. Moreover, the rise of proxy advisors and hedge funds has forced corporations to change their attitudes toward their large shareholders. Formerly these investors got no attention from management beyond the press releases available to everyone. Now managers actively seek out major shareholders so as to solicit their views and explain managements' conduct.[39]

In any case, it would make no sense to increase regulation of proxy advisors just because some people mistakenly believe that advisors wield great influence. The evidence that the influence of

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It is impossible to say how much influence ISS exerted, however, because ISS's recommendations are not random but are based on the contents of the proposed pay plan and on the performance of the company. *Id.* at 984, 989-90. It is impossible to say how much "against" votes are induced by these factors and how much they are independently influenced by ISS's recommendations. *Id.* Of the 173 resolutions on which ISS recommended a "no" vote, 142 (82.1%) still received a majority "for" vote. *Id.* at 983. Thus, management recommendations prevailed overwhelmingly even in the face of a contrary ISS recommendation.

37. *See* LATHAM & WATKINS LLP, CORPORATE GOVERNANCE COMMENTARY: PROXY ADVISORY BUSINESS: APOTHEOSIS OR APOGEE? 2 (2011) [hereinafter APOTHEOSIS OR APOGEE?], *available at* http://www.lw.com/upload/pubContent/_pdf/pub4042_1.pdf.

38. *See* CALL FOR CHANGE, *supra* note 16, at 21 (recognizing that proxy advisors may *be* influential simply because issuers *think* they are influential).

39. *See* David Gelles, *Unlikely Allies Seek to Check Power of Activist Hedge Funds*, N.Y. TIMES (Feb. 3, 2014, 10:01 PM), http://dealbook.nytimes.com/2014/02/02/unlikely-allies-seek-to-check-power-of-activist-hedge-funds/ (reporting formation of the Shareholder-Director Exchange to promote communication between corporations and shareholders).

proxy advisors is modest does not necessarily mean that no change is called for, but it does counsel caution toward managers' cries of alarm and demands for drastic action.

II. IMPROPER DELEGATION OF FIDUCIARY DUTIES

Investment advisors are fiduciaries. Fiduciaries may seek expert advice, but they cannot delegate their decision making to others.[40] Critics charge that many institutional investors have improperly delegated their proxy-voting decisions to their proxy advisors.[41] They add that the SEC has abetted this problem by requiring asset managers to vote proxies they hold in the best interests of their clients,[42] but allowing them to rely on proxy advisors to discharge that duty.[43] They urge the SEC either to retract the requirement to vote proxies (so that institutions could abstain) or to declare that reliance on a proxy advisor is not enough to satisfy an institution's fiduciary duty in proxy voting.[44]

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40. With some exceptions, "a fiduciary is not to delegate the performance of matters involving the exercise of discretion." WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP 22 (3d ed. 2001).

41. *See Policymakers, Regulators Must Question Role of Proxy Advisory Firms, Gallagher Says*, 45 Sec. Reg. & L. Rep. (BNA), at 977 (May 27, 2013) [hereinafter *Policymakers Must Question*] (quoting SEC Commissioner Daniel Gallagher as criticizing institutional investors for "'over-relying on analyses by proxy advisory firms'" and saying "'[n]o one should be able to outsource their fiduciary duties'"); Wilczek, *SEC to Mitigate*, *supra* note 7, at 2277 (paraphrasing former SEC chairman Harvey Pitt as saying that there is "an environment in which portfolio managers believe they can 'outsource' their voting responsibilities").

42. 17 C.F.R. § 275.206(4)-6 (2012). This duty has been made explicit with respect to employee benefit plans. 29 C.F.R. § 2509.94-3 (2012). The SEC also adopted a rule that requires investment advisors to vote proxies in the best interests of their clients and to disclose their voting policies and voting records. *See* 17 C.F.R. § 275.206(4)-6.

43. The source for this claim is two "no-action" letters from the SEC. Egan-Jones Proxy Servs., SEC No-Action Letter, 2004 SEC No-Act. LEXIS 636 (May 27, 2004), *available at* http://www.sec.gov/divisions/investment/noaction/egan052704.htm (stating that an investment adviser may avoid a charge of conflict of interest by relying on the advice of a proxy advisor); Institutional Shareholder Servs., Inc., SEC No-Action Letter, 2004 SEC No-Act. LEXIS 736 (Sept. 15, 2004), *available at* http://www.sec.gov/divisions/investment/noaction/iss091504.htm (stating that in fulfilling its fiduciary duty in proxy voting an investment advisor may review a proxy advisor's overall conflict of interest procedures rather than perform a case-by-case analysis).

44. Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 920 (2007); Wilczek, *SEC to Mitigate*, *supra* note 7, at 2278 (citing former SEC Chairman Harvey Pitt as suggesting "that the SEC embrace a set of core principles

Fifteen to twenty percent of mutual funds have authorized ISS to vote their shares.[45] Others have an announced policy of generally following advisor recommendations.[46] However, each institution retains ultimate control over its voting; it may withdraw authority from ISS in individual cases or rescind its authority completely.[47]

Every fiduciary is free to rely on experts so long as the fiduciary makes the ultimate decision. Thus, the SEC statements allowing asset managers to rely on proxy advisors did not confer any new permission. Directors of corporations (including investment companies) are not required or expected to be experts in all aspects of their business.[48] They must follow expert advice in the many areas that require special expertise. Boards do not fashion corporate business strategy from scratch; they assign certain agents—the company's executives—to draft a business plan, which the board reviews and, typically, approves.[49]

It would be impractical and negligent for the board of any institution that holds stock in several public companies to discuss and resolve at a board meeting every proxy resolution that the institution faces. Directors have neither the time nor the expertise to do that; they need expert advice. The experts may be company

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that clearly articulates the [proxy voting] responsibilities" of portfolio managers, but not stating what those principles should be); *see also* Belinfanti, *supra* note 14, at 430 (seeming to agree with this recommendation); *Policymakers Must Question*, *supra* note 41, at 977 (citing SEC Commissioner Daniel Gallagher as urging the SEC to take unspecified steps "'to ensure that advisers to institutional investors . . . are not over-relying on analyses by proxy advisory firms'").

45. *See* Belinfanti, *supra* note 14, at 386. In addition, "[m]any institutional investors vote in lockstep with the recommendations of proxy advisory firms." Gow, *supra* note 5, at 1, 5 exh. 1. These tend to be the smaller funds. Larger funds rely more on internal staffs and often have "client-specific custom policies." *See infra* notes 67-68, 81 and accompanying text.

46. *See* Belinfanti, *supra* note 14, at 410-11 (giving examples).

47. *See* GAO REPORT, *supra* note 12, at 16-17 ("[W]hether large or small, all of the institutional investors we spoke with explained that they retain the fiduciary obligation to vote proxies in the best interest of their clients irrespective of their reliance on proxy advisory firms.").

48. Delaware courts will not even ask whether a director's decision was reasonable much less whether the directors possessed some degree of skill. *See infra* notes 143-44 and accompanying text.

49. *See* Miriam Schwartz-Ziv & Michael S. Weisbach, *What Do Boards Really Do? Evidence from Minutes of Board Meetings*, 108 J. FIN. ECON. 349, 350 (2013) (finding that boards receive proposals from the CEO; that 99% of the time they receive only one option; and that they disagree with the CEO only 2.5% of the time).

employees or outsiders.[50] Indeed, one of the most fundamental tasks of any board is to decide what functions the company will perform in-house and which will be outsourced.[51] Economists call this the "make or buy" decision.[52] There is no reason why proxy voting should be singled out and excluded from the directors' general right to rely on experts.

Corporate executives and their allies routinely insist that directors be allowed to act with minimal interference from courts or administrative agencies. These groups have never complained when institutional investors followed the Wall Street Rule and automatically voted with management. Thus it is suspicious that they call for restricting boards' right to rely on experts only when it is reliance on proxy advisors.

For proxy voting, the advantages of using an outsider are obvious. The primary goal of institutional investors is to maximize the value of their portfolios.[53] It makes economic sense to pay a third party a small fee (which is also charged to many other investors holding the same stock) to research whether each proxy resolution serves that goal rather than to incur the expense of doing that research in-house. Moreover, similar proxy resolutions, like those relating to executive compensation, arise at hundreds of publicly traded companies. A single institution may hold stock in just a few companies with a particular proxy issue, so it might not make economic sense for it to research that issue extensively, especially if

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50. *See* DEL. CODE ANN. tit. 8, § 141(e) (2014) (creating a right of directors to rely on "any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation").

51. *See* R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 394-95 (1937).

52. Ronald Coase first framed the theory of the firm based on the distinction between which functions were more economically performed within the entity and which were better contracted for in the market, which was later coined the "make or buy decision." *See id.*

53. Some institutional investors, like union pension funds, may also have social or political goals. *See* JAMES R. COPLAND & MARGARET M. O'KEEFE, MANHATTAN INST., PROXY MONITOR 2013: A REPORT ON CORPORATE GOVERNANCE AND SHAREHOLDER ACTIVISM 2 (2013), *available at* http://www.proxymonitor.org/pdf/pmr_06.pdf. However, these investors are exceptions. *See* George W. Dent, Jr., *The Essential Unity of Shareholders and the Myth of Investor Short-Termism*, 35 DEL. J. CORP. L. 97, 106-09 (2010).

it is a small institutional investor.[54] However, for ISS, which researches hundreds of issuers with resolutions on a given subject, it makes excellent sense to develop expertise on that subject.

The need for outside expertise is much greater now than it was just twenty years ago. By giving shareholders a say-on-pay, the Dodd–Frank Act requires them to vote on detailed compensation plans, something that was almost never submitted to shareholders before.[55] Also, twenty years ago shareholder resolutions on corporate governance almost never passed, so an institutional investor might have deemed it unimportant how it voted on these matters. Now, such resolutions are usually hotly contested and often pass.[56] Until

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54. "Without proxy advisers, many pension plans—particularly smaller funds with limited resources—would have difficulty managing their highly seasonal proxy voting responsibilities for the thousands of companies in their portfolios." E-mail from Council of Institutional Investors, *supra* note 26. For this reason it is not surprising that large institutions report that they rely less on proxy advisors' recommendations than do smaller institutions. *See* GAO REPORT, *supra* note 12, at 5-6; BEW & FIELDS, *supra* note 27, at 15. Index funds seem also to rely more heavily on proxy advisors. *Id.* This is not surprising because index funds compete by "keep[ing] expenses as low as possible." Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. LAW. 1079, 1082-83 (2008).

55. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899-1900 (2010) (codified as amended at 15 U.S.C. § 78n-1 (2012)). This rule covers about 7,300 public companies. *See* APOTHEOSIS OR APOGEE?, *supra* note 37, at 2-3.

