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## **PROXY ADVISORY FIRMS: A GUIDE FOR REGULATORY REFORM**

### **ABSTRACT**

*Proxy advisory firms exist at the nexus of some of the most high-profile corporate law discussions—most notably, the shareholder voting process, which has recently been the subject of much scholarly and legal debate. As proxy advisory firms are used prevalently by institutional investors to aid them in voting their proxies, it is no surprise that the firms now find themselves the target of regulatory reform efforts. While proxy advisory firms are frequently discussed in the news, criticized by boards of directors and corporate law scholars, and trumpeted by their clients, there is still a significant amount of misinformation and mischaracterization about their function, use, and influence. Because the SEC has announced its intentions to regulate the proxy advisory industry, an informed understanding of proxy advisory firms and their influence on the shareholder franchise is necessary for the promulgation of sound and nonreactive regulatory measures.*

*This Comment parses critics' concerns with the proxy advisory industry and reconciles the motivations for regulation with how proxy advisory firms function and are used. Particularly, this Comment dispels the notion that proxy advisory firms wield too much influence over institutional investors and shareholder voting, and it explains that the fears of conflicts of interest are likely overstated. Utilizing Anthony Downs's research on the application of economic theory to democratic voting, this Comment demonstrates that proxy advisory firms are vital in facilitating the rational, efficient exercise of the shareholder franchise. In light of these findings, this Comment proposes a regulatory approach that subjects proxy advisory firms to federal oversight without imposing unjustified, onerous measures. By using a piecemeal regulatory approach—centered on amending Securities Exchange Act of 1934 Rule 14a-2(b)(3) to require that proxy advisory firms disclose significant relationships with corporate issuers and providing explicit guidance to institutional investors regarding their fiduciary duties to vote proxies in their clients' best interests—proxy advisory firms can be regulated without impairing their utility or the ability of their clients to cast informed votes.*

## INTRODUCTION

In the aftermath of the Enron and WorldCom accounting scandals, the subprime mortgage crisis, and the rise of institutional investors, a battle has broken out over how much power shareholders should have in the corporate decision-making process. Corporate traditionalists<sup>1</sup> have long argued that vesting power in anyone outside of management is foolish and undermines the health of publicly traded corporations.<sup>2</sup> Despite their objections, corporate traditionalists are losing this fight; shareholder voting is becoming more prominent and powerful.<sup>3</sup>

In response, advocates of the traditional corporate power structure have initiated a counteroffensive, aiming criticisms at the purported power behind the shareholder vote: proxy advisory firms.<sup>4</sup> Proxy advisory firms are information-gathering companies hired by institutional investors to issue voting recommendations regarding everything from executive compensation to proposed mergers.<sup>5</sup> While this service may seem unobjectionable on its face, it has produced a wave of criticism predicated on the argument that proxy advisory firms are not mere “researchers” who advise their clients on the best way to vote, but instead power behind the power—exerting undue influence over their clients and lacking accountability and adequate monitoring.<sup>6</sup>

The Securities and Exchange Commission (SEC), in keeping with its newfound ethos of aggressive responses to potential problems, has taken up the sword on behalf of those who fear the influence and unaccountability of proxy advisory firms. After publishing the Concept Release on the U.S. Proxy System (Concept Release), which solicited feedback regarding how proxy

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<sup>1</sup> The term *corporate traditionalist* is adopted from a Leo Strine article and is meant to encapsulate the views of those who prefer the status quo of corporate governance, chiefly the “empowerment of centralized management,” and reject the arguments in favor of shareholder empowerment. See Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk’s Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1763 (2006).

<sup>2</sup> See generally Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2006) (challenging the claim that taking power away from directors and giving it to shareholders will benefit shareholders); Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601 (2006) (arguing that the director system in the United States serves investors and society well); Strine, *supra* note 1.

<sup>3</sup> See Anabtawi, *supra* note 2, at 562.

<sup>4</sup> See Letter from Niels Holch, Exec. Dir., S’holder Comm’ns Coal., to Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm’n (Jan. 17, 2012) [hereinafter Shareholder Communications Coalition Letter], available at <http://www.shareholdercoalition.com/SCCLetter11712.pdf>.

<sup>5</sup> See *id.*

<sup>6</sup> See *infra* Part II.

advisory firms operate and how they should be regulated, the SEC announced that it would be “considering how to provide guidance” on how to regulate proxy advisory firms.<sup>7</sup> Then-SEC Chairperson Mary Schapiro cited a combination of criticisms concerning potential interference with effective management-to-shareholder communication, lack of accountability, and the quality of advisory firm recommendations as the impetus behind the decision.<sup>8</sup>

Given the recent corporate fraud fiascos and the concerns raised in the comments to the Concept Release,<sup>9</sup> the SEC’s desire to regulate proxy advisory firms is not unreasonable on its face. However, this Comment argues that the form of regulation recommended by the SEC in response to the outcry of corporate traditionalists will be disproportionately severe, and it will stem from a want of consideration of the important role proxy advisory firms play in ensuring the rational and efficient exercise of the shareholder franchise. A regulatory regime for proxy advisory firms that takes into account the utility and demand for this industry can be achieved.

Part I of this Comment briefly discusses the importance of shareholder voting and the rise of the proxy advisory industry. Part II provides an overview of the movement toward federal regulation of proxy advisory firms and describes the proposed regulatory frameworks that have been offered by the SEC and others. Part III explores the two most prominent criticisms of proxy advisory firms and discusses why these criticisms are overstated in consideration of recent studies and evidence showing that many institutional investors do not rely solely on one firm’s recommendation. Part IV provides a detailed analysis of the utility of proxy advisory firms. In particular, this analysis applies the theoretical framework of Anthony Downs to shareholder voting and proves that proxy advisory firms are not only efficient, but also vitally important to the rational exercise of the shareholder franchise. Finally, Part V discusses the SEC’s recent trend toward overregulation and the cost associated therewith, and it proposes regulatory frameworks that can effectively and responsibly deal with the rational concerns regarding the proxy advisory industry.

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<sup>7</sup> Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm’n, Remarks at the Transatlantic Corporate Governance Dialogue (Dec. 15, 2011) [hereinafter Remarks at the Transatlantic Corporate Governance Dialogue], available at <http://www.sec.gov/news/speech/2011/spch121511mls.htm>.

<sup>8</sup> *Id.*

<sup>9</sup> See *supra* Part II.

## I. THE RISE OF SHAREHOLDER VOTING AND PROXY ADVISORY FIRMS

This Part provides an overview of the rise of shareholder voting and proxy advisory firms. While the issue of expanded shareholder voting falls outside the scope of this Comment, an understanding of the increasing importance of shareholder voting is crucial to an understanding of proxy advisory firms. This Part discusses, first, the recent trend of shareholder empowerment and, second, an overview of proxy advisory firms and the role they play in corporate governance.

### A. *The Importance of Shareholder Voting*

According to its proponents, shareholder voting is the traditional lynchpin that both legitimizes the theoretical foundations of the modern corporate structure<sup>10</sup> and provides adequate avenues of oversight to enable shareholders to protect their interests.<sup>11</sup> In *Blasius Industries, Inc. v. Atlas Corp.*, the Delaware Chancery Court emphasized the importance of the shareholder franchise and noted that, absent selling the stock they own, the only protection shareholders have against subpar corporate performance is the ability to vote out incumbent directors.<sup>12</sup> According to Professor Lucian Bebchuk, this means of control is paramount, as the interests of directors are not necessarily the same as those of shareholders.<sup>13</sup> Directors do not own the property they control, and therefore they may subordinate the interests of ownership (held by shareholders) in favor of their own.<sup>14</sup>

While the importance of shareholder voting is hardly universally accepted,<sup>15</sup> it is incontrovertible that recent trends favor promoting the shareholder franchise. For instance, there has been a shift among U.S.

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<sup>10</sup> *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.”).

<sup>11</sup> Lucian A. Bebchuk, *Shareholder Rights and the DGCL*, DEL. LAW., Spring 2008, at 16, 16 (“The shareholder franchise is a key mechanism for establishing board accountability under Delaware law.”).

<sup>12</sup> See 564 A.2d at 659.

<sup>13</sup> Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 850 (2005).

<sup>14</sup> *Id.*

<sup>15</sup> See generally Anabtawi, *supra* note 2, at 570 (“[The] limitations on the effectiveness of shareholder participation in corporate decisionmaking suggest that shareholders presently have the potential to operate as only a weak constraint on managers.”); Bainbridge, *supra* note 2, at 616 (“[S]hareholder [rights] . . . are so weak that they scarcely qualify as part of corporate governance.”).

companies from plurality voting in director elections to majority voting.<sup>16</sup> Whereas plurality voting allows a candidate to win an election with a single shareholder vote if no other candidate received a vote, majority voting requires a candidate to receive the majority of the votes to win a director seat.<sup>17</sup> Because almost all directors run unopposed,<sup>18</sup> this development has given shareholders a more significant voice in director elections.<sup>19</sup> Similarly, nonstaggered boards are becoming more prevalent, thereby increasing the opportunities for shareholders to vote.<sup>20</sup>

The SEC and Congress have been attempting to expand proxy access to shareholders, which would allow shareholders to nominate directors and have their choices included in the proxy.<sup>21</sup> The SEC's efforts suffered a setback when the U.S. Court of Appeals for the D.C. Circuit vacated Exchange Act Rule 14a-11, a regulation which would have allowed proxy access for certain shareholders.<sup>22</sup> However, the SEC successfully amended Exchange Act Rule 14a-8 to prevent companies from excluding shareholder proposals that relate to director elections, nominations, or the procedures for the elections.<sup>23</sup> In response, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, which contains a provision that calls for "say on pay" votes.<sup>24</sup> This provision requires that "shareholders have a periodic nonbinding vote on executive compensation at least once every three years."<sup>25</sup> Despite the vote's nonbinding nature, the "say on pay" provision has attracted considerable attention for "substantially increas[ing] the number of proxy votes on ballots annually."<sup>26</sup> Likewise, individual shareholders have also pushed for proxy access. For example, Amalgamated Bank, which owns close to 400,000 shares

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<sup>16</sup> See Stephen Choi et al., *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 873 (2010) ("[T]he shift to a majority standard substantially increases the importance of shareholder voting in uncontested elections.").

<sup>17</sup> *Id.* at 872-73.

<sup>18</sup> See Jie Cai et al., *Electing Directors*, 64 J. FIN. 2389, 2390 (2009).

<sup>19</sup> See Choi et al., *supra* note 16, at 873.

<sup>20</sup> *See id.*

<sup>21</sup> Ronald Barusch, *Dealpolitik: Is H-P Setting a Trend for Proxy Access?*, WALL ST. J. BLOG DEAL J. (Feb. 7, 2012, 4:55 PM), <http://blogs.wsj.com/deals/2012/02/07/dealpolitik-is-h-p-setting-a-trend-for-proxy-access/>.

<sup>22</sup> *See Bus. Roundtable v. SEC*, 647 F.3d 1144, 1156 (D.C. Cir. 2011).

<sup>23</sup> 17 C.F.R. § 240.14a-8 (2012).

<sup>24</sup> 15 U.S.C. § 78n-1 (2006 & Supp. V 2012); CTR. ON EXEC. COMP., A CALL FOR CHANGE IN THE PROXY ADVISORY INDUSTRY STATUS QUO: THE CASE FOR GREATER ACCOUNTABILITY AND OVERSIGHT 4 (2011), available at [http://www.hrpolicy.org/downloads/2011/c11-07a%20Proxy%20Advisory%20White%20Paper%20FULL%20COLOR\\_.pdf](http://www.hrpolicy.org/downloads/2011/c11-07a%20Proxy%20Advisory%20White%20Paper%20FULL%20COLOR_.pdf).

<sup>25</sup> CTR. ON EXEC. COMP., *supra* note 24, at 4; *see also* 15 U.S.C. § 78n-1(a)(1).

<sup>26</sup> CTR. ON EXEC. COMP., *supra* note 24, at 4.

of Hewlett-Packard, successfully negotiated for Hewlett-Packard to recommend a proxy access proposal at its annual shareholder meeting in 2013.<sup>27</sup>

As the private and regulatory attention on shareholder voting has increased, there has been an amplified focus on, and criticism of, the ultimate role proxy advisory firms play in corporate governance. Section B discusses the role of proxy advisory firms and their influence on shareholding voting.

