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Lorenia Lopez

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WHO REALLY HOLDS THE POWER IN CORPORATE BOARD ROOMS?

In May 2016, Representative Sean Duffy from Wisconsin introduced The Corporate Governance Reform and Transparency Act of 2016 (H.R. 5311).¹ The bipartisan bill aims to protect investors and improve corporate governance of publicly-held companies by giving the United States Securities and Exchange Commission (SEC) the tools and information it needs to provide better oversight of proxy advisors.² H.R. 5311 will require proxy advisory firms to register with the SEC, disclose potential conflicts of interest, and make publicly available their methodologies for formulating proxy recommendations and analyses.³

Under the current system, two companies, Institutional Shareholder Services (ISS) and Glass Lewis, control the proxy advisory market and provide unsubstantiated recommendations that are often based on erroneous facts.⁴ Conversely, H.R. 5311 encourages competition and accuracy; by requiring firms to disclose their methodologies, the bill not only holds proxy advisory firms accountable for the recommendations they provide, but it also leaves room for emerging firms to utilize these methodologies to formulate competing recommendations.⁵ At the most basic level, the bill promotes accountability and competition in a currently monopolized market through transparency requirements.⁶ To appreciate the magnitude of this proposed legislation, one must first understand two things. First, what proxy advisory firms are, and second, what institutional investors are. Once these two concepts are clear, we can comprehend the enormous power that both ISS and Glass Lewis wield in

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² Id.
⁵ Id.
⁶ Id.
the country’s public companies, and recognize the rampant corruption within the system.7

What is a Proxy Advisory Firm, and Who Do They Advise?

Simply put, proxy advisory firms provide institutional investors with information and advice on how to vote at a company’s annual meeting.8 An institutional investor is an entity that pools money to invest on behalf of its members; they include hedge funds, mutual funds, and pension.9 Institutional investors rely on proxy advisory firms to help advise them on how to balance their fiduciary duty to vote in the best interests of the beneficiary owners they represent.10 Voting in accordance with these third party recommendations allows institutional investors to avoid potential conflicts of interest.11 These recommendations carry enormous weight and often predict the outcome of board meetings.12

A Monopolized and Corrupt Proxy Advisory Market

Proxy advisory firms wield a great deal of power and operate largely unchecked.13 ISS and Glass Lewis, control 97% of the market in the proxy advisory business which means that they control roughly 40% of all shareholder ballots.14 This control is problematic because these firms are not publicly accountable for the advice they provide and are under no obligation to be transparent in their dealings.15 More specifically, both fail to avoid conflicts of interest.16 ISS provides advice while at the same time offering paid consulting services to the companies whose proxies they evaluate, and Glass Lewis is owned by the Ontario Teachers’ Pension Plan, which invests in

7 Id.
9 Luis A. Aguilar, Comm’r, SEC, Address at the Georgia State University College of Business Workshop (April 19, 2013).
10 Hearings, supra note 4. at 2 (statement of John Hayes).
11 Id.
12 Letter from Bruce Josten, Exec. Vice President, Chamber of Commerce, to Jeb Hensarling, Chairman, Comm. on Fin. Serv. (June 14, 2016) (on file with author).
13 See Aguilar, supra note 9.
15 Id.
16 Id.
companies on whose proxies Glass Lewis makes recommendations. Further, the current system allows the members of proxy advisory firms to invest in, and serve on the boards of the public companies whose proxies they assess. There is a glaring conflict of interest in these dealings and a clear lapse in effective corporate governance.

The problems do not stop there; these firms are not held accountable for their voting recommendations, and they operate with an alarming lack of transparency. Both ISS and Glass Lewis provide recommendations based on undisclosed research sources and methods, and neither firm explains whether its decisions are based on creation and preservation of shareholder value or on another, arguably far less legitimate premise. Further, Business Roundtable, which is comprised of CEOs of major American companies operating in every sector of the country’s economy, surveyed its members and found that neither ISS nor Glass Lewis provide the sources of their information even when the company proves that the firm’s recommendation is based on factually inaccurate information. This points to a large disconnect between these firms and appropriate government regulation.

H.R. 5311: Efforts Toward Transparency and Increased SEC Regulation

H.R. 5311 would require proxy advisory firms to operate under the watchful eye of the SEC by giving the Commission the information and tools it requires to effectively enforce regulatory provisions. The bill functions in two key ways. First, it requires that proxy advisory firms register with the SEC. Second, it mandates that the firms provide the agency with material disclosures including its procedures and research methodologies and existing and potential conflicts of interest. The bill is clear in defining conflicts of

17 Id.
20 Id.
21 Id.
23 Id.; See H.R. 5311, 114th Cong. (2016).
interest, and is largely concerned with how firms are compensated by clients, relationships between the firm and clients, and occasions when firms issue proxy voting recommendations to companies where they also provide advisory services. H.R. 5311 acknowledges that proxy advisory firms have been allowed to run rampant due to a lack of effective supervision, and that the American people potentially bear the burden of ineffective, overly powerful third party voting recommendations that largely influence proxy decisions. The purpose of the bill is to increase transparency and accountability in order to reduce, and perhaps potentially eliminate, corruption in the current system.

The opposition claims that the bill is unnecessary and would significantly weaken the role of institutional investors by giving companies inappropriate influence over the proxy advisory firm’s report. The dominant idea is threefold. First, that proxy advisory firms only provide necessary information and recommendations which do not determine institutional investor voting patterns because investors vote based on independent, particularized strategies. Second, that institutional investors need this unbiased information to exercise voting rights on the companies in which they invest. Lastly, that the bill would impose burdensome costs on the proxy advisory firms.

While the opposition is not without merit, its basis pales in comparison to the staunch lack of transparency which the bill combats. The perspective that proxy advisory firms provide research that does not heavily influence voting patterns greatly understates their role. Their existence is centered on the perception that they provide expert analysis; it seems unlikely that an extremely lucrative industry would have reached such heights if the product it provides were useless and set aside by consumers. Two firms hold a largely uncontested monopoly over the proxy advisory market, and it is clear that

25 See id.
26 See Hayes, supra note 15.
29 Id.
30 Id.
neither is exemplary. The current system disregards investor’s expectations that their shareholder rights will not be weakened by conflicted third party advisors whose recommendations influence institutional investor voting patterns. This bill will require transparency and accountability which, in turn, will benefit investors and improve the corporate governance system. Under this country’s current financial structure, two companies cannot be allowed to hold largely unchecked power and operate without effective regulation. This bill is an important step toward necessary SEC oversight that will benefit investors.

LORENA LÓPEZ*

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34 See Duffy, supra note 34.

35 See Hayes, supra note 20.

36 See Duffy, supra note 34.

* Emory University School of Law, J.D. Candidate, 2018; Staff Writer, Emory Corporate Governance and Accountability Review; Emory Constitutional Council; Competitor 2016 Finalist, Alternative Dispute Resolution Society – Negotiations Team; B.A. English and Political Science, University of Miami. I would like to thank Tayler Bolton for her guidance and advice during the extensive drafting process.