56. The number of successful shareholder proposals fell from fifty-three (15% of the total) in 2006 to fourteen (6% of the total) in 2012. JAMES R. COPLAND, YEVGENIY FEYMAN & MARGARET O'KEEFE, MANHATTAN INST., PROXY MONITOR 2012: A REPORT ON CORPORATE GOVERNANCE AND SHAREHOLDER ACTIVISM 17 (2012), *available at* http://www.proxymonitor.org/pdf/pmr_04.pdf.

> The key reason for this overall downward trend appears to be a shift from more popular proposals to less appealing ideas. . . . As [the more popular] ideas have been adopted, . . . they are less likely to be the subject of shareholder proposals, for the simple reason that they are no longer relevant for many companies.

Id. at 18. It is also likely that issuers have become more sophisticated in dealing with shareholder dissatisfaction and shareholder proposals. For example, many issuers admit to adopting ISS's guidelines on executive compensation. *See supra* note 37 and accompanying text. Such behavior reduces the chances that an issuer will face a serious shareholder challenge. Moreover, many companies that do receive a serious challenge either concede without a fight or compromise with the proponents. For example, shareholders dislike staggered boards of directors, but they alone cannot change them in Delaware because provisions for staggered boards are contained in the charter, which cannot be amended without a positive vote of both the board and the shareholders. DEL. CODE ANN. tit. 8, §§ 141(d), 242(b) (2014). Nonetheless, ninety-seven companies that received proposals in 2012–2013 to de-stagger their recently, nearly all American corporations had plurality voting for the board of directors. Except in the rare case of a serious proxy contest, election of the company's official slate of nominees was automatic, so institutions might have thought it irrelevant how they voted. Now, most corporations have majority voting, and it is not uncommon for official candidates to fail to get a majority vote.[57] Also, SEC regulations now require issuers to disclose more information, which increases the burden of researching proxy issues.[58]

The results of all these changes are that shareholders are now asked to vote on more issues than before, disclosures are more complex, and more issues are seriously contested so that an institution's vote is now more likely to make a difference.[59] These changes would drastically increase costs to institutional investors if they had to perform all research in-house.[60] Use of a proxy advisor is far wiser.

To follow anyone's advice unthinkingly would be an improper delegation of a fiduciary's duty, but that is not what institutions have done with proxy voting.[61] First, an advisor is not chosen at random.

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boards (about three-quarters of such companies) agreed to move to annual elections after receiving declassification proposals. June Rhee, *The Shareholder Rights Project's Mid-Year Update*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 10, 2013, 9:34 AM), http://blogs.law.harvard.edu/corpgov/2013/07/10/the-shareholder-rights-projects-mid-year-update/. Evidently these issuers have bowed to the power of shareholders. Thus the declining success rate of proposals does not seem to evidence declining shareholder influence. *See id.*

57. *See* Sarah Johnson, *In the Minority on Majority Voting*, CFO (Jan. 27, 2011), http://www.cfo.com/article.cfm/14552148?=rsspage ("Nearly 70% of S&P 500 companies now have a majority-voting standard . . . ."). However, boards often ignore such failures and leave the director in place. *See* James B. Stewart, *Bad Directors and Why They Aren't Thrown Out*, N.Y. TIMES (Mar. 29, 2013), http://www.nytimes.com/2013/03/30/business/why-bad-directors-arent-thrown-out.html?pagewanted=all&_r=0 ("Of the 61 directors who failed to get majority approval [in 2012], only six actually stepped down or were asked to resign. Fifty-one are still in place, as of the most recent proxy filings.").

58. *See* CALL FOR CHANGE, *supra* note 16, at 5.

59. *Id.* at 17.

60. TIAA-CREF manages $840 billion in Assets. *See Who We Are*, TIAA-CREF, https://www.tiaa-cref.org/public/about-us/who-we-are-at-tiaa-cref (last visited Nov. 22, 2014). It says: "Though we dedicate a significant amount of resources to corporate governance research and the voting of proxies, we still would have difficulty processing the 80,000 plus unique agenda items voted by our staff annually without utilizing this research [or proxy advisers]." Letter from TIAA-CREF, *supra* note 22.

61. *See supra* notes 29-35 and accompanying text.

Instead, most institutional investors "determine which proxy advisor has a voting policy they most agree with."[62] To the extent that institutions vote with ISS and Glass Lewis it is because they "have some common views on corporate governance."[63]

Some institutions also subscribe to more than one proxy advisory firm and consider the recommendations of all of them.[64] Advisors publicize their general policies and specific recommendations.[65] Sometimes they disagree among themselves.[66] Many institutions (especially the larger ones) maintain internal staffs to research proxy issues, and they often reject the advice of a proxy advisor and follow the contrary recommendations of their own staffs.[67]

Over 400 institutions do not accept the standard voting recommendations of a proxy advisor but have "client-specific custom policies" that are "implemented on behalf of clients tailored to their investment philosophies" and which together total over "50 percent of ballots that flow through ISS' voting system."[68] ISS also considers the views of investors in formulating its policies.[69] This is

62. Choi, Fisch & Kahan, *The Power of Proxy Advisors*, *supra* note 20, at 883.

63. Proxy Roundtable, *supra* note 8, at 54 (citing remarks of Lynn Turner, Managing Director, LitNomics, Inc.).

64. *See* GAO REPORT, *supra* note 12, at 15 (reporting that eight of twenty institutions interviewed followed this practice).

65. *See generally, e.g.*, INSTITUTIONAL S'HOLDER SERVS. INC., U.S. CORPORATE GOVERNANCE POLICY: 2013 UPDATES (2012) [hereinafter 2013 UPDATES], *available at* http://www.issgovernance.com/files/2013USPolicyUpdates.pdf.

66. *See* Stephen J. Choi, Jill E. Fisch & Marcel Kahan, *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 649 (2009) (finding that "the four proxy advisory firms differ substantially from each other in their willingness to issue a withhold recommendation").

67. *See* GAO REPORT, *supra* note 12, at 16 (stating that fifteen of twenty large institutions interviewed by the GAO "reported that they generally rely more on their own in-house research and analyses to make voting decisions than on the research and recommendations provided by their proxy advisory services"); *see also* Proxy Roundtable, *supra* note 8, at 53 (citing remarks of Lynn Turner, Manager Director, LitiNomics, Inc., stating that her institution voted against management more often than Glass Lewis so recommended).

68. PATRICK MCGURN ET AL., INSTITUTIONAL S'HOLDER SERVS. INC., TWELVE FOR 2012: NOTABLE CHANGES TO THE ISS BENCHMARK VOTING POLICY FOR THE UPCOMING PROXY SEASON 3 (2012), *available at* http://www.issgovernance.com/files/2012USPoliciesUpdatesWebcastSlidePresentation.pdf.

69. *Id.* at 2 (citing 335 investor responses to an ISS survey and six roundtable discussions).

hardly surprising. ISS is a business; it has no reason to pursue an independent agenda and every reason to please its customers.

More important, although ISS and Glass Lewis may dominate among proxy advisors, proxy advisors are far from the sole voices on proxy issues. For many institutions, the recommendations of a proxy advisor are just "one of many inputs" in deciding how to vote.[70] Public pension funds are vocal shareholders.[71] Four public pension funds and one foundation work with the Shareholders Rights Project (SRP) at Harvard Law School on certain issues relating to corporate governance.[72] The SRP not only provides an alternative source of advice for the institutions that work with it, but also publicizes its views for other institutions to consider. Some large institutions publish in advance their own positions on proxy issues.[73] Other institutions are free to adopt these positions.

The funds working with SRP submitted seventy-six shareholder resolutions in 2013[74] and eighty-nine in 2012[75] to declassify boards. ISS generally supports these resolutions. However, managements often spend considerable sums from the corporate treasury in efforts (including direct solicitation of institutional investors) to curry support for their recommendations.[76]

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70. Proxy Roundtable, *supra* note 8, at 45 (citing remarks of Michelle Edkins, Managing Director and Global Head, Corporate Governance and Responsible Investment, BlackRock, Inc.).

71. *See Public Pension Funds Increasingly Active as Shareholders in 2013 Proxy Season*, 45 Sec. Reg. & L. Rep. (BNA), at 1003 (May 27, 2013) [hereinafter *Public Funds Active*].

72. *See* SHAREHOLDER RTS. PROJECT, http://srp.law.harvard.edu/index.shtml (last visited Nov. 22, 2014) (describing the Shareholder Rights Project and listing the funds represented by the SRP).

73. *See Public Funds Active*, *supra* note 71, at 1007 ("For the 2013 proxy season, CalPERS [the California Public Employees' Retirement System] will be disclosing its proxy votes for 376 companies in advance of their annual meeting dates. The information is posted on the CalPERS website.").

74. *2013 Proposals by SRP-Represented Investors*, SHAREHOLDER RTS. PROJECT, http://www.srp.harvard.edu/2013-declassification-proposals.shtml (last visited Nov. 22, 2014).

75. *Outcomes of 2012 Proposals by SRP-Represented Investors*, SHAREHOLDER RTS. PROJECT, http://www.srp.law.harvard.edu/2012-declassification-proposals.shtml (last visited Nov. 22, 2014).

76. *See* Aaron Lucchetti, *Companies Fight Back on Executive Pay*, WALL ST. J. (Feb. 7, 2011, 12:01 AM), http://online.wsj.com/articles/SB10001424052748 703989504576128350414836400 (describing lobbying efforts directed at 100 large institutional investors by the Center on Executive Compensation, an organization created by several large public companies); BEW & FIELDS, *supra* note 27, at 18

Public corporations also collaborate in various ways to publicize their views. Several organizations funded by public corporations (like the Business Roundtable and the Center on Executive Compensation) routinely release statements on proxy issues, including direct criticisms of proxy advisors.[77] By contrast, proxy challengers must fund their campaigns out of their own pockets. As a result, only thirty-nine of SRP's resolutions were approved by shareholders in 2012, and nineteen were carried in 2013.[78] These results do not indicate that institutional investors are blindly following proxy advisors—or anyone else—in their proxy voting.

"In addition, large and small institutional investors reported that they tend to provide greater in-house scrutiny to, and rely even less on, proxy advisory firm recommendations about certain high-profile or controversial proxy issues, such as mergers and acquisitions or executive compensation."[79] Even those who allege undue reliance by institutions on proxy advisors tend to acknowledge an exception "for votes with clear economic significance (such as mergers or election contests)."[80] Thus, institutions' reliance on proxy advisors may be significant primarily for smaller institutions[81] and in fairly routine and uncontested matters.[82]

Some have expressed skepticism about "institutional investors' insistence that they make independent decisions notwithstanding ISS's influence. Yes, some do. But how many institutional investors would actually confess . . . 'Yep, most of the time I just vote the way

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(quoting one asset manager as saying, "'We talked to about 400 issuers last year about compensation'").