### *B. The Rise of Proxy Advisory Firms*

Employed by an array of institutional investors,<sup>28</sup> proxy advisory firms provide analysis and voting recommendations on shareholder voting issues included in proxy statements.<sup>29</sup> The first proxy advisory firm was Institutional Shareholder Services (ISS), which began offering voting recommendation services to institutional investors in 1986.<sup>30</sup> ISS, which merged with RiskMetrics in 2007, has remained the titan of the industry, boasting “over 1,700 institutional clients managing \$26 trillion in assets, including 24 of the top 25 mutual funds, 25 of the top 25 asset managers and 17 of the top 25 public pension funds.”<sup>31</sup> The proxy advisory firms of Egan-Jones Proxy (Egan-Jones) and Glass, Lewis & Company (Glass Lewis) entered the market in 2002 and 2003, respectively,<sup>32</sup> and PROXY Governance, Incorporated which received the backing of Business Roundtable,<sup>33</sup> began making recommendations in 2005.<sup>34</sup>

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<sup>27</sup> Barusch, *supra* note 21.

<sup>28</sup> The SEC Concept Release said clients of proxy advisory firms are “investment advisers, pension plans, employee benefit plans, bank trust department and funds.” Concept Release on the U.S. Proxy System, Exchange Act Release No. 62,495, Investment Advisers Act Release No. 3052, Investment Company Act Release No. 29,340, 75 Fed. Reg. 42,982, 43,009 (July 22, 2010) [hereinafter SEC Concept Release].

<sup>29</sup> U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 1–2 (2007) [hereinafter GAO REPORT]; *see also* SEC Concept Release, *supra* note 28. Additional services provided by proxy advisory firms include vote execution on behalf of clients, administrative tasks related to vote casting, and oversight of decisions by corporations. *See id.*

<sup>30</sup> Stephen J. Choi et al., *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 651–52 (2009).

<sup>31</sup> *Id.* at 652–53 (internal quotation marks omitted); Robert Daines et al., *Rating the Ratings: How Good Are Commercial Governance Ratings?* 2 (Stanford Univ. Rock Ctr. for Corporate Governance, Working Paper No. 1, 2009), available at <http://ssrn.com/abstract=1152093>.

<sup>32</sup> Choi et al., *supra* note 30, at 654.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.* PROXY Governance, Inc. folded in 2010 and subsequently entered into an agreement to transfer its clients to Glass Lewis. *Glass Lewis Announces Agreement with PGI*, PR NEWSWIRE (Dec. 20, 2010), <http://www.prnewswire.com/news-releases/glass-lewis-announces-agreement-with-pgi-112178089.html>.

The appearance of competing proxy advisory firms has been attributed to a response to massive frauds perpetrated by public companies,<sup>35</sup> the expanded fiduciary duties the SEC implemented in 2003 requiring institutional investors to vote in the “best interest” of their clients,<sup>36</sup> and the tremendous growth of institutional ownership of publicly traded securities.<sup>37</sup> The latter two developments go hand in hand with explaining the rise of proxy advisory firms: holdings of publicly traded stocks by institutional investors grew from 37% in 1992 to more than 60% in 2005,<sup>38</sup> and institutional investors hire proxy advisory firms based on a belief that the firms’ voting recommendations will satisfy the “best interest” requirement of the new SEC regulations.<sup>39</sup> Simply put, more potential clients entered the market, and more incentives were given for them to engage the services of proxy advisory firms.

The increase in prominence of proxy advisory firms, combined with concerns over the lack of accountability and the scope of influence they exert over their clients, has prompted a call for regulation of proxy advisory firms in an effort to bring this industry within the oversight of the SEC.<sup>40</sup>

## II. THE CALL FOR REGULATION

On July 22, 2010, the SEC published the Concept Release on the U.S. Proxy System.<sup>41</sup> In the Concept Release, the SEC raised two issues associated with the current operation of proxy advisory firms that could impair shareholder voting: (1) a lack of “adequate accountability for informational accuracy in the development and application of voting standards,” and (2) conflicts of interests that are “insufficiently disclosed and managed.”<sup>42</sup> It also voiced concerns about the scope of influence proxy advisory firms hold over their clients, “without appropriate oversight” or “an actual economic stake in

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<sup>35</sup> 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, 392 (2009) (citing GAO REPORT, *supra* note 29, at 6–7).

<sup>36</sup> See Choi et al., *supra* note 30, at 653; see also 17 C.F.R. § 275.206(4)-6 (2012); GAO REPORT, *supra* note 29, at 7. Further emphasis was placed on proxy voting when the SEC adopted Rule 30b1-4 under the Investment Company Act of 1940, which required annual disclosure of their voting policies. See Choi et al., *supra* note 30, at 653.

<sup>37</sup> See Choi et al., *supra* note 30, at 655.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> See SEC Concept Release, *supra* note 28, at 43,009–10 (justifying regulation of proxy advisory firms based on their “solicitation” of votes or their role as “investment advisers”).

<sup>41</sup> *Id.* at 42,982.

<sup>42</sup> *Id.* at 43,011.

the issuer.”<sup>43</sup> The SEC proffered three possible avenues of regulation to address these concerns: (1) subjecting proxy advisory firms to the rules governing proxy solicitation; (2) amending Rule 14a-2(b)(3) to include relevant provisions to address proxy advisory firms; or (3) amending the Advisers Act to require registration for all proxy advisory firms.<sup>44</sup>

Many of the comments to the Concept Release advanced the same concerns voiced by the SEC. While the comments favored the regulations proposed by the SEC, they also suggested that more expansive regulatory measures should be adopted. At the Transatlantic Corporate Governance Dialogue, then-SEC Chairperson Mary Schapiro remarked that many of the comments indicated frustration with the scope of influence proxy advisory firms have, and she raised questions about the accountability of the firms and the quality of the information they provide.<sup>45</sup> Ultimately, boards of directors feel that proxy advisory firm recommendations interfere with constructive dialogue between the board and shareholders that use proxy advisory firms’ recommendations.<sup>46</sup> In light of these comments and the SEC’s assessment of the proxy advising industry, the SEC has recently announced that it will provide guidance to Congress on how to regulate proxy advisory firms.<sup>47</sup>

There are two forms of regulatory measures that may be used in the regulation of proxy advisory firms. The first (“soft regulation”) focuses chiefly on the avoidance of conflicts of interest and the establishment of regulatory oversight, and it requires all proxy advisory firms to register with the SEC.<sup>48</sup> The second (“hard regulation”) centers on the power and influence of proxy advisory firms and seeks strict oversight of their voting methodologies, the justifications behind their recommendations, and other means of policing the actual product the proxy advisory firms provide.<sup>49</sup> Generally, hard regulation subsumes soft regulation.<sup>50</sup>

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<sup>43</sup> *Id.*

<sup>44</sup> *Id.* at 43,012–13.

<sup>45</sup> Remarks at the Transatlantic Corporate Governance Dialogue, *supra* note 7.

<sup>46</sup> *Id.*

<sup>47</sup> Reese Darragh, *SEC Reveals Plan to Regulate Proxy Advisory Firms*, COMPLIANCE WEEK (Dec. 16, 2011), <http://www.complianceweek.com/sec-reveals-plan-to-regulate-proxy-advisory-firms/article/219827/>.

<sup>48</sup> See Letter from Glenn Davis, Senior Research Assoc., Council of Institutional Investors, to Elizabeth M. Murphy, Sec’y, U.S. Sec. & Exch. Comm’n 6–7 (Oct. 14, 2010) [hereinafter Council of Institutional Investors Letter], available at <http://www.sec.gov/comments/s7-14-10/s71410-80.pdf> (“The Council supports the registration of proxy advisory firms, but opposes regulatory involvement in methodologies used by proxy advisers to determine vote recommendations.”).

<sup>49</sup> For instance, the Shareholder Communications Coalition (comprised of the Business Roundtable, the National Investor Relations Institute, and the Society of Corporate Secretaries & Governance Professionals,

Central to both soft and hard regulation of proxy advisory firms is the registration of firms with the SEC. In its Concept Release, the SEC suggested two pieces of existing federal legislation that could be used as avenues to gain oversight of proxy advisory firms.<sup>51</sup> The first is Rule 14a-(2)(b)(3) of the Exchange Act of 1934,<sup>52</sup> which currently exempts proxy advisory firms from federal proxy rules. An amendment, revision, or some means of “interpretive guidance” to Rule 14a-(2)(b)(3) is “one potential solution to the concerns regarding a proxy advisory firm’s disclosures about conflicts of interest.”<sup>53</sup> The Advisers Act of 1940 is the second piece of existing legislation that could be amended to mandate registration of proxy advisory firms.<sup>54</sup>

#### A. Exchange Act Rule 14-a(2)(b)(3) and the Federal Proxy Rules

Federal proxy rules provide that anyone who solicits a proxy from a shareholder must comport with the registration requirements of 15 U.S.C. § 78l.<sup>55</sup> This provision requires fairly extensive disclosures of information, including “the organization, financial structure, and nature of the business”;<sup>56</sup> information about “the directors, officers, and underwriters, and each security holder . . . holding more than 10 per centum of any class of any equity security of the issuer”;<sup>57</sup> “management and service contracts”;<sup>58</sup> profit and loss statements;<sup>59</sup> balance sheets with up to three of the previous fiscal years certified by a registered public accounting firm;<sup>60</sup> and “any further financial statements which the Commission may deem necessary or appropriate for the protection of investors.”<sup>61</sup> The SEC explained that the definition of solicitation is broad and, depending on their activities, proxy advisory firms may fall

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with the Securities Transfer Association as an associate member) sent a letter to then-Chairperson Mary Schapiro articulating a proposed regulatory framework for proxy advisory firms. *See* Shareholder Communications Coalition Letter, *supra* note 4.

<sup>50</sup> *See id.* at 2–4 (proposing measures to correct inaccuracies and address conflicts of interest).

<sup>51</sup> *See* SEC Concept Release, *supra* note 28, at 43,012–13.

<sup>52</sup> 17 C.F.R. § 240.14a-2(b)(3) (2012).

<sup>53</sup> SEC Concept Release, *supra* note 28, at 43,012.

<sup>54</sup> *See id.* at 43,010.

<sup>55</sup> *See* Exchange Act of 1934 § 14, 15 U.S.C. § 78n(a) (2006).

<sup>56</sup> *Id.* § 78l(b)(1)(A).

<sup>57</sup> *Id.* § 78l(b)(1)(D). The named people must supply “their remuneration and their interests in the securities of, and their material contracts with, the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, the issuer.” *Id.*

<sup>58</sup> *Id.* § 78l(b)(1)(G).

<sup>59</sup> *Id.* § 78l(b)(1)(K).

<sup>60</sup> *Id.* § 78l(b)(1)(J).

<sup>61</sup> *Id.* § 78l(b)(1)(L).

within the broad definition of solicitation “because they provide recommendations that are reasonably calculated to result in the procurement, withholding, or revocation of a proxy.”<sup>62</sup>

Due to the expansive definition of solicitation, proxy advisory firms would be subject to federal proxy rules if not for the exemption found in Exchange Act Rule 14a-2(b)(3).<sup>63</sup> Rule 14a-2(b)(3) exempts “the furnishing of proxy voting advice by any advisor to any other person with whom the advisor has a business relationship”<sup>64</sup> from the federal proxy requirements, so long as four requirements are met: (1) “The advisor renders financial advice in the ordinary course of his business”;<sup>65</sup> (2) “The advisor discloses to the recipient of the advice any significant relationship with the registrant or any of its affiliates, or a security holder proponent of the matter on which advice is given, as well as any material interests of the advisor in such matter”;<sup>66</sup> (3) “The advisor receives no special commission or remuneration for furnishing the proxy voting advice from any person other than a recipient of the advice and other persons who receive similar advice under this subsection”;<sup>67</sup> and (4) “The proxy voting advice is not furnished on behalf of any person soliciting proxies or on behalf of a participant in an election subject to the provisions of § 240.14a-12(c).”<sup>68</sup>

The second requirement, which provides that an advisor must disclose “any significant relationship” with a party related to the matter upon which advice is given, is where the SEC would look to propose regulation.<sup>69</sup> Many proxy advisory firms give disclaimers that say they may have business relationships with issuers: Glass Lewis provides an extensive disclosure and conflict-of-interest statement on its website,<sup>70</sup> and ISS has a “Due Diligence Compliance Package” available on its website that includes a “Conflict Policy Review” undertaken by Sullivan & Cromwell.<sup>71</sup> Despite the efforts of proxy advisory

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<sup>62</sup> SEC Concept Release, *supra* note 28, at 43,009.