77. *See generally, e.g.*, CALL FOR CHANGE, *supra* note 16.

78. *See* SHAREHOLDER RTS. PROJECT, *supra* note 72. ISS "supports annual director elections rather than a classified board structure." INSTITUTIONAL S'HOLDER SERVS. INC., 2013 SRI U.S. PROXY VOTING GUIDELINES 45 (2013), *available at* http://www.issgovernance.com/file/2013-policies/2013ISSSRIUSPolicy.pdf.

79. GAO REPORT, *supra* note 12, at 17; *see also* Proxy Roundtable, *supra* note 8, at 152 (quoting remarks of Eric Komitee, General Counsel, Viking Global Investors, GP, saying, "the more contested the vote is the less likely we are to be swayed in the end one way or another by what the proxy advisor is recommending").

80. LATHAM & WATKINS, LLP, CORPORATE GOVERNANCE COMMENTARY: THE PARALLEL UNIVERSES OF INSTITUTIONAL INVESTING AND INSTITUTIONAL VOTING 1 (2010), *available at* http://www.lw.com/upload/pubContent/_pdf/pub3446_1.pdf.

81. *See* Proxy Roundtable, *supra* note 8, at 56 (quoting remarks of Karen Barr, General Counsel, Investment Adviser Association, saying, "Smaller [investment] advisors tend to rely more heavily on the research and recommendations of proxy advisory firms").

82. *See supra* note 32 and accompanying text.

they tell me.'"[83] However, the professionals interviewed by the GAO agreed "that large institutional investors would be likely to use proxy advisory firms as one of several factors they consider in the research and analysis they perform."[84] "The influence of ISS is thus mostly due to funds' measured evaluation of the ISS recommendations, with significant thinking on their own, rather than to funds' blindly following these recommendations."[85]

Restricting the use of proxy advisors by institutional investors would have several negative consequences. Probably no fund would respond by creating a large in-house staff to research all proxy issues; that is not economically practicable.[86] If proxy advisors have been compelled to "automate their decision-making processes" by the "sheer volume of shareholder votes,"[87] even the largest institutional investors could not hope to study every voting decision. Rather, most institutions (especially the smaller ones) would revert to their former practices—generally following the Wall Street Rule by voting for management.[88] The result would not be more independent evaluation of proxy issues by institutional investors but delegation of decisions by default to the issuer's management. Of course, this is probably just the result that the foes of proxy advisors want.

If institutions were forced to handle proxy voting in-house,[89] they would reduce diversification of their portfolios because fewer

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83. Broc Romanek, *GAO Report on Proxy Advisors: No Smoking Guns*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 3, 2007, 7:36 AM), http://blogs.law.harvard.edu/corpgov/2007/08/03/gao-report-on-proxy-advisors-no-smoking-gun.

84. GAO REPORT, *supra* note 12, at 17.

85. Stephen J. Choi, Jill E. Fisch & Marcel Kahan, *Voting Through Agents: How Mutual Funds Vote on Director Elections* 9 (Univ. of Pa., Inst. for Law & Econ., Research Paper No. 11-28, 2011), *available at* http://ssrn.com/abstract=1912772.

86. Romanek, *supra* note 83 ("The reality is that institutional investors are trying to keep their expense ratios down–and even the larger institutions typically have only a few employees dedicated to vetting voting issues.").

87. *See* APOTHEOSIS OR APOGEE?, *supra* note 37, at 1.

88. "[T]he impetus for enacting the SEC 2003 Rule [regarding proxy voting by mutual funds] was a concern that mutual funds were voting portfolio shares in blind accordance with company management's recommendations . . . ." Belinfanti, *supra* note 14, at 438; *see also supra* note 42.

89. *See* NAT'L INVESTOR RELATION INST. & SOC'Y OF CORPORATE SECRETARIES & GOVERNANCE PROF'LS, PROXY ADVISORY SERVICES: THE NEED FOR MORE REGULATORY OVERSIGHT AND TRANSPARENCY 8-9 (2010) [hereinafter NIRI LETTER], *available at*

holdings would require less expense for research. However, diversification is an axiom of modern investment theory.[90] In particular, institutional investors would divest stocks of smaller companies, for which holdings are likely to be smaller and for which the costs of proxy research would be harder to justify. This would be undesirable at a time when the number of publicly traded companies is already falling. It would also discourage investment in foreign companies, thereby increasing the investment risks of excessive dependence on the American economy.

Many mutual funds have conflicts of interest that incline them to vote with the issuer's management.[91] Some funds offer various corporate services, and therefore have an incentive to curry favor with managers of current and potential clients by voting shares of those companies that they own in line with the managers' wishes.[92] Thus, "the greater the dependency of [a mutual fund family] upon [corporate clients] for asset management business, the less likely the fund family will be to support shareholder-sponsored governance resolutions."[93] Thus, the recommendations of proxy advisors offset (but only somewhat) the tendency of institutions to vote with management.

Thus, restricting the use of proxy advisors would harm the institutional investors' own shareholders—the very people whom the critics of proxy advisors supposedly want to help. It would favor larger institutions because they could better absorb the increased costs of proxy voting. The increased costs would be passed along to the institutions' own investors, who would therefore suffer lower returns. These consequences seem unjustifiable when the corresponding benefits are dubious.

Alternatively, it has been suggested that institutional investors not vote at all on substantive issues.[94] The idea is that if institutions

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http://www.shareholdercoalition.com/SCSGP_NIRI_Discussion_Draft_3-4-2010.pdf; CALL FOR CHANGE, *supra* note 16, at 86.

90. *See* RICHARD A. BREALEY, AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS 42-46, 48-54, 115-31 (1969); JEFFREY J. HAAS, CORPORATE FINANCE IN A NUTSHELL § 26, at 150-52 (2004).

91. *See infra* note 212 and accompanying text.

92. *See* Paul H. Edelman, Randall S. Thomas & Robert B. Thompson, *Shareholder Voting in an Age of Intermediary Capitalism*, 87 S. CAL. L. REV. 1359, 1401-06 (2014) (describing the conflicts of interest of many mutual funds).

93. Jennifer S. Taub, *Able but Not Willing: The Failure of Mutual Fund Advisers to Advocate for Shareholders' Rights*, 34 J. CORP. L. 843, 846 (2009).

94. *See* APOTHEOSIS OR APOGEE?, *supra* note 37, at 6-9. Institutions could submit a proxy simply to be present so as to satisfy the quorum requirement. Current

cannot cast a carefully, independently informed vote on an issue, they should simply abstain. This, too, is transparently self-serving advice from the minions of corporate executives. Many issuers still require only a plurality vote for election to the board. In these elections, abstentions are irrelevant since the official nominee can be elected with just a handful of votes from insiders. Further, as noted, many institutions are rationally reluctant to vote at all.[95] For them, "mandatory voting facilitates a solution to the shareholders' collective action problem."[96]

Shareholder resolutions require a majority vote. Managers routinely oppose these resolutions, and institutions are likely to vote with management unless a resolution is supported by its proxy advisor. If proxy advisors are put out of business or reduced to insignificance, shareholder resolutions will become less effective. Moreover, if abstention becomes more common it will become even easier than it is now for boards of firms with majority voting for directors to leave in place a director who has not received a majority vote.[97]

The proxy advisory industry began largely because institutions sought expert help on voting.[98] The rise of proxy advisors seems to have enhanced stock values.[99] Regulation restricting the use of proxy advisors would reverse this trend; if some institutions cease to use proxy advisors, the advisors must raise their fees or reduce their services. Either response will cause more institutions to drop the service. Thus costs could spiral up, the collective action problem would resurface, and proxy voting would become less effective.

The purpose of the shareholder franchise is that managers should be accountable to shareholders and not absolute autocrats.[100]

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federal regulations require (or seem to require) institutions to vote on substantive issues, so these regulations would have to be amended to allow routine abstention. *See id.* at 5-9.

95. *See supra* notes 4-7 and accompanying text.

96. Edelman, Thomas & Thompson, *supra* note 92, at 1424.

97. Many boards already ignore the failure of a candidate to receive a majority vote. *See* Stewart, *supra* note 57.

98. *See* Proxy Roundtable, *supra* note 8, at 28-29 (citing remarks of Neil Minow, Co-Founder and Board Member, GMI Ratings).

99. *See* Jiekun Huang, Shareholder Coordination, Corporate Governance, and Firm Value 3-5 (Dec. 12, 2013) (unpublished manuscript), *available at* http://www.ssrn.com/abstract=2380284 (discussing how the "ease of coordination among institutional shareholders enhances firm value").

100. *See* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.").

Only if we want to rescind shareholder democracy does it make sense to forbid reliance on proxy advisors. Put another way, the question is whether it is better to have major influence from proxy advisors or to have managerial autocracy. The former, though imperfect, is clearly the better alternative.[101]

III. MONOPOLY

Critics claim that ISS exerts excessive influence because it enjoys a virtual monopoly in the proxy advisory industry.[102] As discussed above, claims of ISS's domination are exaggerated, partly because institutions have both additional outside sources and internal staffs for advice on how to vote.[103] Nonetheless, the claims of monopoly deserve some discussion.

ISS and Glass Lewis together have over 90% of the proxy advisory market.[104] High startup costs pose a daunting barrier to entry by newcomers.[105] Although ISS and Glass Lewis compete with each other and with several smaller advisory firms, it is alleged that "[n]o sane institutional investor is going to assume the risk inherent in moving thousands of accounts and ballots from ISS to another provider. The chance that accounts would be lost, not voted, or voted incorrectly is far too great."[106]

This concern seems overblown. First, only 15% to 20% of mutual funds have given ISS authority to vote their shares.[107] Although this is a substantial number, most mutual funds can switch advisors without incurring this risk. Further, no institutional investor has ever been held liable for failing to vote proxies or voting them "incorrectly," so the risk of liability for an institution switching to a new proxy advisor seems nonexistent.

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101. *See generally* George W. Dent, Jr., *Corporate Governance Without Shareholders: A Cautionary Lesson from Non-Profit Organizations*, 39 DEL. J. CORP. L. 93 (2014) (stating that the absence of shareholder power in non-profit organizations generally leads to poor governance).

102. *See* CALL FOR CHANGE, *supra* note 16, at 76-78 (alleging that ISS lacks serious competition); Belinfanti, *supra* note 14, at 411-17 (alleging that "ISS currently operates without significant competitive pressure"); GAO REPORT, *supra* note 12, at 13-15 (referring to ISS's "dominance in the proxy advisory industry").

103. *See supra* notes 23-25, 67, 70-77 and accompanying text.

104. *See supra* note 16.

105. *See* Proxy Roundtable, *supra* note 8, at 94-97 (citing remarks of Michael Ryan, Vice President, Business Roundtable).

106. Romanek, *supra* note 83; *see also* Belinfanti, *supra* note 14, at 413-14.

107. *See supra* note 45 and accompanying text.

Although concentration is a concern in any industry, it is not clear that it has caused any problems in this case. ISS is not alleged to reap monopoly profits; even its critics acknowledge that its advisory operations are not very profitable.[108] Even if we assume that the smaller proxy advisors do not give stiff competition to the duopoly of ISS and Glass Lewis, the ability of these two to extract supra-competitive profits is limited by the option of large institutions to perform proxy analysis in-house and of smaller institutions to follow the Wall Street Rule or some other simple formula for voting.

There is some slight evidence that ISS pressures issuers to retain its consulting services by giving more favorable proxy voting recommendations to companies that do so.[109] However, that practice seems to dissipate when Glass Lewis, which does not offer such consulting services, also gives proxy advice concerning an issuer.[110] Glass Lewis has now grown and holds over 40% of the proxy advisory market.[111] If ISS once had market power that allowed it to indulge in this practice, that power may be evaporating.

Further, the success of ISS and Glass Lewis is not alleged to stem from predation.[112] It seems, rather, the product of economies of scale. Indeed some of the GAO's interviewees "questioned whether the market could sustain the current number of firms."[113] Accordingly, it does not seem that restructuring the industry would have much impact in the long term since economics would push the industry toward renewed concentration. Perhaps the most telling evidence against the monopoly-profits thesis is that the proxy advisors' clients—those who would be injured by excessive fees—are not complaining.[114]

Ironically, proposals to regulate or limit the use of proxy advisors would exacerbate rather than alleviate concentration in the industry. If new measures reduced the use of proxy advisors, ISS could survive the decline, but smaller advisors might not. Further, the costs of regulation are more easily borne by large firms than by

108. *See* CALL FOR CHANGE, *supra* note 16, at 32.

109. *See infra* note 201 and accompanying text.

110. *See* CALL FOR CHANGE, *supra* note 16, at 35.

111. *See* LI, *supra* note 17, at 4, 35 fig.1.

112. ISS has acquired several smaller advisors. *See* CALL FOR CHANGE, *supra* note 16, at 29-30. Further acquisitions could be a legitimate matter of concern for antitrust regulators.

113. GAO REPORT, *supra* note 12, at 15.

114. *See id.* at 15.

small firms.[115] The costs of the added regulations sought by critics of proxy advisors might increase rather than reduce concentration in the industry.

Thus, the complaints of monopoly seem intended more to harass proxy advisors than to remedy any real problems in the industry. Corporate managers dislike the large proxy advisors not because their fees are too high but because of the voting advice they give. However, the dominance of ISS and Glass Lewis suggests the soundness of their general approach to corporate governance issues. If their advice did not generally advance shareholder interests, competitors could lure away many of their clients by offering a different philosophy. Several institutions interviewed by the GAO reported that they "subscribe to ISS's services . . . because they . . . trust it to provide reliable, efficient services."[116] Only because there is little disagreement among proxy advisors about their basic approach do the economies of scale enjoyed by the larger firms become dispositive.

If public issuers and their allies think that proxy advisors are doing a poor job, they can create their own proxy advisor to offer better service. This has not happened, which strongly suggests that competitors do not detect any fundamental client dissatisfaction with the industry leaders.[117]

Some complain that proxy advisors influence proxy voting even though they have no "skin in the game."[118] The charge is ironic because it is often alleged by corporate managers and their allies that the views of institutional investors are tainted because stock holdings make them short-term oriented and that this bias must be rectified by assigning firm governance to a board dominated by outside directors who have little "skin in the game" and, therefore, can be objective

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115. *See* CALL FOR CHANGE, *supra* note 16, at 55.

116. GAO REPORT, *supra* note 12, at 13.

117. Some competitors "have attempted to differentiate themselves from ISS by . . . emphasizing that they provide only proxy advisory services and not corporate consulting services." GAO REPORT, *supra* note 12, at 5. Their evident purpose is to avoid the conflict of interest that some have ascribed to ISS. *See infra* Part V. Also, "some firms have started to focus their research and recommendation services on particular types of proxy issues or on issues specific to individual corporations." GAO REPORT, *supra* note 12, at 14. However, no competitor has marketed a fundamentally different philosophy of corporate governance than ISS's. *See id.*

118. Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (And Europe) Face*, 30 DEL. J. CORP. L. 673, 688 (2005).

and dispassionate.[119] The charge is further ironic because executives and their allies invariably reject complaints that many corporate directors own little stock in their companies and, therefore, have little "skin in the game." Again, the complaints against proxy advisors seem more self-interested than principled.

IV. TRANSPARENCY AND ACCURACY

A. Disclosure of Methodologies

> One of [sic] most troubling developments with respect to proxy advisory firm analysis is the number and scope of inaccuracies in the research reports they produce on corporate issuers and a general lack of transparency in many of the methodologies, metrics and decision processes utilized by them to make voting recommendations.[120]

Proxy advisors already disclose much more than just their voting recommendations and corporate governance ratings, including much underlying data that they review and the general principles that they follow.[121] ISS publishes its corporate governance policies annually.[122] Every year there are changes, and ISS has recently added a feature to its website that allows an issuer to verify data underlying ISS's evaluation of its compensation plan.[123] If issuers feel that proxy advisors' disclosures are inadequate, they can individually or collectively present their case to shareholders, and they do so.[124]

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119. *See* Marleen A. O'Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899, 956 (1993) (proposing that directors be "neutral referee[s]" for the various corporate constituencies).

120. CALL FOR CHANGE, *supra* note 16, at 55.

121. For example, after enactment of Dodd–Frank, Glass Lewis, "in response to client requests, . . . enhanced the types of information it presents to clients so they can make better informed decisions on say-on-pay votes." Joyce, *Say-on-Pay Votes Change Role*, *supra* note 30, at 1306. ISS has issued a paper describing its methods for evaluating pay-for-performance compensation plans. *See generally* GARY HEWITT & CAROL BOWIE, EVALUATING PAY FOR PERFORMANCE ALIGNMENT: ISS' QUANTITATIVE AND QUALITATIVE APPROACH (2012) [hereinafter EVALUATING PAY FOR PERFORMANCE], *available at* http://www.issgovernance.com/files/EvaluatingPayForPerformance_final_updated_02172012.pdf.

122. *See, e.g.*, 2013 UPDATES, *supra* note 65, at 3.

123. *See* Michael Greene, *ISS's New Data Portal to Shed Light on Firms' Evaluations*, 17 Corp. Governance Rep. (BNA), at 104 (Sept. 1, 2014); *ISS Releases Revamped Score Card on Governance Policies*, 17 Corp. Governance Rep. (BNA), at 20 (Feb. 3, 2014).

124. *See supra* note 39 and accompanying text.

Some critics argue for requiring proxy advisors to register under the Investment Advisers Act so as to achieve greater transparency.[125] However, ISS is already a registered investment adviser required to describe its voting policies and procedures.[126] A registration requirement would only extend registration to smaller firms.

If there is a problem of inadequate transparency, it concerns not what ISS's policies are but how it arrives at and implements its policies. ISS is open about how it develops its policies, but "precisely how those policies are *implemented* remains unclear. Even more unclear is how ISS determines a company's [Corporate Governance Quotient] score."[127] However, it is not clear who is harmed by this alleged problem. Again, the clients of proxy advisors are not complaining or firing their advisors, and shareholder organizations are not complaining.[128] Dissatisfaction seems to be limited to the managers of issuers whose monopoly on corporate power has been weakened by the proxy advisors.

Increasing the disclosure obligations of proxy advisors would increase their costs, which would have to be passed on to their clients. However, their services are not mandatory. Faced with higher fees, some institutions would probably just drop the service, which would require imposition of even higher fees on the shrinking client base. At the least this would mean many more institutions voting their shares blindly—quite possibly by following the Wall Street Rule. At the worst, it could destroy the economic viability of the proxy advisors. That is undoubtedly the result for which corporate executives and their hired guns hope.

Proxy advisors' recommendations are currently exempt from SEC regulation of proxy solicitations.[129] It has been proposed that proxy advisors be compelled to disclose the methodologies they use to make recommendations and compute corporate governance

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125. *See* NIRI LETTER, *supra* note 89, at 7 ("At a minimum, all proxy advisory firms should be required to register as investment advisers . . . under the Investment Advisers Act of 1940.").

126. *See* SEC. & EXCH. COMM'N, OMB NO. 3235-0049, FORM ADV: UNIFORM APPLICATION FOR INVESTMENT ADVISER REGISTRATION pt. 2, at 8-9 (2014).

127. Belinfanti, *supra* note 14, at 419 (footnote omitted).

128. *See* GAO REPORT, *supra* note 12, at 11.

129. 17 C.F.R. § 240.14a-2(b)(3) (2014). Proxy advisors are, however, subject to rule 14a-9's prohibition on materially false and misleading statements. *See* Concept Release on the U.S. Proxy System, Exchange Act Release No. 34-62495, at 109 (July 14, 2010) [hereinafter Concept Release].

ratings.[130] This would be unwise. Proxy advisors' clients are large, sophisticated institutions. Any client that wants more information from a proxy advisor can demand it and take its business elsewhere if that information is denied. Clients are not demanding more information from proxy advisors; they seem satisfied with the status quo. Increased disclosure requirements would raise advisors' costs (and fees) without generating much benefit.

The required disclosures would also include valuable proprietary information.[131] Proxy advisors' product is their advice. Requiring them to disclose their methodologies would be like requiring a chef to disclose her recipes. Competitors might use information released by ISS to make their own recommendations without bearing the costs that ISS incurred to conduct research and formulate its voting policies and corporate governance ratings.[132]

B. Factual Errors by Proxy Advisors

Proxy advisors are accused of committing many significant factual errors in their research reports.[133] One alleged reason for errors or poor judgment by proxy advisors is

> [t]he sheer volume of shareholder votes requiring recommendations each year, numbering in the tens of thousands, which is straining the capacity of the proxy advisors' production system and jeopardizing the integrity and credibility of the output. The large and growing number of annual voting recommendations, largely crammed into a four-month proxy season, dictates that proxy advisors automate their decision-making processes to the greatest extent feasible and that both inputs and outputs be as simple as

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130. Belinfanti, *supra* note 14, at 434-35; CALL FOR CHANGE, *supra* note 16, at 86; Wilczek, *Nasdaq Petitions SEC*, *supra* note 7, at 1927-28 (requesting mandatory disclosure of "'the models, formulas and methodologies pursuant to which [proxy advisers] evaluate and make recommendations regarding how shareholders should vote'" (quoting Nasdaq's petition)).