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

<sup>65</sup> 17 C.F.R. § 240.14a-2(b)(3)(i) (2012).

<sup>66</sup> *Id.* § 240.14a-2(b)(3)(ii).

<sup>67</sup> *Id.* § 240.14a-2(b)(3)(iii).

<sup>68</sup> *Id.* § 240.14a-2(b)(3)(iv).

<sup>69</sup> SEC Concept Release, *supra* note 28, at 43,012–13.

<sup>70</sup> *Conflict of Interest Statement*, GLASS LEWIS & CO., <http://www.glasslewis.com/about-glass-lewis/disclosure-of-conflict/> (last visited June 18, 2013).

<sup>71</sup> *Due Diligence Materials*, ISS, <http://www.issgovernance.com/duediligence> (last visited June 18, 2013); Letter from H. Rodgin Cohen & Marc R. Trevino, Sullivan & Cromwell LLP, to Nominating &

firms to apprise their clients of possible conflicts of interest, the SEC has suggested the need for regulation aimed at ensuring that disclosures are adequate, and that potential conflicts of interests are sufficiently explained to investors.<sup>72</sup> In practice, this means that Rule 14a-2(b)(3) would be amended to “require more specific disclosure regarding the presence of a potential conflict.”<sup>73</sup>

Further reform to the Rule 14a-2(b)(3) exemption would center on addressing the gray area between fraud and subpar advice.<sup>74</sup> Firms that avoid disclosure due to Rule 14a-2(b)(3) are still subject to Rule 14a-9’s antifraud provisions,<sup>75</sup> which prevent the firms from giving voting advice that is “false or misleading” due to any statements or omissions of material fact.<sup>76</sup> The mere absence of fraud is not sufficiently palliative to “certain participants in the proxy process,”<sup>77</sup> who would like to amend Rule 14a-2(b)(3) to specifically require that proxy advisory firms divulge the reasoning behind their recommendations to ensure accuracy.<sup>78</sup>

Including proxy advisory firms within the purview of the federal proxy rules, as discussed above, would address the major concerns articulated by the SEC by substantially increasing regulatory oversight. However, it is not as stringent of a measure as forcing proxy advisory firms to register as investment advisers under the Advisers Act of 1940, which is discussed in the next section.

### *B. Regulation Under the Advisers Act*

Proxy advisory firms are already subject to certain provisions of the Advisers Act because they qualify as “investment advisers.”<sup>79</sup> An investment adviser is someone who, “for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of

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Corporate Governance Comm., RiskMetrics Grp., Inc. (Nov. 29, 2007), *available at* [http://www.issgovernance.com/files/ISS\\_Corporate\\_Services\\_Conflict\\_Policy\\_Review\\_Project.pdf](http://www.issgovernance.com/files/ISS_Corporate_Services_Conflict_Policy_Review_Project.pdf).

<sup>72</sup> SEC Concept Release, *supra* note 28, at 43,012–13.

<sup>73</sup> *Id.* at 43,013.

<sup>74</sup> *See id.* at 43,012.

<sup>75</sup> *Id.*

<sup>76</sup> 17 C.F.R. § 240.14a-9(a) (2012).

<sup>77</sup> *See* SEC Concept Release, *supra* note 28, at 43,012.

<sup>78</sup> Letter from Jeffrey W. Rubin, Chair, Am. Bar Ass’n Comm. on Fed. Regulation of Sec., to Elizabeth M. Murphy, Sec’y, U.S. Sec. & Exch. Comm’n (Dec. 17, 2010) [hereinafter American Bar Association Letter], *available at* <http://www.sec.gov/comments/s7-14-10/s71410-283.pdf>.

<sup>79</sup> SEC Concept Release, *supra* note 28, at 43,010.

investing in, purchasing, or selling securities, or . . . issues or promulgates analyses or reports concerning securities.”<sup>80</sup> Under Section 206 of the Advisers Act, investment advisers are subject to a fiduciary duty to their advisory clients.<sup>81</sup> Section 206 also contains antifraud provisions that apply to investment advisers<sup>82</sup> and gives the SEC the authority “to adopt rules ‘reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive or manipulative.’”<sup>83</sup>

Although proxy advisers are already subject to some regulation, they are not required to register with the SEC under the Advisers Act.<sup>84</sup> In fact, investment advisers who have less than \$110 million in assets under their management are prohibited from registration.<sup>85</sup> As explained in the Concept Release, “[p]roxy advisory firms are unlikely to have sufficient assets under management to register with the Commission because they typically do not manage client assets.”<sup>86</sup> However, several proxy advisory firms, most notably ISS, are eligible to register with the SEC<sup>87</sup> because they qualify for one of the exemptions under Rule 203A-2 of the Advisers Act.<sup>88</sup> Firms such as Egan-

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<sup>80</sup> Investment Advisers Act of 1940 § 202, 15 U.S.C. § 80b-2(a)(11) (2006); *accord* SEC Concept Release, *supra* note 28, at 43,010 (“[P]roxy advisory firms provide analyses of shareholder proposals, director candidacies or corporate actions and provide advice concerning particular votes in a manner that is intended to assist their institutional clients in achieving their investment goals with respect to the voting securities they hold. In that way, proxy advisory firms meet the definition of investment adviser because they, for compensation, engage in the business of issuing reports or analyses concerning securities and providing advice to others as to the value of securities.”).

<sup>81</sup> SEC Concept Release, *supra* note 28, at 43,010 (“The Supreme Court has construed Section 206 of the Advisers Act as establishing a federal fiduciary standard governing the conduct of investment advisers.”). The Court interpreted the provisions as Congress’s intention to “eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.” SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191–92 (1963).

<sup>82</sup> 15 U.S.C. § 80b-6(1) to (2); SEC Concept Release, *supra* note 28, at 43,010.

<sup>83</sup> SEC Concept Release, *supra* note 28, at 43,010 (quoting Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. 3043, 75 Fed. Reg. 41,018, 41,022 (July 14, 2010)). Section 206(4) was added to the Advisers Act by the 1960 amendments to the Act. *See id.* at 43,010 n.254; *see also* Act of Sept. 13, 1960, Pub. L. No. 86-750, 74 Stat. 885.

<sup>84</sup> SEC Concept Release, *supra* note 28, at 43,009–10.

<sup>85</sup> *Protect Your Money: Check Out Brokers and Investment Advisers*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/investor/brokers.htm> (last visited June 18, 2013). The SEC Concept Release, as well as the responses to it, was authored when the threshold was \$25 million. *See* 15 U.S.C. § 80b-3a(a)(1); SEC Concept Release, *supra* note 28, at 43,010.

<sup>86</sup> SEC Concept Release, *supra* note 28, at 43,010.

<sup>87</sup> James Hyatt, *Proxy Advisors Find Themselves in the Spotlight*, BUS. ETHICS (May 17, 2010), <http://business-ethics.com/2010/05/17/243-proxy-advisors-find-themselves-in-the-spotlight/>; *Proxy Advisory Services*, SHAREHOLDER COMM. COALITION, <http://www.shareholdercoalition.com/proxyadvisory.html> (last visited June 18, 2013).

<sup>88</sup> 15 U.S.C. § 80b-3a(c); SEC Concept Release, *supra* note 28, at 43,010.

Jones<sup>89</sup> and Glass Lewis<sup>90</sup> do not qualify for such an exemption, and therefore they have not registered with the SEC.<sup>91</sup>

Registration imposes several additional duties on governed entities. These include disclosure of arrangements that may lead to conflicts of interest with their clients,<sup>92</sup> implementation and annual review of internal compliance programs designed to ensure compliance with the Advisers Act,<sup>93</sup> designation of a chief compliance officer to oversee the compliance program,<sup>94</sup> and the creation and preservation of records to be inspected by an SEC examiner.<sup>95</sup> The SEC is considering the following two amendments to the Advisers Act: (1) creating an exemption for registration to allow nonregistered firms to register,<sup>96</sup> and (2) expanding both the disclosure requirements regarding potential conflicts of interest, as well as the fiduciary duty that proxy advisory firms have to their clients.<sup>97</sup>

### C. Hard Regulation Proposals

The SEC limited its proposed regulatory frameworks to those discussed above, but it left the door open to the possibility of additional, tougher regulations. Such regulations include requiring “increased disclosure regarding the extent of research involved with a particular recommendation and the extent and/or effectiveness of its controls and procedures in ensuring the

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<sup>89</sup> The SEC provides a searchable database on its website that contains all registered investment advisers; a search for Egan-Jones yields no result. *Investment Adviser Search*, U.S. SEC. & EXCHANGE COMMISSION, [http://www.adviserinfo.sec.gov/%28S%28g5ama2zwsjjj5gswxtg10v3y%29%29/IAPD/Content/Search/iapd\\_Search.aspx](http://www.adviserinfo.sec.gov/%28S%28g5ama2zwsjjj5gswxtg10v3y%29%29/IAPD/Content/Search/iapd_Search.aspx) (last visited June 18, 2013).

<sup>90</sup> Letter from Katherine Rabin, Chief Exec. Officer, & Robert McCormick, Chief Policy Officer, Glass Lewis & Co., to Office of Regulations and Interpretations, U.S. Dep’t of Labor (Jan. 20, 2011), *available at* <http://www.dol.gov/ebsa/pdf/1210-AB32-053.pdf> (“[W]e are not registered as an investment advisor.”).

<sup>91</sup> SEC Concept Release, *supra* note 28, at 43,010; Hyatt, *supra* note 87; *Proxy Advisory Services*, *supra* note 87.

<sup>92</sup> SEC Concept Release, *supra* note 28, at 43,011 n.265 (“Part II of Form ADV, or a brochure containing the information in the Form, is required to be delivered to advisory clients or prospective clients by Rule 204-3 under the Advisers Act [17 C.F.R. § 275.204-3]. In addition to the disclosure of certain conflicts of interest, Part II contains information including the adviser’s fee schedule and the educational and business background of management and key advisory personnel of the adviser. Part II is currently not submitted to the SEC but must be kept by advisers in their files and made available to the SEC upon request and is “considered filed.”).

<sup>93</sup> 17 C.F.R. § 275.206(4)-7(a) to (b) (2012); SEC Concept Release, *supra* note 28, at 43,011.

<sup>94</sup> 17 C.F.R. § 275.206(4)-7(c); SEC Concept Release, *supra* note 28, at 43,011.

<sup>95</sup> 17 C.F.R. § 275.204-2; SEC Concept Release, *supra* note 28, at 43,011.

<sup>96</sup> SEC Concept Release, *supra* note 28, at 43,013 (“[W]e should establish an additional exemption from the prohibition on federal registration for proxy advisory firms to register with the Commission as investment advisers.”).