131. "[T]he algorithms and data used by [proxy advisory] firms are considered proprietary." David F. Larcker & Brian Tayan, *Do ISS Voting Recommendations Create Shareholder Value?*, STAN. CLOSER LOOK SERIES (Stanford Graduate Sch. of Bus., Stanford, Cal.), Apr. 19, 2011, at 1, *available at* https://www.gsb.stanford.edu/sites/default/files/13_ExchangeOffers.pdf.

132. ISS's procedures in formulating its policies include distributing a survey (which in 2013 received over 500 responses) and conducting roundtables with institutional investors and issuers. *See* Proxy Roundtable, *supra* note 8, at 131 (citing remarks of Gary Retelny, President, Institutional Shareholder Services, Inc.).

133. CALL FOR CHANGE, *supra* note 16, at 55.

> possible, making consideration of each company's particular circumstances infeasible.[134]

It is further alleged that all this has led to "[g]rowing discontent on the part of companies and company advisers with the one-size-fits-all analytics used by proxy advisory firms, as well as with the lack of transparency of the firms' analytics and the lack of satisfactory processes for correction of errors and of opportunities for questioning conclusions."[135] Critics want proxy advisors to commit greater resources so as to exercise "due care" and achieve "completeness" in their analyses.[136]

How accurate is the charge of frequent errors? The Center On Executive Compensation (COEC) made the claim based on two surveys by COEC's parent, HR Policy Association, of its own members—that is, public companies. "Of those responding [in one survey], 53 percent said that a proxy advisory firm had made one or more mistakes in a final published report on the company's compensation programs."[137]

The indictment has several flaws. First, COEC does not report what percent of the companies surveyed bothered to respond. Presumably those that believed they had been victims of errors would be more likely to respond. Second, nearly half of respondents reported no errors.[138] Third, we are not told how many reports were filed or how many years were covered. The 53% figure seems to include any company that reported a single error in any year by any proxy advisor.

Most important, we have no way of knowing how significant these errors were or even if the charges are true. Many complaints alleged use of an improper peer group or peer data.[139] Issuers who

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134. APOTHEOSIS OR APOGEE?, *supra* note 37, at 1.

135. *Id.* The same report alleges that proxy advisors use "inflexible, one-size-fits-all voting policies and simplistic analytic models designed to utilize standard and easily accessible inputs that can be derived from readily available data and to avoid any need for particularized research or the application of meaningful judgment." *Id.* at 4; *see also* Che Odom, *Directors: On Compensation, Proxy Advisers Missing Mark*, 17 CORP. GOVERNANCE REP. (BNA), at 6 (Jan. 6, 2014) (quoting a former executive as saying that on say-on-pay proxy advisors "base their advice on inflexible models that don't take into account many variables unique to a company").

136. CALL FOR CHANGE, *supra* note 16, at 55, 86.

137. *Id.* at 58. The COEC reports only anecdotes, not statistical data, from its other survey. *Id.* at 58-59.

138. *See id.* at 58.

139. *Id.* at 10, 58.

believe that such an error has occurred can present their cases to the advisor, and many do.[140] In 96% of such complaints about a draft report, the statements were not adjusted in the final report.[141] This suggests that the proxy advisor simply disagreed with the issuer about the proper peer group or data.[142]

Information is never complete. Under the principle of bounded rationality, decision makers must first decide how much information to gather before making a substantive decision.[143] In business, this is a matter of business judgment with which courts rarely interfere.[144] Corporate executives would be outraged if the SEC tried to dictate required levels of investigation in other areas. Similarly, the SEC should not dictate standards of investigation for proxy advisors. The market—that is, the proxy advisors' clients—will dictate the proper level of research.

The COEC report specifically suggests that "inaccuracies at ISS [may be] negatively impacting the compensation programs at a meaningful number of companies."[145] However, COEC presents no evidence of "inaccuracies" beyond the general and bare management complaints already mentioned. Of course, if ISS does commit an error, issuers may solicit shareholders (as proxy advisors may not) and seek to correct it. COEC does not say how many of the plans opposed by ISS were actually disapproved by shareholders or how

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140. *See* Strine, *supra* note 118, at 688 ("[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 . . . .").

141. CALL FOR CHANGE, *supra* note 16, at 58.

142.

> [O]ften what a corporation indicates is an error is ultimately a difference in interpretation or opinion regarding a certain issue, and therefore requires no correction. As of May 31, 2013, material errors in Glass Lewis' research (brought to our attention by the company, its advisors or through subsequent disclosure) that resulted in a change to the Glass Lewis recommendation represented one-tenth of 1% of the items up for vote at US companies analyzed by Glass Lewis.

Examining the Market Power and Impact of Proxy Advisory Firms: Hearing Before the Subcomm. on Capital Mkts. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs., 113th Cong. 416 (2013) [hereinafter *Examining the Market Power*] (statement of Katherine H. Rabin, CEO, Glass, Lewis & Co.).

143. For a discussion of this concept, see Gerd Gigerenzer & Reinhard Selten, *Rethinking Rationality*, *in* BOUNDED RATIONALITY: THE ADAPTIVE TOOLBOX 1, 5 (G. Gigerenzer & R. Selten eds., 2002).

144. *See generally* FRANKLIN A. GEVURTZ, CORPORATION LAW §§ 4.1.2-4.1.3, at 286-311 (2d ed. 2010) (describing the business judgment rule and its consequences).

145. CALL FOR CHANGE, *supra* note 16, at 61.

many of those plans were actually altered as a result of the negative vote. In general, executive compensation has continued to rise far faster than the rate of inflation or of the growth of the economy,[146] so it does not seem that proxy advisors' errors have caused a general impairment of executive pay (although it might not be a bad thing if it had). In sum, we have no solid evidence of how many errors proxy advisors have committed or whether those errors have caused any damage.

Accepting, however, that accuracy is better than error, we should ask what remedies are proposed to reduce errors. Some comments made to the SEC in response to its Proxy Concept Release[147] urged that proxy advisors "be required to allow companies to review and comment on their research before it is issued, at least to permit correction of factual errors, and that they be required to be far more transparent about their internal decision making processes and outcomes."[148] Others would require "consideration of each company's particular circumstances."[149]

At the least, a "right to correct" would create serious timing problems. An advisor cannot prepare a report until it receives the

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146. *See* Gretchen Morgenson, *An Unstoppable Climb in C.E.O. Pay*, N.Y. TIMES (June 29, 2013), http://www.nytimes.com/2013/06/30/business/an-unstoppable-climb-in-ceo-pay.html. Some studies have found that say-on-pay has had little or no impact on managers' pay. *See* Christopher S. Armstrong, Ian D. Gow & David F. Larcker, *The Efficacy of Shareholder Voting: Evidence from Equity Compensation Plans*, 51 J. ACCT. RES. 909, 948 (2013); *see also* Vicente Cuñat, Mireia Giné & Maria Guadalupe, *Say Pays! Shareholder Voice and Firm Performance* 26 (Oct. 2014), *available at* http://ssrn.com/abstract=2514731; Mathias Kronlund & Shastri Sandy, *Does Shareholder Scrutiny Affect Executive Compensation? Evidence from Say-on-Pay Voting* 3-4 (Oct. 20, 2014) (unpublished manuscript), *available at* http://ssrn.com/abstract=2358696. One study finds that say-on-pay actually *increased* executive pay, and also the sensitivity of pay to performance. Peter Iliev & Svetia Vitanova, *The Effect of Say-on-Pay in the U.S.* 3 (Feb. 27, 2014), *available at* http://www.ssrn.com/abstract=2235064. However, another study found that executive pay rates have risen more slowly in countries that have say-on-pay than in countries that do not. Ricardo Correa & Ugur Lel, *Say on Pay Laws, Executive Compensation, Pay Slice, and Firm Valuation Around the World* 2 (Apr. 2014) (unpublished manuscript), *available at* http://ssrn.com/abstract=2243921. And one study finding little impact on executive pay nonetheless found that say-on-pay has increased firm value in countries where it has been adopted. *See* Cuñat, Giné & Guadalupe, *supra*, at 23.

147. *See generally* Concept Release, *supra* note 129.

148. APOTHEOSIS OR APOGEE?, *supra* note 37, at 5; *see also* CALL FOR CHANGE, *supra* note 16, at 10; NIRI LETTER, *supra* note 89, at 8.

149. *See* APOTHEOSIS OR APOGEE?, *supra* note 37, at 1 (criticizing proxy advisors for failing to give such consideration).

issuer's proxy statement, and it must then deliver its report to its clients in time for them to vote. Issuers are already free to object to a report and seek corrections,[150] but the schedules for proxy votes leave little time for this process.[151] A regulatory "right to correct" would have to be accompanied by a rule revision requiring issuers to file their proxy statements sooner (which no issuer has recommended), or it would leave proxy advisors unable to deliver their reports in time to be considered by their clients.

Further, with a "right to correct," issuers' lawyers could easily devise and publish a standard-form complaint to be filed by every issuer that receives an unfavorable recommendation. The form complaint would charge that the advisor failed to consider the "company's particular circumstances"[152] and reached unwarranted conclusions. For each complaint, the advisor would presumably have to provide a hearing before a disinterested arbiter and prepare a detailed answer to the complaint. Every recommendation to vote against management would lead to an expensive dispute. Presumably, due process would also require the same right to a hearing for the supporters of every shareholder resolution that received a negative recommendation from an advisor.

The charge of a one-size-fits-all approach is at best grossly exaggerated.[153] ISS has a sophisticated approach to evaluate "pay for performance" that makes several distinctions.[154] Moreover, proxy advisors offer clients custom voting policies, which further belies the one-size-fits-all charge.[155] It is true, however, that ISS does not make the kind of individualized review that each board of directors makes

150. *See supra* note 140 and accompanying text.

151. *See* Proxy Roundtable, *supra* note 8, at 140 (citing remarks of Michael Ryan, Vice President, Business Roundtable, on the limited amount of time available to proxy advisors); *id.* at 141 (citing remarks of Gary Retelny, President, Institutional Shareholder Services, Inc., stating that ISS tries to give issuers twenty-four to forty-eight hours to respond to their reports).

152. *See* APOTHEOSIS OR APOGEE?, *supra* note 37, at 1.

153. *See supra* note 135 and accompanying text.