<sup>97</sup> *See id.*

accuracy of issuer data” and “requiring proxy advisory firms to file their voting recommendations with [the SEC] as soliciting material . . . to facilitate independent evaluation by market participants of the quality of those recommendations.”<sup>98</sup> To this end, the Shareholder Communications Coalition, whose membership is composed of some of the largest corporate officer groups,<sup>99</sup> proposed a regulatory framework that called for the firms to maintain public records of all voting recommendations—with disclosure of the data, information, and rationales used to come to the recommendations.<sup>100</sup> The proposed framework also suggested requiring that proxy advisory firms provide all public companies with drafts of the proxy advisory firms’ reports prior to dissemination to clients.<sup>101</sup> Furthermore, should a public company find an error in the report, proxy advisory firms would have to correct the error.<sup>102</sup>

The response letter from Wachtell, Lipton, Rosen & Katz suggested similar regulatory steps to those of the Shareholder Communication Coalition. The powerhouse law firm recommended “the institution of a standardized process for issuer review of proxy advisory reports during the drafting process, on a timetable that allows for meaningful dialogue between the issuer and the proxy advisory firm regarding any alleged factual mistakes or other disagreements over the objective components of the report,” as well as the right of issuers to have their response letter included in the final report provided by the proxy advisory firm to its clients.<sup>103</sup> This is designed to “contextualize” the recommendation made by a proxy advisory firm, and to give shareholders “a full understanding of the relevant viewpoints.”<sup>104</sup>

Without chronicling every proposed regulatory framework, there are still those who propose even more stringent oversight measures.<sup>105</sup> The details of

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<sup>98</sup> *Id.*

<sup>99</sup> *About the Coalition*, SHAREHOLDER COMM. COALITION, <http://www.shareholdercoalition.com/about.html> (last visited June 18, 2013). Its membership includes the Business Roundtable, an association of chief executive officers of publicly traded companies that account for almost one-third of the total value of the U.S. stock markets. *Id.*

<sup>100</sup> Shareholder Communications Coalition Letter, *supra* note 4.

<sup>101</sup> *Id.*

<sup>102</sup> *Id.*

<sup>103</sup> Letter from Wachtell, Lipton, Rosen & Katz, to Elizabeth M. Murphy, Sec’y, U.S. Sec. & Exch. Comm’n 7 (Oct. 19, 2010) [hereinafter Wachtell Letter], *available at* <http://www.sec.gov/comments/s7-14-10/s71410-129.pdf>.

<sup>104</sup> *Id.* at 8.

<sup>105</sup> *See, e.g.*, Letter from Donald G. Kalfen, Partner, Michael Powers, Managing Partner, & Jim Wolf, Managing Partner, Meridian Comp. Partners, LLC, to Elizabeth M. Murphy, Sec’y, U.S. Sec. & Exch. Comm’n 3–4 (Oct. 20, 2010), *available at* <http://www.sec.gov/comments/s7-14-10/s71410-156.pdf> (recommending that proxy advisory firms develop policies regarding conflicts of interest, interactions with

each proposal differ only slightly, yet all are motivated by the same desire to curb the influence of proxy advisory firms and advance the same general framework of forcing proxy advisory firms to disclose the underpinnings of their recommendations.

### III. THE MOTIVATIONS FOR REGULATION

To create a proper regulatory framework for the proxy advisory industry, an analysis of the justifications and motivations underlying the movement toward regulation is necessary. This Part first explains the two primary concerns associated with proxy advisory firms—the existence of conflicts of interest and the scope of influence firms wield over their clients—and then uses recent studies and other relevant evidence to show that the concerns underlying this motivation are overstated.

#### A. *Conflicts of Interest*

The potential for conflicts of interest has long been a subject of concern for observers of proxy advisory firms: the SEC addressed it in the Concept Release,<sup>106</sup> scholarly literature frequently discusses it,<sup>107</sup> and it is a persistent refrain in the comment letters sent to the SEC.<sup>108</sup> The Concept Release identified several ways in which conflicts of interest may take shape. First, a conflict may arise when a proxy advisory firm gives voting recommendations on a matter put to a shareholder vote while simultaneously offering consulting services to the issuer or proponent of the proposal.<sup>109</sup> There are two concerns associated with this type of conflict. For one thing, the issuer may feel tempted to purchase services from the proxy advisory firm to garner support for its

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issuers, internal controls used to ensure the accuracy of information, and the designation of a chief compliance officer to administer these policies). The letter went on to note that the authors “believe[d] it [was] appropriate and important for the Commission to promulgate rules overseeing the operations of proxy advisory firms.” *Id.* at 3.

<sup>106</sup> SEC Concept Release, *supra* note 28, at 43,011–12.

<sup>107</sup> *See, e.g.*, Belinfanti, *supra* note 35, at 399–400; Choi et al., *supra* note 30, at 657–58, 697; Paul Rose, Commentary, *On the Role and Regulation of Proxy Advisors*, 109 MICH. L. REV. FIRST IMPRESSIONS 62, 62–63 (2011), <http://www.michiganlawreview.org/assets/fi/109/rose.pdf>.

<sup>108</sup> *See, e.g.*, SEC Concept Release, *supra* note 28, at 43,011–12; GAO REPORT, *supra* note 29. For a nonexhaustive look at concerns raised from comments submitted to the SEC, see American Bar Association Letter, *supra* note 78; Council of Institutional Investors Letter, *supra* note 48; Letter from Darren T. Brady, Manager, & James Davidson, Assistant Manager, Hermes Equity Ownership Servs., to Elizabeth Murphy, Sec’y, U.S. Sec. & Exch. Comm’n (Oct. 20, 2010), available at <http://www.sec.gov/comments/s7-14-10/s71410-150.pdf>.

<sup>109</sup> SEC Concept Release, *supra* note 28, at 43,011–12 (citing GAO REPORT, *supra* note 29, at 10–11).

proposal.<sup>110</sup> Also, a proxy advisory firm may recommend an issuer's proposal to avoid alienating the issuer and losing its business.<sup>111</sup> In either case, the underlying concern is that the integrity of a voting recommendation issued by the proxy advisory firm will be compromised by business considerations.

The other potential conflict of interest occurs when a proxy advisory firm provides corporate governance ratings to institutional investors while simultaneously offering services to the subject corporation so that it can receive a higher corporate governance score.<sup>112</sup> This potential conflict of interest exists only for ISS, as it is the only proxy advisory firm with corporate clients that provides corporate governance ratings.<sup>113</sup> The GAO report<sup>114</sup> noted that there are "various situations" in which advising both corporation and investor could lead to conflicts of interest.<sup>115</sup> The implication is that ISS may be acting in a similar vein as WorldCom and Enron<sup>116</sup> or, if such a comparison is too strong, that there is a clear element of impropriety in this business model, through which ISS "serv[es] two masters."<sup>117</sup>

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<sup>110</sup> *Id.* at 43,012.

<sup>111</sup> *Id.*

<sup>112</sup> *Id.*

<sup>113</sup> Belinfanti, *supra* note 35, at 397 (noting that Glass Lewis has made inroads into ISS's market share by not selling governance advice to corporations, which makes it "free from the perceived conflict-of-interest problems that cloud ISS's[s] recommendations"); Colin Diamond & Irina Yevmenenko, *Who Is Overseeing the Proxy Advisors?*, 3 BLOOMBERG CORP. L.J. 606, 608 (2008) ("ISS also provides corporate governance consulting services. By contrast, the other three proxy advisors do not provide consulting services."); Robert D. Hershey Jr., *A Little Industry with a Lot of Sway on Proxy Votes*, N.Y. TIMES, June 18, 2006, § 3, at 6 ("Both [Glass Lewis and PROXY Governance] proclaim themselves free of conflicts of interest, because, they say, they do not advise corporations on governance issues.").

<sup>114</sup> In 2007, two members of Congress requested the Government Accountability Office (GAO) to report on the state of the proxy advisory industry. Specifically, the GAO was asked to look into (1) "potential conflicts of interest that may exist with proxy advisory firms and the steps that the Securities and Exchange Commission (SEC) has taken to oversee these firms"; (2) "the factors that may impede or promote competition within the proxy advisory industry"; and (3) "institutional investors' use of the firms' services and the firms' potential influence on proxy vote outcomes." GAO REPORT, *supra* note 29.

<sup>115</sup> For instance, the report gives the following hypothetical: "ISS could help a corporate client design an executive compensation proposal to be voted on by shareholders and subsequently make a recommendation to investor clients to vote for this proposal." *Id.* at 10.

<sup>116</sup> Peter Galuszka, *Conflicts of Interest in Advisory Firms*, CBS MONEY WATCH (July 15, 2008, 7:49 PM), [http://www.cbsnews.com/8301-505125\\_162-28241214/conflicts-of-interest-in-advisory-firms/?tag=bnetdomain](http://www.cbsnews.com/8301-505125_162-28241214/conflicts-of-interest-in-advisory-firms/?tag=bnetdomain) ("Gee, isn't it funny that the big accounting firms got into big trouble a few years ago for profiting from a very similar situation. They vetted financial reports of companies while selling them consulting services, with the idea being, (wink wink) that if you play ball on hiring our consultants, we'll play ball on your screwy, dishonest financial statements.").

<sup>117</sup> See Gretchen Morgenson, *And They Call This Advice?*, N.Y. TIMES, Aug. 21, 2005, § 3, at 1 [hereinafter Morgenson, *And They Call This Advice?*]; see also Gretchen Morgenson, *Pfizer and the Proxy Adviser*, N.Y. TIMES, Apr. 21, 2006, at C1 [hereinafter Morgenson, *Pfizer*] (wondering whether Pfizer's CEO's

## B. *Fears of Influence*

Those advocating for more stringent regulations are also concerned with the influence proxy advisory firms purportedly wield over their clients. The Shareholder Communications Coalition’s letter cited the “tremendous influence of proxy advisory firms” as justification for mandating that proxy advisory firms maintain public records of their recommendations and disclose the data, information, and reasoning they use when formulating those recommendations.<sup>118</sup> Leo E. Strine, Jr. has frequently painted proxy advisory firms as unaccountable bogeymen.<sup>119</sup> In labeling ISS an interloper that is taking advantage of an “opportunistic breach,” Strine highlighted the fundamental mistrust and skepticism that proxy advisory firms face from established business interests and corporate issuers.<sup>120</sup>

Even those who use less derisive language than Strine still characterize proxy advisory firms as wielding significant power over institutional investors. For instance, corporate law scholar Professor Lynn Stout stated that institutional investors “follow ISS [vote recommendations] en masse,”<sup>121</sup> and Professor Tamara Belinfanti characterized institutional investors’ use of proxy advisory firms as the “transferring [of] power” to proxy advisory firms.<sup>122</sup> Corporate issuers echoed these sentiments. In a letter to the SEC, the 3M Company bemoaned the power conferred “on a small group of associations

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recommendation to buy and promote PROXY Governance “reflects an unbiased point of view or a relationship with the company and its top executive”).

<sup>118</sup> Shareholder Communications Coalition Letter, *supra* note 4, at 3.

<sup>119</sup> Strine painted proxy advisory firms, specifically ISS, as feudal lords-cum-oracles:

[The proxy advisory firms forced] powerful CEOs [to] come on bended knee to Rockville, Maryland, where ISS resides, to persuade the managers of ISS of the merits of their views about issues like proposed mergers, executive compensation, and poison pills. They do so because the CEOs recognize that some institutional investors will simply follow ISS’s advice rather than do any thinking of their own. ISS has been so successful that it now has a California rival, Glass Lewis.

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) [hereinafter Strine, *The Delaware Way*]; *see also* Strine, *supra* note 1, at 1765 (“The influence of ISS and its competitors over institutional investor voting behavior is so considerable that the traditionalist will be concerned that any initiative to increase stockholder power will simply shift more clout to firms of this kind—firms even more unaccountable than their institutional investor clients.”).

<sup>120</sup> Strine, *The Delaware Way*, *supra* note 119, at 688.

<sup>121</sup> Belinfanti, *supra* note 35, at 387 (alteration in original) (quoting Lynn A. Stout, *Why Should ISS Be the New Master of the Corporate Governance Universe?*, CORP. GOVERNANCE, Jan. 4, 2006, at 14, 15) (internal quotation marks omitted).

<sup>122</sup> *Id.* at 389.

with ranking systems.”<sup>123</sup> Wachtell, Lipton, Rosen & Katz described proxy advisory firms as “powerful intermediaries with great influence over corporate policy” that do not have an “equivalent economic interest.”<sup>124</sup> Thus, there is a persistent chorus—comprised of government representatives, academics, and businesses—identifying proxy advisory firms as wielders of significant power that must be reined in.

### *C. Revisiting the Motivations for Regulation*

#### *1. Conflicts of Interest*

While conflicts of interest could potentially undermine the integrity of voting recommendations, the concerns are exaggerated. The GAO report found that the SEC’s examination of firms registered as investment advisers did not reveal any major violations.<sup>125</sup> ISS, the largest and most successful proxy advisory firm, is already registered with the SEC under the Advisers Act,<sup>126</sup> and it is thus already subject to disclosure arrangements that may reveal conflicts of interest, implementation and annual review of internal compliance programs designed to ensure compliance with the Advisers Act,<sup>127</sup> designation of a chief compliance officer to oversee the compliance program,<sup>128</sup> and the creation and preservation of records to be inspected by an SEC examiner.<sup>129</sup>

Furthermore, ISS has taken several steps in response to the heavy criticism it receives for providing corporate governance services in addition to its shareholder voting services. Most notably, ISS has created a firewall between the proxy advisory and corporate governance businesses: they have separate staffs, operate in separate buildings, and even go so far as to “use segregated office equipment and information databases in order to help avoid discovery of corporate clients by the proxy advisory staff.”<sup>130</sup> According to a statement on its website, the company has instituted a policy requiring every ISS proxy analysis to “carry a disclosure statement advising the client of the work of ICS

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<sup>123</sup> Letter from W. James McNerney, Jr., Chairman of the Bd. & Chief Exec. Officer, 3M Corp., to Jonathan G. Katz, Sec’y, U.S. Sec. & Exch. Comm’n (Dec. 5, 2003), *available at* <http://www.sec.gov/rules/proposed/s71903/3m120503.htm>.

<sup>124</sup> Wachtell Letter, *supra* note 103, at 1.

<sup>125</sup> GAO REPORT, *supra* note 29, at 3–4.

<sup>126</sup> CTR. ON EXEC. COMP., *supra* note 24, at 63.

<sup>127</sup> 17 C.F.R. § 275.206(4)-7 (2012); SEC Concept Release, *supra* note 28, at 43,011.

<sup>128</sup> 17 C.F.R. § 275.206(4)-7(c); SEC Concept Release, *supra* note 28, at 43,011.

<sup>129</sup> 17 C.F.R. § 275.204-2; SEC Concept Release, *supra* note 28, at 43,011.

<sup>130</sup> GAO REPORT, *supra* note 29, at 10.

[ISS Corporate Services, Inc.] and advising ISS's institutional clients that they can get information about an issuer's use of ICS's products and services."<sup>131</sup> These steps appear to have mollified many of the concerns held by institutional investors that subscribe to ISS.<sup>132</sup> Moreover, most institutional investors conduct due diligence "to obtain reasonable assurance that ISS or any other proxy advisory firm is independent and free from conflicts of interest," and retain the ability to take steps on their own to discern conflicts of interest.<sup>133</sup>

If institutional investors are unsatisfied with ISS's efforts to limit the occurrence of conflicts of interest, institutional investors can subscribe to a firm that does not provide corporate governance advice. Indeed, Glass Lewis's growth has been attributed to its abstention from offering corporate governance advice, which "free[s] [Glass Lewis] from the perceived conflict-of-interest problems that cloud ISS'[s] recommendations."<sup>134</sup> Critics may note that Glass Lewis is not registered under the Advisers Act.<sup>135</sup> Thus, an institutional investor's choice is limited to an unregistered proxy advisory firm that is not affected by this type of conflict of interest and a registered firm that is so affected. This point undermines the supposed pressing need to regulate proxy advisory firms by forcing them to register under the Advisers Act: ISS, the largest proxy advisory firm and, unsurprisingly, the one that elicits the most concern,<sup>136</sup> is already registered (and therefore owes its clients a fiduciary duty), and this has done nothing to appease the critics of proxy advisory firms.<sup>137</sup>

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<sup>131</sup> *Id.* (internal quotation marks omitted); *accord* INSTITUTIONAL S'HOLDER SERVS., INC., DUE DILIGENCE COMPLIANCE PACKAGE (2011), available at <http://www.issgovernance.com/files/ISSDueDiligenceCompliancePackage20110413.pdf>; *Due Diligence Materials*, *supra* note 71.

<sup>132</sup> GAO REPORT, *supra* note 29, at 11.

<sup>133</sup> *Id.* ("As part of this process, many of these institutional investors said they review ISS's conflict policies and periodically meet with ISS representatives to discuss these policies and any changes to ISS's business that could create additional conflicts. Finally, . . . institutional investors told us that ISS's recommendations are generally not the sole basis for their voting decisions, which further reduces the chances that these potential conflicts would unduly influence how they vote.").

<sup>134</sup> Belinfanti, *supra* note 35, at 397.

<sup>135</sup> See *supra* note 90 and accompanying text.

<sup>136</sup> See Belinfanti, *supra* note 35, at 406 ("From an agency theory perspective, ISS presents a lethal combination—significant power and virtually no accountability."); American Bar Association Letter, *supra* note 78, at 28 (observing that ISS is amongst the most significant firms contributing to owners not actually exercising their shareholder franchise).

<sup>137</sup> When Providian Financial Corporation merged with Washington Mutual, both Glass Lewis and Egan Jones recommended that shareholders vote against the proposal. Morgenson, *And They Call This Advice?*, *supra* note 117. ISS, meanwhile, gave a lukewarm report echoing many of the complaints that were made by Glass Lewis and Egan Jones, but ultimately approved the merger on the basis that there was "insufficient consensus surrounding Providian's long-term earnings potential that would warrant a higher valuation and

Notably, proxy advisory firms do not give recommendations in secrecy or in a vacuum. The default (not customized) recommendations of proxy advisory firms are often publicized and compared to one another,<sup>138</sup> and many institutional investors subscribe to more than one proxy advisory firm, maintain in-house research staff, or both.<sup>139</sup> This allows for market forces to bear on proxy advisory firms: if a firm issues a recommendation that is out of step with other firms or an institutional investor's in-house research staff, it could be subject to scrutiny.<sup>140</sup> As an example, for a 2006 director election at Pfizer, both Glass Lewis and ISS recommended that shareholders withhold votes for certain board members due to the corporation's pay practices.<sup>141</sup> PROXY Governance, however, gave a recommendation in favor of all thirteen directors, for which it was criticized.<sup>142</sup>

Proxy advisory firms have a vested interest in avoiding conflicts of interest. When a firm's integrity is called into question, there can be severe damage to the company. By way of example, in 2006, Glass Lewis was purchased by Chinese media conglomerate Xinhua Media.<sup>143</sup> Being associated with "an information and media conglomerate with close ties to the Chinese government" created an appearance of impropriety that had deleterious effects on Glass Lewis: two prominent executives quit, clients departed, and ultimately the firm had to be sold.<sup>144</sup> At the heart of this ordeal was the erosion of Glass Lewis's reputation as a result of it being owned by an unseemly Chinese company.<sup>145</sup>

Though conflicts of interest are by their very nature difficult to see and can never be guaranteed to be fully accounted for, the possibility of their existence does not justify imposing any and all manners of regulation to address the

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voting against this transaction." *Id.* (internal quotation marks omitted). Despite being registered as an investment adviser, ISS was still attacked for being potentially conflicted. *Id.*

<sup>138</sup> *Id.* (comparing recommendations regarding Provident Financial's merger with Washington Mutual); Mia Lamar, *Proxy Advisory Firms Split in Icahn-Oshkosh Battle*, WALL ST. J. (Jan. 19, 2012), <http://online.wsj.com/article/SB10001424052970204555904577168740496960360.html>.

<sup>139</sup> GAO REPORT, *supra* note 29, at 16.

<sup>140</sup> See, e.g., Morgenson, *And They Call This Advice?*, *supra* note 117 (analyzing the differing recommendations of ISS and of Glass Lewis and Egan-Jones); Morgenson, *Pfizer*, *supra* note 117 (examining the split between PROXY Governance, ISS, and Glass Lewis regarding votes for board members over executive pay).

<sup>141</sup> Morgenson, *Pfizer*, *supra* note 117.

<sup>142</sup> *Id.*

<sup>143</sup> CTR. ON EXEC. COMP., *supra* note 24, at 34–35.

<sup>144</sup> *Id.* at 35.

<sup>145</sup> *Id.*

problem. As this section shows, institutional investors have measures at their disposal to uncover conflicts of interest, while market scrutiny favors disclosure of conflicts of interest by proxy advisory firms, thereby ameliorating some of the concerns that proxy advisory firms are plagued with significant issues of conflicts of interest. The next section shows that the concerns over the influence of proxy advisory firms are overstated as well.

## 2. *Fears of Influence*

In 2010, a group of professors conducted an empirical study of uncontested director elections from 2005 to 2006.<sup>146</sup> They analyzed how four of the largest proxy advisory firms made their recommendations<sup>147</sup> and the influence of those recommendations on shareholder voting.<sup>148</sup> This study was distinguished from other studies on the topic because it addressed the underlying factors that influence both the recommendation and the vote.<sup>149</sup> This conceptually and empirically disentangled the difference between a recommendation being correlated with a vote or being the cause of a vote. Their findings undermined the claim that proxy advisory firms wield tremendous influence.

The study indicated that ISS is the only proxy advisory firm whose recommendation causes a significant shift in votes: the authors “consider[ed] it likely that an ISS recommendation shifts 6% to 10% of shareholder votes.”<sup>150</sup> In consideration of the estimates of other commentators, which range from 19%<sup>151</sup> to 30%,<sup>152</sup> it appears that the fears surrounding the scope of ISS’s influence are significantly overstated.<sup>153</sup> As Choi, Kahan, and Fisch further suggested, much of the influence that ISS has may be attributed to it being the

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<sup>146</sup> See Choi et al., *supra* note 30, at 651; Choi et al., *supra* note 16, at 871–73.

<sup>147</sup> Choi et al., *supra* note 30, at 651. They focused on uncontested director elections due to both practical concerns and the import of the votes, as the directors manage the corporations. *Id.* On the practical level, the frequency of such votes made it easier to measure the recommendations.

<sup>148</sup> Choi et al., *supra* note 16, at 871–73.

<sup>149</sup> *Id.* at 869.

<sup>150</sup> *Id.* at 906.

<sup>151</sup> Cai et al., *supra* note 18, at 2404.

<sup>152</sup> William J. Holstein, *Is ISS Too Powerful? And Whose Interests Does It Serve?*, CBS MONEY WATCH (Feb. 7, 2008, 11:03 AM), [http://www.cbsnews.com/8301-505125\\_162-28241100/is-iss-too-powerful-and-whose-interests-does-it-serve/](http://www.cbsnews.com/8301-505125_162-28241100/is-iss-too-powerful-and-whose-interests-does-it-serve/).

<sup>153</sup> Council of Institutional Investors Letter, *supra* note 48, at 5–6 (“ISS issued a baseline recommendation of ‘against’ for 28 out of 136 management-sponsored say-on-pay proposals in 2010. Only three of the 28 proposals actually failed to pass, and the average shareowner support of those 28 proposals was 74 percent. . . . Of 15,044 ISS baseline recommendations for nominees in 2010, 13 percent were ‘withhold’ or ‘against.’ Of the 1,879 nominees receiving ‘withhold’ or ‘against’ baseline recommendations with available voting results, less than 5 percent failed to receive majority support from shareowners.”).

proxy advisory firm most aligned with shareholder preferences.<sup>154</sup> Conversely, the other proxy advisory firms are less influential because they are arguably less in sync with the factors that shareholders care about.<sup>155</sup> The findings indicated that ISS may dominate the market by catering to the market. As a result, if ISS ceased giving recommendations that aligned with its clients' preferences, ISS would lose its influence.<sup>156</sup> ISS therefore isn't a "Pied Piper," but instead "an information agent and guide, helping investors to identify voting decisions that are consistent with their existing preferences."<sup>157</sup>

The GAO report produced at the behest of the SEC echoed the findings of Professors Choi, Fisch, and Kahan. It included a survey of thirty-one randomly selected institutional investors, including twenty "large" institutional investors.<sup>158</sup> Of the twenty large investors interviewed, fifteen reported that they generally rely more on their own in-house research staffs than the recommendations of proxy advisory firms.<sup>159</sup> These investors subscribed to proxy advisory firms to "supplement their own analysis," and use the recommendations as one of several factors in formulating their vote.<sup>160</sup> Fourteen of the large institutional investors said they used a customizable voting policy; "proxy advisory firms simply apply their clients' voting policies, which then drive the voting decisions."<sup>161</sup> Eight of the investors said they subscribed to more than one proxy advisory firm to "gain a broader range of information on proxy issues and to help make well-informed voting decisions."<sup>162</sup> The results of the survey were consistent with the conclusions drawn from Choi, Fisch, and Kahan's study: proxy advisory firms are less Pied Pipers and more "information agent[s] and guide[s]."<sup>163</sup>

It is worth noting that the eleven "small" institutional investors interviewed indicated that they were more likely to rely heavily on proxy advisory firm

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<sup>154</sup> Choi et al., *supra* note 16, at 899 ("While catering to clients' views may explain ISS's market dominance, it also suggests the limits of such dominance—if ISS were to shift its recommendations away from the views of its clients, it would likely lose those clients to competing advisory firms.").