154. *See* EVALUATING PAY FOR PERFORMANCE, *supra* note 121, at 6. ISS also claims that it makes case-by-case determinations. *See infra* note 174 and accompanying text. One study concluded that proxy advisors look at each firm's performance and compensation scheme in making their recommendations and "do not appear to follow a 'one-size-fits-all' approach." Yonca Ertimur, Fabrizio Ferri & David Oesch, *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay* (Columbia Bus. Sch., Research Paper No. 13-88, 2013), *available at* http://ssrn.com/abstract=2360156.

155. *See* Sagiv Edelman, Comment, *Proxy Advisory Firms: A Guide for Regulatory Reform*, 62 EMORY L.J. 1369, 1391-92 (2013).

when adopting an executive compensation plan. Indeed, given the hundreds of thousands of resolutions on which ISS makes recommendations, it *could not* make such a review within a workable cost structure. As critics acknowledge, providing recommendations on every resolution for thousands of companies is already a "monumental task."[156] Requiring further customization would raise advisors' costs—and fees.

Given the heavy burden that the regulations recommended by critics would impose, it is unsurprising that even COEC is ambivalent about greater regulation of proxy advisors, recognizing that increased regulation would increase costs and that the "impact of these increased costs would likely be most significant . . . for smaller firms in the industry and potential new entrants, rather than on the industry leaders."[157] As COEC says, proxy advisor errors arise from "lack of adequate resources and quality control procedures, pressures on the industry to reduce costs and the extremely short turnaround time available for proxy analyses."[158] Regulation cannot change these factors for the better. The market exerts a cost–benefit analysis that seems to result in the proper degree of care and accuracy in proxy advisors' reports.

C. Misguided Policies

A different order of alleged error concerns the basic philosophy of proxy advisors about corporate governance. One study concluded that the corporate governance ratings issued by ISS, GovernanceMetrics International, and The Corporate Library "have either limited or no success in predicting firm performance or other outcomes of interest to shareholders."[159] Other empirical studies have questioned the benefits of proxy advisors concerning stock option repricing[160] and say-on-pay policies.[161]

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156. CALL FOR CHANGE, *supra* note 16, at 55; *see also* APOTHEOSIS OR APOGEE?, *supra* note 37, at 3-4 (describing the scope of ISS's task); LATHAM & WATKINS, *supra* note 80, at 5 (stating that such a mandate would "impos[e] greater cost on the institutional voting system").

157. CALL FOR CHANGE, *supra* note 16, at 74; *see also* Rose, *supra* note 44, at 924 ("SEC regulation of the industry may actually increase the market power of the few major corporate governance players.").

158. CALL FOR CHANGE, *supra* note 16, at 55.

159. Robert M. Daines, Ian D. Gow & David F. Larcker, *Rating the Ratings: How Good Are Commercial Governance Ratings*, 98 J. FIN. ECON. 439, 460 (2010).

160. *See generally* David F. Larcker, Allan L. McCall & Gaizka Ormazabal, *Proxy Advisory Firms and Stock Option Exchanges* (Rock Ctr. for Corporate

It is not clear that these findings are accurate. One other study found that high scores on ISS's Corporate Governance Quotient (CGQ) were associated with higher current stock returns, higher accounting returns, lower volatility, and higher dividends, although this study was backward-looking and did not address the predictive value of the CGQ.[162] Another backward-looking study found that companies with high ISS corporate governance ratings were less likely to use opportunistic timing of executive stock options.[163] It is also possible that the criteria used in the more recent study failed to detect the benefits of the corporate governance ratings.[164] ISS also revises its policies continually[165] and has revised them several times since that study was published.[166] It is possible that corporate governance ratings have improved since the critical studies were conducted.

Governance, Working Paper No. 100, 2012), *available at* http://ssrn.com/abstract=1811130.

161. *See generally* David F. Larcker, Allan L. McCall & Gaizka Ormazabal, *The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policies* (Rock Ctr. for Corporate Governance, Working Paper No. 119, 2014), *available at* http://ssrn.com/abstract=2101453; *see also* George Paulin, *Five 'Say-on-Pay' Lessons*, BLOOMBERG BUSINESSWEEK (July 29, 2011), http://www.businessweek.com/management/five-sayonpay-lessons-07292011.html (stating that for say-on-pay resolutions "ISS uses a flawed methodology").

162. Lawrence D. Brown & Marcus L. Caylor, Corporate Governance and Firm Performance 15 (Dec. 7, 2004) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=586423.

163. *See* Pandej Chintrakarn, Pornsit Jiraporn & J.C. Kim, The Effect of Corporate Governance on CEO Luck: Evidence from the Institutional Shareholder Services (ISS) 2 (June 8, 2013) (unpublished manuscript), *available at* http://www.ssrn.com/abstract=2276585.

164. For example, "[o]ne possible explanation for the absence of robust relations between the three primary governance ratings and operating performance is that it may take more than three years for the effects of good or bad governance . . . to be observed in firm profits." Daines, Gow & Larcker, *supra* note 159, at 451.

165. *See* Proxy Roundtable, *supra* note 8, at 112-13 (citing remarks of Gary Retelny, President, Institutional Shareholder Services, Inc., on the process ISS goes through to review its policies).

166. The study used data through early 2007. *See* Daines, Gow & Larcker, *supra* note 159, at 443. Since then ISS has revised its approach to corporate governance ratings. In 2013, ISS introduced "Governance QuickScore," a "quantitatively-driven" data solution "designed to help institutional investors identify governance risk within portfolio companies." INSTITUTIONAL S'HOLDER SERVS., ISS GOVERNANCE QUICKSCORE 2.0: OVERVIEW AND UPDATES 3 (2014), *available at* http://www.issgovernance.com/file/files/ISSGovernanceQuickScore2.0.pdf. It made further revisions in 2014. *See id.*; *see also ISS Releases Revamped Score Card*, *supra* note 123, at 20.

The study questioning the value of proxy advisors' say-on-pay policies is also dubious. Say-on-pay is an issue on which institutions rely heavily on proxy advisors.[167] In general, giving shareholders a say on pay seems to have been beneficial both here and abroad.[168] ISS recommendations in support of dissident shareholders have been "associated with positive abnormal [stock] returns."[169] These facts suggest that the policies of proxy advisors are not misguided.

However, even if ISS's corporate governance ratings have little predictive value and proxy advisors' voting recommendations are suboptimal, it is not clear that the government should step in. Any restriction on issuing ratings could violate the First Amendment and squelch the search for useful ratings.[170] Issuers and critics of the ratings are free to voice their objections and have done so.[171] Their efforts may have succeeded. One study found that corporate

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167. *See supra* text accompanying notes 55-60.

168. *See* Cuñat, Giné & Guadalupe, *supra* note 146, at 1 (finding that adoption of say-on-pay requirement led to a 4.6% increase in market values); Lilian Ng et al., *Does Shareholder Approval Requirement of Equity Compensation Plans Matter?*, 17 J. CORP. FIN. 1510, 1510 (2011) (finding that the quality of equity compensation proposals improved after adoption of say-on-pay requirements); Steven Balsam & Jennifer Yin, The Impact of Say-on-Pay on Executive Compensation 22 (Mar. 19, 2012) (unpublished manuscript), *available at* http://www.ssrn.com/abstract=2026121 (finding improved compensation structures after adoption of say-on-pay requirements); Marinilka B. Kimbro & Danielle Xu, Shareholders Have a Say on Executive Compensation: Evidence from Say-on-Pay in the United States 1 (Apr. 1, 2013) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2209936 (finding that "shareholder voting rights—even when non-binding—could be an effective mechanism of corporate governance"); *see also supra* note 146. Variations of say-on-pay have also been adopted in the United Kingdom, Netherlands, Australia, Sweden, Norway, and India. *See* Fabrizio Ferri & David A. Maber, *Say on Pay Votes and CEO Compensation: Evidence from the UK*, 17 REV. FIN. 527, 527, 562-63 (2013).

169. *See* Cindy R. Alexander et al., *The Role of Advisory Services in Proxy Voting* 18 (Nat'l Bureau of Econ. Research, Working Paper No. 15143, 2009), *available at* http://www.nber.org/papers/w15143.pdf.

170. The status of corporate governance ratings and proxy advisors' recommendations under the First Amendment is unclear. Some courts have held that similar pronouncements are protected unless shown to be made with actual malice. *See* First Equity Corp. of Fla. v. Standard & Poor's Corp., 690 F. Supp. 256, 259 (S.D.N.Y. 1988) (discussing a suit for common law fraud alleging an inaccurate description of a company's convertible bonds), *aff'd*, 869 F.2d 175 (1989); *In re* Enron Corp. Sec., Derivative & "ERISA" Litig. v. Enron Corp., 511 F. Supp. 2d 742, 825 (S.D. Tex. 2005) (alleging negligent misrepresentation by a bond rating agency).

171. *See* Paulin, *supra* note 161 ("At one large company . . . management made more than 200 calls to investors in order to get a narrow say-on-pay win.").

governance ratings had very little effect on the outcomes of shareholder voting.[172] Investors can decide for themselves how much to credit these ratings; there is no need for government intrusion.

A related criticism is that "proxy advisory firms are working hand-in-hand with unions and other activist institutional shareholders to impose social agendas on corporations that are immaterial to the business interests of the companies and their shareholders."[173] ISS denies this charge. "When evaluating social and environmental shareholder proposals, ISS . . . [g]enerally vote[s] CASE-BY-CASE, taking into consideration whether implementation of the proposal is likely to enhance or protect shareholder value," and adding some other factors it considers.[174] Moreover, proxy advisors may be even less influential on "social responsibility" issues than on other questions.[175]

Institutional shareholders are not complaining about ISS's policies.[176] If there were latent dissatisfaction, competitors would certainly exploit it by highlighting their policy differences. They do not. Other than proclaiming their overall quality, the smaller proxy advisors seek to differentiate themselves from ISS by stressing that they have no conflicts of interest because they do not offer corporate governance consulting services, not by offering different policies.[177]

Regulation to hobble proxy advisors might not even benefit the corporate managers who are pushing such regulation. Some investors vote against management more often than their proxy advisor recommends,[178] which suggests that whatever influence proxy advisors have may be less anti-management than many managers seem to believe. Also, the influence of hedge funds and other activist

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172. *See* Daines, Gow & Larcker, *supra* note 159, at 459-60.

173. Richard Hill, *Financial Services Lawmakers Spar over Influence of Proxy Advisory Firms*, 45 Sec. Reg. & L. Rep. (BNA), at 1081 (June 10, 2013) (citing House Financial Services Capital Markets Subcommittee Chairman Scott Garret); James R. Copland, *Politicized Proxy Advisers vs. Individual Investors*, WALL ST. J., Oct. 8, 2012, at A17.

174. 2013 UPDATES, *supra* note 65, at 18.