<sup>155</sup> *Id.* at 898–99 ("The results further suggest that these advisors are less in sync with shareholders than ISS. For example, the four most important factors affecting the recommendations of Egan Jones and Proxy Governance do not correspond closely to the factors affecting the shareholder vote.").

<sup>156</sup> *Id.* at 899.

<sup>157</sup> *Id.* at 906.

<sup>158</sup> GAO REPORT, *supra* note 29, at 15.

<sup>159</sup> *Id.* at 16.

<sup>160</sup> *Id.*

<sup>161</sup> *Id.*

<sup>162</sup> *Id.*

<sup>163</sup> Choi et al., *supra* note 16, at 906.

recommendations and “vote proxies based strictly on the research and recommendations of their firm.”<sup>164</sup> Nonetheless, these investors acknowledged that they still have a fiduciary duty to vote the proxies according to the best interest of their client, and they retain the ability to override the recommendations of the advisory firm.<sup>165</sup> While the results of the GAO report indicated that small institutional investors are the ones that are at risk of being influenced by proxy advisory firms, large institutional investors “cast the great majority of proxy votes made by institutional investors,” which limits the scope of influence of proxy advisory firms.<sup>166</sup>

The custom voting policies offered by proxy advisory firms, and frequently used by institutional investors, provide yet another reason to doubt that proxy advisory firms have as strong an influence as critics claim. Both ISS<sup>167</sup> and Glass Lewis<sup>168</sup> provide customizable voting services, making it difficult for them to strictly influence subscribers—a point made by both TIAA-CREF<sup>169</sup> and the Council of Institutional Investors in response letters to the SEC’s Concept Release.<sup>170</sup> Glass Lewis claimed that “the majority of Glass Lewis’[s] clients, based on both a pure numerical basis as well as on assets under management, have elected to vote according to one or more custom voting policies.”<sup>171</sup> In addition to customizable policies, proxy advisory firms also offer different pre-made voting packages: ISS has policy options for “sustainability, socially-responsible investors, public funds, labor unions and mission and faith-based investors.”<sup>172</sup> The high degree of control exercised by clients of proxy advisory firms in selecting the inputs for vote

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<sup>164</sup> GAO REPORT, *supra* note 29, at 16.

<sup>165</sup> *Id.* at 17.

<sup>166</sup> *Id.* at 5–6.

<sup>167</sup> *Custom Proxy Advisory*, ISS, <http://www.issgovernance.com/proxy/custom> (last visited June 18, 2013).

<sup>168</sup> Letter from Katherine Rabin, Chief Exec. Officer, & Robert McCormick, Chief Policy Officer, Glass Lewis & Co., to Mary L. Schapiro, Chair, U.S. Sec. & Exch. Comm’n (Oct. 18, 2010) [hereinafter Glass Lewis Letter], available at <http://www.sec.gov/comments/s7-14-10/s71410-100.pdf>.

<sup>169</sup> Letter from Jonathan Feigelson, Senior Vice President, Gen. Counsel, & Head of Corporate Governance, TIAA-CREF, to Elizabeth M. Murphy, Sec’y, U.S. Sec. & Exch. Comm’n 5 (Nov. 8, 2010), available at <http://www.sec.gov/comments/s7-14-10/s71410-263.pdf> (“In this way, the vote mechanics and record keeping are technically ‘outsourced’, but the institution itself retains the ability to customize the policy in furtherance of what the institution believes as a fiduciary to be in the best interests of their clients.”).

<sup>170</sup> Council of Institutional Investors Letter, *supra* note 48, at 6 (“We stress that proxy advisers’ clients retain the ability to vote however they wish, and regularly diverge from their proxy advisers’ recommendations through customized voting guidelines or case-by-case review.”).

<sup>171</sup> Glass Lewis Letter, *supra* note 168.

<sup>172</sup> *Proxy Advisory Services*, ISS, <http://www.issgovernance.com/proxy/advisory> (last visited June 18, 2013).

recommendations further weakens the Pied Piper narrative propagated by the firms' critics.

Additionally, the existence and use of custom voting policies controverts the argument that proxy advisory firms only use "one-size-fits-all" methodologies.<sup>173</sup> Ignoring the prevalence of custom voting policies indicates that many critics do not understand how proxy advisory firms function and how they are ultimately used. More troubling, the SEC seemingly endorses this ill-informed viewpoint: the Concept Release highlighted the "concern that proxy advisory firms may base their recommendation on [a] one-size-fits-all governance approach."<sup>174</sup> When then-Chairperson Schapiro stated that the SEC was "considering how to provide guidance on how the federal securities laws should regulate the activities of proxy advisory firms," she cited the comments the SEC received in response to the Concept Release.<sup>175</sup> These were the very comments that mischaracterized how proxy advisory firms formulate recommendations and how those recommendations are used.

### 3. *Conclusions About the Concerns*

The concerns that prompted the push for regulation of proxy advisory firms are significantly overstated. Former Chairperson Schapiro's remarks, which relied on poor information, were especially troubling. Her comment that "proxy advisory firms may interfere with, rather than enhance, the communication at the heart of effective engagement" was divorced from empirical research and the reality of how proxy advisory firms function.<sup>176</sup> Former Chairperson Schapiro's statement gave the impression that she was giving disproportionate weight to the complaints of companies<sup>177</sup> and made no

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<sup>173</sup> Letter from Cleary Gottlieb Steen & Hamilton LLP, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 3 (Nov. 4, 2010), *available at* <http://www.sec.gov/comments/s7-14-10/s71410-261.pdf> (noting that "those policies are by their nature 'one size fits all'"); Letter from Tom D. Seip, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 2 (Oct. 20, 2010), *available at* <http://www.sec.gov/comments/s7-14-10/s71410-196.pdf> ("[W]e are concerned with the practice of at least one proxy advisory firm to implement what is effectively a 'one-size-fits-all' policy that applies one vote recommendation to all similar proxy proposals without analyzing the issue on a company-by-company basis."); Letter from Sidley Austin LLP, to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n 11 (Oct. 20, 2010), *available at* <http://www.sec.gov/comments/s7-14-10/s71410-191.pdf> ("[W]e have concerns about the 'one-size-fits-all' approach that some proxy advisory firms take in their articulation of voting guidelines and the influence that those guidelines carry.").

<sup>174</sup> SEC Concept Release, *supra* note 28, at 43,012.

<sup>175</sup> Remarks at the Transatlantic Corporate Governance Dialogue, *supra* note 7.

<sup>176</sup> *Id.*

<sup>177</sup> *Id.* ("Companies are frustrated by the influence these firms have, and worry that they may not be accountable for, or even concerned with, the quality of the information on which they make voting

mention of the helpful role proxy advisory firms play. Given her remarks, it seems possible that regulation of proxy advisory firms may be aimed at problems that do not exist. While some form of regulation would be beneficial, proposed regulations should be tailored to real problems and reflect a sufficient understanding of the issues at hand—especially how vital proxy advisory firms are to shareholder voting.

#### IV. HOW IMPORTANT ARE PROXY ADVISORY FIRMS?

This Part shows that proxy advisory firms are highly efficient and crucially important for the exercise of rational shareholder voting. Utilizing Anthony Downs's research on the application of economic theory to democracy, this Part demonstrates that proxy advisory firms are necessary for institutional investors to optimize the vote they cast in their clients' best interests. Considering proxy advisory firms in this theoretical framework emphasizes their importance to the shareholder franchise in a novel way that is divorced from the self-motivated pronouncements of interested parties.

##### A. *Rational, Efficient Voting and the Delegation of Decision Making*

Like shareholder voting, democratic voting has long been the subject of academic debate centered on its efficiency, utility, or the lack thereof.<sup>178</sup> Much of the negative view of democratic voting hinges on the costs of becoming sufficiently informed about politics to vote in a manner that is rational and aligned with one's preferences; when faced with the costs of becoming informed and the benefits it brings, voters may rationally choose to remain ignorant.<sup>179</sup> The main cost of becoming informed is that of time: people only

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recommendations. . . . [W]hen boards believe that a recommendation has been based on incorrect information, those recommendations can act as a barrier to boards' efforts to persuade investors to change their minds.").

<sup>178</sup> See generally SAMUEL L. POPKIN, *THE REASONING VOTER: COMMUNICATION AND PERSUASION IN PRESIDENTIAL CAMPAIGNS* 6–21 (1991) (exploring the democratic voting process and rebutting the presumption that uninformed voters are swayed unfairly by candidates and the media); DONALD A. WITTMAN, *THE MYTH OF DEMOCRATIC FAILURE: WHY POLITICAL INSTITUTIONS ARE EFFICIENT* 1–6 (1995) (arguing for the efficiency and utility of democratic institutions despite the widespread belief that economic markets are considered to be far more efficient).

<sup>179</sup> Michael S. Kang, *Democratizing Direct Democracy: Restoring Voter Competence Through Heuristic Cues and "Disclosure Plus,"* 50 *UCLA L. REV.* 1141, 1153 (2003) ("It makes sense to stay uninformed in light of the high costs of learning more about politics, the low instrumental utility of a single vote, and the opportunity costs of neglecting life's other demands.").

have so much time available to devote to gathering information and deciding between alternatives.<sup>180</sup>

Anthony Downs has broken down the process of voting into seven steps.<sup>181</sup> The seven steps are as follows:

1. Gathering information relevant to each issue upon which important political decisions have been (or will be) made.
2. For each issue, selecting from all the information gathered that which will be used in the voting decision.
3. For each issue, analyzing the facts selected to arrive at specific factual conclusions about possible alternative policies and their consequences.
4. For each issue, appraising the consequences of every likely policy in light of relevant goals. This is a value appraisal, not a strictly factual one.
5. Coördinating the appraisals of each issue into a net evaluation of each party running in the election. This is also a value judgment personally tailored to the goals of the voter himself.
6. Making the voting decision by comparing the net evaluations of each party and weighting them for future contingencies.
7. Actually voting or abstaining.<sup>182</sup>

Each step of this process has corresponding costs associated with it.<sup>183</sup> When a step is delegated, additional steps are created and added to the process; with each additional step, there is additional cost, such as the cost of an expert acquiring information on an issue, or the cost of the expert transmitting the analysis of an issue to the voter.<sup>184</sup>

There is a dilemma involved in negotiating the steps of rational voting: not only are there costs associated with the gathering of data, there are also costs associated with the parsing of the data so that a voter can decide the “crucial question” of which information to keep and which to reject.<sup>185</sup> The selection

<sup>180</sup> ANTHONY DOWNS, AN ECONOMIC THEORY OF DEMOCRACY 209 (1957) (“The main scarce resource consumed . . . is the time . . .”).

<sup>181</sup> *Id.*

<sup>182</sup> *Id.*

<sup>183</sup> These costs are broken into “transferable costs,” which can be shifted from the voter onto someone else, and “nontransferable costs,” which must be borne by the voter. *Id.* at 210. Transferable costs are further broken into three sub-costs: “(a) *Procurement costs* are the costs of gathering, selecting, and transmitting data. (b) *Analysis costs* are the costs of making factual analysis of data. (c) *Evaluative costs* are the costs of relating data or factual analyses to specific goals.” *Id.*

<sup>184</sup> Downs asserted that steps one through six can all be delegated. *Id.* at 209.