175. In one survey, institutional investors reported that they found proxy firm data most useful in say-on-pay and international votes. BEW & FIELDS, *supra* note 27, at 2, 4, 13. "Most of our research participants indicated that they treat environmental and social proposals on a case-by-case basis, drawing on a variety of sources of input." *Id.* at 25.

176. *See infra* note 210 and accompanying text.

177. *See* LI, *supra* note 17, at 5.

178. *See supra* note 173-175 and accompanying text.

investors has mushroomed in recent years.[179] In battles over firm policy, managers must persuade shareholders that their opposition to the activist furthers the interests of the shareholders and not just the managers' own interests. As disinterested experts, proxy advisors can give managers invaluable credibility by supporting them. Recently, activist Carl Icahn dropped his call for a big stock repurchase by Apple due in part to the opposition of ISS.[180] Proxy advisors and activist investors (like Icahn and hedge funds) offer alternative means for shareholders to wield influence. If proxy advisors are curbed, institutional investors will be forced to pay more attention to activist investors.[181] Presumably this is not what corporate executives want.

In sum, the market dictates the conduct of proxy advisors; their clients are content with their services. Pleas for further regulation come from managerial interests that want only to hamper the effectiveness of those services.

V. FIDUCIARY DUTIES AND CONFLICTS OF INTEREST

ISS and some other proxy advisors have registered under the Investment Advisers Act of 1940.[182] Registered advisers are *ipso facto* fiduciaries.[183] However, providing proxy-voting advice alone does not require registration.[184] Several advisors have not registered

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179. *See* Gelles, *supra* note 39 ("[A]ctivist investors have upended relations between companies and institutional investors in recent years.").

180. *See* Michael J. de la Merced, *Icahn Ends Call for Apple Stock Buyback*, N.Y. TIMES, Feb. 11, 2014, at B4.

181. *See* Ronald J. Gilson & Jeffrey N. Gordon, *Agency Capitalism: Further Implications of Equity Intermediation* 17-18 (European Corporate Governance Inst., Working Paper No. 239, 2014), *available at* http://ssrn.com/abstract=2359690 (explaining how activist investors enable shareholders to wield influence when no other means are available).

182. 15 U.S.C. § 80a-1 (1940). "Of the five major proxy advisory firms, three—ISS, [Marco Consulting Group], and [Proxy Governance, Inc.]—are registered with SEC as investment advisers and are subject to agency oversight, while according to corporate officials, the other two firms are not." GAO REPORT, *supra* note 12, at 8.

183. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-92 (1963).

184. 17 C.F.R. § 240.14a-2(b)(3) (2014). The SEC believes that whether a proxy advisor must register under the Act "depends on several factors." Concept Release, *supra* note 129, at 112. The statute defines "investment adviser" as

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling

and thus are not deemed fiduciaries.[185] Registered advisers must also disclose their potential conflicts of interest.[186] ISS has done this.[187]

It is said that "[t]he trend of substituting ISS' recommendations for those of company managers means that mutual funds are replacing agents who are constrained by relatively strong fiduciary duties with agents who have relatively weak fiduciary duties."[188] The Department of Labor has proposed a rule to make proxy advisors fiduciaries with respect to ERISA plans for which they provide advice.[189] This would subject them to ERISA liability for breaches of the duties of loyalty and care.[190]

It is questionable what this step would achieve and whether it is needed. Corporate managers have very different interests from those of their shareholders. When managers held an iron grip on shareholder voting through their control of the corporate proxy machinery and shareholders were weak due to the collective action problem, managers had wide discretion to serve their own interests rather than the shareholders'. Although managers still control the corporate proxy machinery, the rise of proxy advisors has greatly alleviated the collective action problem.

The consequences of saddling proxy advisors with fiduciary duties would depend largely on the details of the regulation.

> [T]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?[191]

The SEC has said that "as a fiduciary, [a] proxy advisory firm has a duty of care requiring it to make a reasonable investigation to determine that it is not basing its recommendations on materially

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> securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities[,]

with certain exceptions. Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11) (1940). Some proxy advisors believe that their activities do not meet this definition. A proposed rule of the Department of Labor could also classify proxy advisors as fiduciaries. *See infra* note 189 and accompanying text.

185. *See* GAO REPORT, *supra* note 12, at 8.

186. *Capital Gains Research Bureau, Inc.*, 375 U.S. at 191-92.

187. *See infra* note 198 and accompanying text.

188. Belinfanti, *supra* note 14, at 423.

189. Definition of the Term "Fiduciary," 75 Fed. Reg. 65,263 (proposed Oct. 22, 2010) (to be codified at 29 C.F.R. pt. 2510).

190. *See* APOTHEOSIS OR APOGEE?, *supra* note 37, at 1.

191. SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943).

inaccurate or incomplete information."[192] The question here would be what constitutes a "reasonable investigation" when a firm makes recommendations on tens of thousands of resolutions involving thousands of companies.

As a registered investment advisor, ISS is already subject to fiduciary duties.[193] No complaints have been filed against it for failing to discharge these duties. Compelling smaller proxy advisors to register would accomplish nothing but to impose extra costs on them. The added costs could force them out of business, thereby reducing competition. As already discussed, market forces will induce the proper level of care; further SEC regulation is not needed and could be counterproductive.[194]

ISS has also been accused of two kinds of conflicts of interest. First, it "advises institutional investor clients on how to vote their proxies and at the same time provides consulting services to help corporations develop management proposals and improve their corporate governance. . . . [T]his could lead corporations to feel obligated to retain ISS's consulting services in order to obtain favorable proxy vote recommendations."[195] The COEC believes that it is "impossible for a proxy advisory firm to provide both [consulting services to corporate issuers and proxy voting advice] and still meet their fiduciary obligations to institutional investors."[196] It therefore calls on the SEC to ban the practice.[197]

ISS dismisses this concern for two reasons. First, it discloses information about its potential conflicts.[198] Second, its proxy advisory and corporate consulting businesses have separate staff, operate in separate buildings, and use segregated office equipment and information databases.[199]

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192. Concept Release, *supra* note 129, at 119.

193. *See supra* text accompanying notes 182-83.

194. *See supra* Part IV.

195. GAO REPORT, *supra* note 12, at 4; *see also* Concept Release, *supra* note 129, at 116-18.

196. CALL FOR CHANGE, *supra* note 16, at 85.

197. *Id.*

198. *See id.* at 45; *see also* GAO REPORT, *supra* note 12, at 10.

199. *See* INSTITUTIONAL S'HOLDER SERVS., INC., DUE DILIGENCE COMPLIANCE PACKAGE 3 (2010), *available at* http://www.issgovernance.com/file/files/ISSDueDiligenceCompliancePackage.pdf; *see also* GAO REPORT, *supra* note 12, at 10; Proxy Roundtable, *supra* note 8, at 110-11 (citing remarks of Gary Retelny, President, Institutional Shareholder Services, Inc., as describing the steps taken to achieve this separation).

Some consider these steps inadequate. One objection is that ISS's disclosure is too vague; it is only "a blanket disclosure . . . that they may have done business with the corporation that is the subject of the report and direct readers to an email address where they can ask for more information."[200] The SEC has been urged to require disclosure of any potential conflict with respect to any proposal.[201]

ISS treats the identity of its clients as confidential.[202] Evidently, most clients appreciate this; they could disclose the relationship themselves if they wished, and few do so. Consultants are not generally compelled to identify their clients, and ISS should not be required to do so unless good cause is shown.

Concerns about conflicts of interest are overblown and somewhat anomalous. ISS's supposed conflicts could distort its recommendations in one of two ways. ISS could punish issuers who eschew its consulting services by opposing its management proposals even when ISS would ordinarily support them; or ISS could reward issuers that do hire it as a consultant by supporting its management proposals even when they would ordinarily be opposed. A recent study suggests that the latter is the dominant effect. Tao Li found that "when Glass Lewis began to cover a company for the first time, ISS's average 'For' recommendations for its management proposals dropped by 1.9-2.3%."[203]

In other words, ISS's consulting services may enable issuers to bribe ISS to get better recommendations than they deserve. Some of ISS's competitors, including Glass Lewis, exploit this possibility; they challenge ISS's supposed conflicts by providing proxy advice only.[204] Institutions that think ISS takes bribes from issuers can switch advisors. Limiting or ending ISS's corporate governance services thus might result in more unfavorable voting recommendations. Moreover, ISS's ratings are worth only what respect they command among investors. If issuers believe that some ratings are punishment for rejecting ISS's corporate governance

200. CALL FOR CHANGE, *supra* note 16, at 69.

201. Concept Release, *supra* note 129, at 120; Edelman, *supra* note 155, at 1406-07.

202. *See* LI, *supra* note 17, at 5.

203. *Id.*

204. *See Examining the Market Power*, *supra* note 142, at 2 (statement of Katherine H. Rabin, CEO, Glass, Lewis & Co.) ("Glass Lewis does not provide consulting services to issuers . . . ."); *see also* GAO REPORT, *supra* note 12, at 14; Concept Release, *supra* note 129, at 117 n.277. Glass Lewis does not offer corporate governance advice, which may explain in part its growing favor with institutional investors. *See* Belinfanti, *supra* note 14, at 397.

services, they can say so individually and collectively. Investors can decide whom to believe.

COEC suggests that ISS's consulting services may subsidize its advisory business.[205] Perhaps the critics hope that curbing or ending ISS's consulting activities would put it out of business or force it to raise fees for its proxy advisory services, thereby losing many cost-conscious clients, and that this would reduce ISS's influence, to the benefit of corporate executives. Even without regulation, however, the growth of Glass Lewis may be diminishing the ability of ISS to extort issuers.[206] Since the consequences of restricting or banning ISS's consulting services are so uncertain and ISS's proxy advice clients are not complaining, the case for regulation is not compelling.

Another alleged conflict is that proxy advisors give recommendations on shareholder proposals and "vote no" campaigns proposed by client firms.[207] The concern is that "proxy advisory firms will make favorable recommendations to other institutional investor clients on such proposals in order to maintain the business of the investor clients that submitted these proposals."[208] This does not seem to be a major problem. First, the critics offer no evidence that advisors discard their usual principles to support proxy campaigns by their clients or that shareholder campaigns are favored more often by proxy advisors hired by the proponent than by other proxy advisors.[209] The burden of proof should be on those seeking further regulation, and they have not sustained that burden.

Further, if shareholder activists succeed, in most cases they get no more pro rata benefit than any other shareholder. In these cases there is no reason to fear that the proxy advisor is favoring the proponent at the expense of its other clients. If the proponent does

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205. *See* CALL FOR CHANGE, *supra* note 16, at 32.