<sup>185</sup> *Id.* at 211.

and refinement of which data to use in this process is a much more difficult assessment than typical decisions people make in their lives.<sup>186</sup> Most of the decisions people are faced with involve present returns and clear alternatives—e.g., choosing which restaurant to go to or which television to buy.<sup>187</sup> However, voting decisions are essentially investments made in the hopes of future gains.<sup>188</sup> Therefore, the analysis and refinement of gathered data is incredibly important in formulating a rational vote.<sup>189</sup> The process of making voting decisions is complicated by the costs of being fully informed; while a voter wants to gather as much information as possible, he is limited by the demands of rationality, which dictate that the voter spend no more time or money in obtaining the information than would be justified by the returns.<sup>190</sup>

Voters are thus faced with a common decision: maximizing what they want (knowledge), while keeping costs down.<sup>191</sup> If a voter does not want to simply reduce the information he receives, Downs suggests two solutions: (1) reduce the costs of procuring the information, and (2) delegation.<sup>192</sup> Reducing the costs of procurement is done through the use of free and subsidized information,<sup>193</sup> and delegation is employed when the free information on hand is insufficient.<sup>194</sup>

Free information is not information that has no cost, but rather information that is so cheap that there is almost no way to, or purpose in, transferring its cost.<sup>195</sup> In this way, Downs's definition of free information is fairly tautological: free information is information that is acquired without needing to delegate.<sup>196</sup> Free information generally is information that is absorbed as a by-product of voters' daily activities<sup>197</sup>: watching television and seeing political ads and campaigns, reading newspapers, and engaging in conversations with

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<sup>186</sup> See POPKIN, *supra* note 178, at 10.

<sup>187</sup> *Id.*

<sup>188</sup> *Id.*

<sup>189</sup> Downs called the question "crucial" because it shapes subsequent decisions and whether they are effective. DOWNS, *supra* note 180, at 211.

<sup>190</sup> *Id.* at 227–28.

<sup>191</sup> *Id.* at 228.

<sup>192</sup> *Id.*

<sup>193</sup> *Id.* at 228–29; see POPKIN, *supra* note 178, at 213.

<sup>194</sup> DOWNS, *supra* note 180, at 228–29; see POPKIN, *supra* note 178, at 213. There is no real reason to distinguish between free information and subsidized information because they function in the same way and have the same weaknesses. DOWNS, *supra* note 180, at 230.

<sup>195</sup> DOWNS, *supra* note 180, at 222.

<sup>196</sup> See *id.*

<sup>197</sup> POPKIN, *supra* note 178, at 23.

other people.<sup>198</sup> Another significant source of free information is heuristic cues, reliable informational shortcuts such as brand names for products.<sup>199</sup> In the political voting context, the most important heuristic cue is party affiliation,<sup>200</sup> or when evaluating candidates, personal characteristics and campaign behavior.<sup>201</sup>

The biggest weakness of free information is that the selection biases of the information provider are most often different than that of the voter; it is cheap for that very reason.<sup>202</sup> When reading a newspaper article on healthcare for instance, a voter is at the mercy of what the author thinks is important about healthcare. A voter has no input in determining what issues the providers of free information take into account, nor does the voter have the ability to influence the analysis or conclusions reached.<sup>203</sup>

When voters want information from sources that are already matched with their selection preferences, or want to obtain higher quality information than that from free information sources, they can shift the gathering, analysis, and even the evaluation of facts to experts through delegation.<sup>204</sup> In situations when the issue at hand is too complex or difficult to understand, rational voters, by necessity, must rely on experts.<sup>205</sup> Crucially, information received from experts is relatively cheap because of the division of labor and specialization.<sup>206</sup>

Rational action in the context of voting requires that voters will not expend more effort and resources in becoming informed than is justified by the returns available.<sup>207</sup> As the process of becoming informed thus becomes a balancing of costs and benefits, free information would be the first type of information sought out—if not truly “free,” it carries an almost nominal cost.<sup>208</sup> If voters could become fully informed through free information, they would unerringly

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<sup>198</sup> See DOWNS, *supra* note 180, at 229–30.

<sup>199</sup> See Kang, *supra* note 179, at 1149.

<sup>200</sup> *Id.* at 1150.

<sup>201</sup> POPKIN, *supra* note 178, at 44.

<sup>202</sup> DOWNS, *supra* note 180, at 230 (“[E]ach consumer gains financially only by sacrificing control over the selection principles behind the information. . . . [T]his sacrifice may completely offset his economic gain.”).

<sup>203</sup> *See id.*

<sup>204</sup> *Id.* at 231. For the delegation of evaluation to be rational, Downs argued that the “evaluative delegator” must determine that the delegated agent has similar goals, more data, and powers of judgment that are good enough to not offset the advantages gained through his possession of superior knowledge. *Id.* at 232.

<sup>205</sup> *Id.* at 231.

<sup>206</sup> *Id.* at 225, 231.

<sup>207</sup> *Id.* at 227–28.

<sup>208</sup> *See id.* at 222.

choose this path, as it would be the most cost-efficient route. Therefore, voters delegate when they cannot become sufficiently informed by free information, implying an inverse relationship between the suitability<sup>209</sup> of free information and the need to delegate.<sup>210</sup>

The nature of free information yields another conclusion: the more complex or esoteric an issue is, the less free information there will be available.<sup>211</sup> Free information generally cannot be about complex issues because the definition of free information necessitates that the information be digestible.<sup>212</sup> Complex issues present “literally incomprehensible problems” to most voters, necessitating delegation.<sup>213</sup> Information about esoteric issues is unlikely to be disseminated by the traditional sources<sup>214</sup> of free information. If a topic is esoteric, it is unlikely to be discussed at a water cooler, talked about on television, or otherwise discussed in avenues in which voters come across free information.<sup>215</sup> It follows, therefore, that for issues that are complex or esoteric, voters are forced to delegate to become sufficiently informed.<sup>216</sup>

While there are still costs associated with delegation—e.g., paying for the expert’s services<sup>217</sup>—the savings are ultimately tremendous and lead to two important conclusions: (1) rational, political action democracy cannot exist

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<sup>209</sup> When talking about the “suitability” of free information, the information must contribute to a voter’s goal of being sufficiently informed for it to count as suitable. *See id.* at 241. For a piece of free information to count as suitable, it must contribute to the voter becoming closer to being fully informed. *See id.* So while there may be many newspaper articles about an issue, if they do not contribute to the voter becoming sufficiently informed, there is a lack of suitable free information, despite the quantity. In this sense, free information can be viewed as points available toward becoming 100% sufficiently informed.

<sup>210</sup> Much of this idea is represented in the literature about information shortcuts and heuristic cues. *See generally* POPKIN, *supra* note 178. For example, Popkin asserted that “[a]t the heart of gut rationality are information shortcuts—easily obtained and used forms of information that serve as ‘second-best’ substitutes for harder-to-obtain kinds of data.” *Id.* at 44.

<sup>211</sup> *See* DOWNS, *supra* note 180, at 230–31.

<sup>212</sup> Free information must be easily understood for it to be free information: if a voter cannot understand the information, there exist transferable costs, which disqualify the information from being free. *See id.* at 222, 230–31.

<sup>213</sup> *Id.* at 230–31.

<sup>214</sup> Traditional sources of free information include: the informal contacts people have with each other, mass media (e.g., newspapers, television, and radio), and entities with a vested interest in the resolution of the issue (e.g., political parties and interest groups). *Id.* at 221–23.

<sup>215</sup> *But see id.* at 222 (noting that esoteric information, such as the President’s Economic Report, can be free information but will have significantly higher nontransferable costs).

<sup>216</sup> *Id.* at 230–31.

<sup>217</sup> The costs for delegation include paying for the analysis and choosing the agent(s) to which to delegate. *Id.* at 231–32.

without the shifting of analysis onto specialists,<sup>218</sup> and (2) it may be rational for a man to delegate all of his political decision making.<sup>219</sup> Delegating in the political process is highly efficient due to the relatively low costs and large gains to be had.<sup>220</sup>

### *B. A Downsian Analysis of Shareholder Voting*

Downs's analysis of the mechanisms of rational, efficient voting can be easily applied to the shareholder voting process, yielding important insights. Chief among these insights is that the need for delegation in the shareholder voting process is even more pronounced, and that the use of proxy advisory firms is highly efficient and fundamental to the beneficial exercise of the shareholder vote. Fundamentally, there is no substantive reason to differentiate between the voting Downs analyzed and the voting done by institutional investors: while the issues voters are confronted with are different, and the mechanisms of the vote are not the same, both democratic voting and shareholder voting involve the collection, analysis, and evaluation of data based on the voters' preferences.<sup>221</sup>

Because there is no salient reason to view voting in a shareholder context differently than voting in a political process, framing shareholder voting through a Downsian framework is highly instructive. Analyzing shareholder voting through the Downsian framework leads to the following conclusions: (1) there is little free information available about the issues that shareholders vote on, making it necessary for institutional investors to delegate almost all aspects of decision making, and (2) the existence and use of proxy advisory firms allow institutional investors to construct a system of information based on delegation that leads to a highly efficient shareholder vote.

#### *1. The Lack of Free Information in Shareholder Voting*

Almost every aspect of shareholder voting points to a need to delegate. The issues on corporate proxies are both esoteric and complex, centered on issues such as: capital structure, auditing, executive compensation, and board composition.<sup>222</sup> Corporate proxies are renowned for their "length and

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<sup>218</sup> *Id.* at 231.

<sup>219</sup> *Id.* at 233.

<sup>220</sup> *Id.* at 231.

<sup>221</sup> The seven steps articulated by Downs should apply to all situations when a person is voting.

<sup>222</sup> DOMINI SOC. INVS., PROXY VOTING GUIDELINES & PROCEDURES 6 (13th ed. 2008), available at <http://www.domini.com/common/pdf/ProxyVotingGuidelines.pdf>.

complexity.”<sup>223</sup> Institutional investors have portfolios consisting of a “multitude” of companies;<sup>224</sup> large institutional investors can face thousands of shareholder meetings a year.<sup>225</sup> As free information is information that can be acquired without delegation,<sup>226</sup> the preceding arguments demonstrate the lack of free information available in shareholder voting.

Furthermore, there are not many analogs of the traditional types of heuristic cues available in democratic voting as in shareholder voting. While director elections contain candidates, there are no voting cues associated with campaign behavior, personal characteristics, and relations with people and groups.<sup>227</sup> There are no political party equivalents that represent bundled ideologies. The only readily available heuristic cue for shareholders is the stock price, which carries with it information concerning the current value of the company and its overall vitality.<sup>228</sup>

Ultimately, though, the information that can be gained from the stock price is materially limited or otherwise insufficient. Critics who argue against shareholder empowerment seize upon the insufficiency of the stock price as an informational cue, arguing that “stock prices are not fully informed because of informational asymmetries enjoyed by managers,” and that stock prices are subject to manipulation and “speculative factors unrelated to fundamental value.”<sup>229</sup> Focus on stock price as an indicator of overall corporate health has been blamed for the scandals of Enron and WorldCom, highlighting its lack of sufficiency as an information provider.<sup>230</sup>

All told, there is a lack of free information available to allow institutional investors to be sufficiently informed when making voting decisions. While

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<sup>223</sup> Bainbridge, *supra* note 2, at 623.

<sup>224</sup> Belinfanti, *supra* note 35, at 409.

<sup>225</sup> For example, BlackRock claimed that it votes at 14,000 shareholder meetings a year—4,000 of which are for companies within the United States. Letter from Abe M. Friedman, Managing Dir., BlackRock, to Elizabeth M. Murphy, Sec’y, U.S. Sec. & Exch. Comm’n (Oct. 29, 2010) [hereinafter BlackRock Letter], available at <http://www.sec.gov/comments/s7-14-10/s71410-254.pdf>.

<sup>226</sup> See *supra* note 196 and accompanying text.

<sup>227</sup> POPKIN, *supra* note 178, at 44.

<sup>228</sup> See generally Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970) (describing an efficient market as one in which prices fully reflect available information).