206. *See supra* note 17 and accompanying text. Two smaller proxy advisors also highlight their lack of conflicts of interest in touting their services. *See* EGAN-JONES PROXY SERVS., EGAN-JONES PROXY SERVICES CONFLICT ANALYSIS (2014), *available at* http://www.ejproxy.com/public/disclosures/Egan-Jones_Proxy_Services_Conflict_of_Interest_Report.pdf (stating that Egan-Jones does not engage in consulting with companies it covers); *see also Proxy Voting*, MARCO CONSULTING GROUP, http://www.marcoconsulting.com/proxy-voting-pages-147.php (last visited Nov. 22, 2014) ("Since MCG does not render consulting services to the corporate community, it has no conflicts of interest.").

207. *See* E-mail from Niels Holch, Exec. Dir., S'holder Commc'ns Coal., to Mary Schapiro, Chairman, U.S. Sec. & Exch. Comm'n (Jan. 17, 2012), *available at* http://www.shareholdercoalition.com/SCCLetter11712.pdf.

208. GAO REPORT, *supra* note 12, at 12.

209. *See id.*

stand to gain some special benefit or has some non-economic (e.g., political) agenda, issuers are free and able to point that out.

Any institution that is troubled by ISS's supposed conflicts is free to switch advisors. However, all the institutions that the GAO interviewed "said that they are satisfied with the steps that ISS has taken to mitigate its potential conflicts."[210] Clients of ISS are also free to ignore its advice if they believe that the advice is tainted, and institutions do often ignore its advice, especially the larger institutions and especially on higher profile issues.[211]

Glass Lewis is also charged with conflicts of interest because it is owned by Ontario Teachers' Pension Plan Board and Alberta Investment Management Corp.[212] Glass Lewis denies that these relationships pose any problem because it operates independently of its owners.[213] As with ISS's Chinese Wall between its proxy advisory and corporate governance consulting services, the adequacy of Glass Lewis's separation from its owners cannot be judged by direct observation because no formal division can prevent the parties from collaborating if they wish to do so. We can only observe whether Glass Lewis's advice seems to be biased. The affected parties—Glass Lewis's clients—are not complaining, so neither should anyone else.

There is considerable irony and audacity in the complaints about proxy advisors' supposed conflicts of interest. "Shareholder activists have long complained that mutual fund and asset management companies have an inherent conflict of interest, since they may be managing company retirement plans, or hoping to gain access to them."[214] One function of proxy advisors is to give these

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210. *Id.* at 11.

211. *See supra* text accompanying notes 33, 67, and 79-82.

212. *About Us*, GLASS LEWIS & CO., http://www.glasslewis.com/about-glass-lewis/ (last visited Nov. 22, 2014).

213. Glass Lewis's says:

> Glass Lewis operates as an independent company separate from OTPP and AIMCo. Neither OTPP nor AIMCO are involved in the day-to-day management of Glass Lewis' business. Moreover, Glass Lewis excludes OTPP and AIMCo from any involvement in the formulation and implementation of its proxy voting policies and guidelines, and in the determination of voting recommendations for specific shareholder meetings.

Conflict of Interest Statement, GLASS LEWIS & CO., http://www.glasslewis.com/about-glass-lewis/disclosure-of-conflict/ (last visited Nov. 22, 2014).

214. Stewart, *supra* note 57; *see also* Edelman, Thomas & Thompson, *supra* note 92, at 1401 (stating that "[i]nstitutional investors' conflicts of interest vary by

asset managers an untainted basis for voting when the managers have such conflicts.[215] The critics of ISS make no complaint about this conflict of interest, which inclines many institutional investors to vote with management. They complain only when there may be a conflict of interest that might lead to votes against management.

Only corporate managers and their mouthpieces are complaining about ISS's conflicts of interest. It seems likely that their concern is not any injury to institutional investors or their beneficiaries since they have not shown any such injury. What seems to bother them is that proxy advisors have helped to loosen the executives' domination of shareholder voting.

VI. FURTHER REGULATORY PROPOSALS

It has been recommended that an oversight board be created for the proxy advisory industry similar to the Public Company Accounting Oversight Boards (PCAOB) with power to promulgate and enforce industry standards and to conduct inspections.[216] However, the accounting industry is very different. PCAOB was created because investors lost billions of dollars from accounting fraud and from corporate actions that were not revealed by auditors because they were not caught by existing accounting and auditing practices.[217] By contrast, there has been no showing of losses to investors from the actions of proxy advisors.

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investor category" and describing these conflicts). *See generally* Gerald F. Davis & E. Han Kim, *Business Ties and Proxy Voting by Mutual Funds*, 85 J. FIN. ECON. 552 (2007).

215. *See* Proxy Roundtable, *supra* note 8, at 80-86 (citing remarks of Yukako Kawata, Partner, Davis Polk & Wardwell, LLP). SEC rules require investment advisors to have policies and procedures reasonably designed to ensure that they vote proxies in the best interests of their beneficiaries. 17 C.F.R. § 275.206(4)-6 (2012). The SEC says that "an adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party." *Final Rule: Proxy Voting by Investment Advisers*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/rules/final/ia-2106.htm (last visited Nov. 22, 2014).

216. *See* Belinfanti, *supra* note 14, at 436-37; CALL FOR CHANGE, *supra* note 16, at 70-71.

217. *See* Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills*, 29 J. CORP. L. 267, 268 (2004) (stating that Congress adopted the Sarbanes–Oxley Act (including PCAOB) in response to the financial scandals of 2001).

The critics have not said what industry standards are needed and what inspections of proxy advisors would be intended to detect and correct. If the regulations of an oversight board merely duplicated what market forces demand, they would be superfluous. If they required something different from what the market demands, the requirements would probably be counterproductive. To create an oversight board without a clear vision of what problems it needs to address and how it will solve them is to invite mischief.

Another proposal is to subject proxy advisors to regulation similar to that for credit rating agencies by the SEC.[218] This comparison is also flawed. The advice of proxy advisors is given to and used by the clients who hire them, while the ratings of credit rating agencies are used by purchasers of securities even though the agencies are paid by the issuers of the securities. Thus, credit rating agencies have an inherent incentive to curry favor with clients by giving inflated ratings, to the detriment of purchasers who rely on these ratings. Proxy advisors have no such skewed incentives.

New regulation was instituted for credit rating agencies after many bonds rated as very safe by the agencies defaulted, causing bond owners huge losses.[219] No such tragedy has befallen the institutional clients of proxy advisors or the institutions' own investors, and neither the institutions nor their investors are demanding more regulation of proxy advisors; the demands are coming from issuers and their allies. The proper analogy here, then, would be a situation in which issuers complained that credit rating agencies were being too negative. In that case it is unlikely that Congress would have imposed costly new regulations but would have left it to the market to handle the alleged problem. That seems to be the appropriate response with respect to proxy advisors.

Another proposal is for greater self-regulation of proxy advisors through a voluntary code of best practices.[220] There is

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218. CALL FOR CHANGE, *supra* note 16, at 70. For some of the possible consequences of subjecting proxy advisors to such regulation, see *id.* at 71. *See also* Concept Release, *supra* note 129, at 121 n.287 (stating that credit rating agencies are subject to SEC regulation pursuant to sections 15E and 17 of the Securities Exchange Act, 15 U.S.C. §§ 78o-7, 78q-1).

219. *See* Lawrence J. White, *A New Law for the Bond Rating Industry*, REGULATION, Spring 2007, at 48, 50 (describing the collapse of several companies with bonds rated as safe).

220. This was advocated in MEAGAN THOMPSON-MANN, VOTING INTEGRITY: PRACTICE FOR INVESTORS AND THE GLOBAL PROXY ADVISORY INDUSTRY app. A at 22-26 (2009), *available at* http://web.law.columbia.edu/sites/default/files/microsites/millstein-center/Voting%20Integrity%20Policy%20Briefing%20No%203%2002%

nothing wrong with such a code if the advisor firms can agree on one. However, additional burdens imposing higher costs would weigh more heavily on smaller firms,[221] and forbidding firms from offering corporate governance advice would strike deeply at ISS but not at the advisors who do not offer such services. Accordingly, it seems unlikely that self-regulation can go very far.

CONCLUSION

Over the last few decades, the balance of power in corporate governance has shifted; corporate managers no longer dominate the process as they once did. A major reason for this change is the rise of proxy advisors, who have enabled institutional investors to exercise their shareholder franchise intelligently at a reasonable cost. Corporate managers resent being dethroned and have sought to hobble proxy advisors with various regulations. Of course, proxy advisors are imperfect—like all human institutions. However, on balance they perform a significant and beneficial role.

The conduct of proxy advisors has also been challenged in Europe. The European Securities and Markets Authority inquired and decided against imposing new rules, although it did recommend that proxy advisors cooperate to develop better policies with respect to transparency, accuracy, and conflicts of interest.[222] This is a sound approach. Every industry should always be encouraged to improve its performance, but regulation should be imposed only when the evidence strongly suggests that its benefits will outweigh its costs. The regulations proposed for proxy advisors do not meet that test.

To repeat, the supposed victims of proxy advisors' shortcomings are institutional investors and their own shareholders or beneficiaries, and none of them are complaining. If, however, someone believes there are problems here, one solution would be to consult those shareholders.[223] It is not practical that each could give

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2027%2009.pdf; *see also* CTR. FOR CAPITAL MKTS., BEST PRACTICES AND CORE PRINCIPLES FOR THE DEVELOPMENT, DISPENSATION, AND RECEIPT OF PROXY ADVICE 4-7 (2013), *available at* http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Best-Practices-and-Core-Principles-for-Proxy-Advisors.pdf.

221. *See supra* note 157 and accompanying text.

222. *See* EUROPEAN SEC. & MKTS. AUTH., FINAL REPORT: FEEDBACK STATEMENT ON THE CONSULTATION REGARDING THE ROLE OF THE PROXY ADVISORY INDUSTRY 3 (2013), *available at* http://www.esma.europa.eu/system/files/2013-84.pdf.

223. For such a proposal, see Taub, *supra* note 93, at 847.

instructions on how her fraction of the fund's shares should be voted on each of the hundreds or thousands of resolutions presented, but they could be given three default options: always vote with the issuer's management, always vote with the fund's proxy advisor, or (as is the case now) leave it to the discretion of the fund's managers.

If most fund shareholders believe the critics of proxy advisors, they could instruct their fund always to vote their interest with the issuer's management, and the power of the proxy advisors would be curbed. If, on the other hand, they believe that the fund tends to vote with management too often,[224] they could instruct the fund always to vote with the proxy advisor's recommendations. It is telling that the critics of proxy advisors have never advocated this approach.

224. Concerning the possible reasons for such behavior, see *supra* notes 91-93 and accompanying text.