<sup>229</sup> William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 661 (2010). “[A]s business-policy choices become more complex, the stock price becomes less an objective report on a particular value outcome and more an input for interpretation.” *Id.* at 695.

<sup>230</sup> Strine, *supra* note 1, at 1764. The meltdowns of Enron and WorldCom have often been cited as watershed moments in the rise of institutional activism and proxy advisory firms. See Belinfanti, *supra* note 35, at 392.

some free information is bound to exist, given the sheer amount of information that would need to exist and the complexity of corporate proxy materials, it follows *a priori* and *a fortiori* that there is not enough free information for shareholders to become sufficiently informed. To do so, shareholders must delegate. In practice, shareholders do actually delegate, further suggesting both the inadequate amount of free information available and the need to delegate.

## 2. *Delegation in Downs and Proxy Advisory Firms as a System of Information*

Revisiting Downs, a rational decision maker must create “a system of information acquisition” that: (1) utilizes information that is chosen in accordance with the voter’s selection principles;<sup>231</sup> (2) delivers the relevant information necessary to make the decision;<sup>232</sup> and (3) possesses adequate internal plurality to function as checks on accuracy and deviation from selection principles.<sup>233</sup> Further, a system of information acquisition predicated on delegation must have the following characteristics: (a) the selection principles used by the agent must be aligned with those of the voter; (b) the goals of the agent should be the same as the voter’s; (c) the agent needs to not only have more information than the voter, but the agent’s information must be enough to make the decision;<sup>234</sup> and (d) there must be adequate internal plurality to insure the accuracy of information and selection principles.<sup>235</sup>

The availability and use of customizable voting policies makes it very likely that proxy advisory firms choose information that is in accordance with their clients’ selection principles. In addition to customizable voting policies, the study of Professors Choi, Fisch, and Kahan indicated that there is “heterogeneity among proxy advisors.”<sup>236</sup> Therefore, not only do institutional

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<sup>231</sup> DOWNS, *supra* note 180, at 213, 218 (emphasis omitted).

<sup>232</sup> *Id.*

<sup>233</sup> *Id.* at 218.

<sup>234</sup> *Id.* at 232.

<sup>235</sup> *Id.* at 218.

<sup>236</sup> Choi et al., *supra* note 30, at 696. The authors found that:

Proxy advisors differ significantly from each other in their propensity to issue withhold recommendations, in the factors on which they base their recommendations, in the weight accorded to those factors, in their propensity to issue a greater number of withhold recommendations for persons nominated for multiple board seats, in their proclivity to issue group-based and spillover recommendations, and in their reasons for doing so.

*Id.* For a discussion of some of the issues on which proxy advisory firms differ, see Diamond & Yevmenenko, *supra* note 113, at 609–14. Some of the primary areas of differentiation are: assessing what constitutes an

investors retain the ability to customize voting policies, they can choose firms based on the differences in their “default” position. With regard to point (b) above, proxy advisory firms do not have to actually share the individual goals of their clients; rather, proxy advisory firms must use these goals in modeling their recommendation. A recommendation issued to a client should be based on, and stem from, a consideration of the voting selections in light of the client’s stated preferences.

Whether a proxy advisory firm has more information than its client will vary with every client. For smaller institutional investors that cannot afford to research matters on their own, proxy advisory firms assuredly possess more information. For larger clients that have in-house research teams, this may not be the case. However, this is not necessarily a point against the utility of proxy advisory firms: Downs made clear that this condition only needs to be true when the client is relying on the judgment of the agent.<sup>237</sup> Therefore, if the client relies on the judgment of the proxy advisory firm, the tacit admission is that the proxy advisory firm possesses more information or keener insight.

While the existence of in-house research teams may seem to make proxy advisory firms redundant or obviate the need for hiring more than one firm, this practice satisfies the fourth component of a rational system of information. The fourth component requires that there be sufficient internal plurality within the system of information capable of providing checks on the accuracy of information and the selection principles used.<sup>238</sup> Using independent sources of information allows the client to “check” each source against one another.<sup>239</sup> This is precisely what is done when an institutional investor hires a proxy advisory firm to supplement its in-house research staff or the other proxy advisory firms it may already subscribe to.

As used by large institutional investors, proxy advisory firms satisfy the four conditions of a rational information system built on delegation. Small institutional investors that lack in-house research staffs or cannot afford to subscribe to more than one proxy advisory firm likely lack sufficient internal plurality or, at the very least, cannot police their system of information as robustly as large institutional investors. Despite this, a system of information

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independent director, the use of predetermined metrics in assessing company performance and executive compensation, having a standing policy toward say-on-pay or using case-by-case assessments, and how to incorporate issues of social responsibility. *Id.*

<sup>237</sup> DOWNS, *supra* note 180, at 232.

<sup>238</sup> *Id.* at 218.

<sup>239</sup> *Id.*

predicated on the use of proxy advisory firms is still highly efficient and necessary for institutional investors to rationally cast informed votes on behalf of their clients.

## V. WHAT REGULATION SHOULD LOOK LIKE

When considering possible regulatory frameworks to govern the operation of proxy advisory firms, the SEC should account for the utility of proxy advisory firms as efficient, information-gathering agents. As discussed in Part III, the motivations that underscore the criticisms of the status quo are not merely overstated,<sup>240</sup> but they are actually discredited by how these firms operate and the diversity of services they provide. To this point, proxy advisory firms are analogous to experts used in the democratic voting arena because proxy advisory firms provide customized voting policies that produce recommendations aligned with shareholder preferences and goals. Application of the Downsian framework discussed in Part IV to shareholder voting illustrates the importance of proxy advisory firms to the rational, efficient exercise of the shareholder franchise.<sup>241</sup> In light of these findings, this Part discusses the SEC's recent trend toward overregulation and the potential problems associated therewith. Finally, it proposes regulatory frameworks that can effectively and responsibly deal with the rational concerns regarding the proxy advisory industry.

### A. *The SEC and Regulation*

According to then-professor, now-Commissioner Troy Paredes, the SEC's approach to securities regulation post-Enron has been aligned with what is known as "the precautionary principle."<sup>242</sup> The precautionary principle is an aggressive, prophylactic-minded form of regulation reflecting the SEC's belief "that it is better to be safe than sorry."<sup>243</sup> Precautionary regulatory approaches are more successful at avoiding potential harms but, as a result, are prone to overregulation.<sup>244</sup> The SEC has moved toward the precautionary regulatory approach due to both internal and external factors.

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<sup>240</sup> See *supra* Part III.

<sup>241</sup> See *supra* Part IV.

<sup>242</sup> Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 1006 (internal quotation marks omitted).

<sup>243</sup> *Id.* at 1007.

<sup>244</sup> *Id.*

Inherent in the nature of the SEC are several cognitive biases and behavioral influences that naturally push toward overregulation.<sup>245</sup> For instance, the “availability heuristic,” whereby prominent recent events are more readily available to the mind, causes regulators to “overstate the probability of some bad recent event occurring again in the future.”<sup>246</sup> Given the massive corporate frauds that have occurred lately, the SEC’s natural biases have caused it to irrationally focus much of its decision-making considerations on the costs of not regulating. In this vein, the SEC has overemphasized the magnitude of these costs and overestimated the likelihood that similar frauds or scandals will occur again.<sup>247</sup>

The SEC’s cognitive biases are “exacerbated by the political imperative,”<sup>248</sup> which coupled with increased media scrutiny results in “excessive” regulations.<sup>249</sup> Big scandals and crises cause the SEC to get heaped with blame, while overly stringent regulations bring about only “mild criticism[s].”<sup>250</sup> Knowing that future scandals will lead to similar criticism and embarrassment, the SEC has started an aggressive regulatory campaign.<sup>251</sup>

Compounding the SEC’s tendency to overregulate is the corresponding difficulty to undo regulations: “Regulations are easy to promulgate but difficult to remove.”<sup>252</sup> The same biases and pressures that cause overregulation can lead to continuing the regulations. For instance, the confirmation bias may “prove” that the regulations are working.<sup>253</sup> Generally, while regulators can mitigate overregulation by pulling back on enforcement efforts, overregulation is “infrequently unwound.”<sup>254</sup>

### *B. The Potential Costs of Overregulation*

Determining the right course of regulation is always difficult; there are no bright lines, guideposts, or markers to find the “sweet spot.”<sup>255</sup> The question of

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<sup>245</sup> *Id.* at 1009–10. For a discussion of the biases within the SEC, see Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 20–36 (2003).

<sup>246</sup> Paredes, *supra* note 242, at 1008 (internal quotation marks omitted).

<sup>247</sup> *Id.* at 977.

<sup>248</sup> Choi & Pritchard, *supra* note 245, at 26.

<sup>249</sup> Paredes, *supra* note 242, at 1015.

<sup>250</sup> *Id.* at 1014.

<sup>251</sup> *Id.* at 1011.

<sup>252</sup> Choi & Pritchard, *supra* note 245, at 45.

<sup>253</sup> *Id.*

<sup>254</sup> Paredes, *supra* note 242, at 1019.

<sup>255</sup> *Id.* at 978–79 (internal quotation marks omitted).

proper regulation centers on normative beliefs regarding tolerable risks, combined with assessments of the likelihood of harm and possible benefits.<sup>256</sup> By its nature, an assessment of normative beliefs does not yield a “right answer” to such an inquiry, and, thus, it seems more apropos to discuss the possible consequences of overregulation based on what is known about how institutional investors use proxy advisory firms.

As the GAO report indicated, large institutional investors generally have their own internal research staffs and use proxy advisory firms as information gatherers to supplement and augment their research.<sup>257</sup> In addition to internal research staff, many large institutional investors subscribe to multiple proxy advisory firms.<sup>258</sup> For example, BlackRock subscribes to three firms.<sup>259</sup> The GAO report noted that small institutional investors are more reliant on proxy advisory firms because of their limited resources,<sup>260</sup> and thus are less likely to have internal research staffs or the reports of other proxy advisory firms to compare and check the information and analysis they are provided. It follows then that small institutional investors are more at risk for whatever potential harms exist in regard to proxy advisory firms.

The fact that small institutional investors are the ones most at risk for problems arising from the use of proxy advisory firms is crucial to note, as many of the proposed regulatory frameworks would work to push the costs of regulation first onto proxy advisory firms,<sup>261</sup> and ultimately onto their clients.<sup>262</sup> These costs are far from insignificant and can be expensive.<sup>263</sup> The more expensive proxy advisory services become, the less likely small institutional investors could subscribe to more than one proxy advisory firm to mitigate the influence of any one report using independent sources of information to “check” each source against one another.<sup>264</sup> As small institutional investors lack the resources to develop their own internal proxy research staffs, overregulation could have the perverse effect of harming the most at-risk class of clients.

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<sup>256</sup> *Id.*

<sup>257</sup> GAO REPORT, *supra* note 29, at 16.

<sup>258</sup> *Id.*

<sup>259</sup> BlackRock Letter, *supra* note 225, at 9.

<sup>260</sup> GAO REPORT, *supra* note 29, at 5.

<sup>261</sup> CTR. ON EXEC. COMP., *supra* note 24, at 74.

<sup>262</sup> Glass Lewis Letter, *supra* note 168.

<sup>263</sup> Paredes, *supra* note 242, at 993.

<sup>264</sup> *See supra* note 238 and accompanying text.

In a similar vein, the increased costs of regulation would likely have a greater effect on smaller proxy advisory firms or new competitors.<sup>265</sup> Regulation of the proxy advisory firm industry may simply entrench the market leaders, specifically ISS, which can withstand the increased costs of operation and could potentially screen out new entrants.<sup>266</sup> Given that ISS is already registered with the SEC as an investment adviser under the Advisers Act, regulation centered on forcing all proxy advisory firms to register would likely just aid ISS and harm competition due to the costs of compliance.<sup>267</sup>

The GAO report states that the institutional investors it interviewed believed “that increased competition could help reduce the cost and increase the range of available proxy advisory services.”<sup>268</sup> At present, there is not much competition in the proxy advisory industry; some have called the level of competition “anemic.”<sup>269</sup> However, BlackRock has remarked that the quality of research has improved in recent years, which it attributes to market discipline.<sup>270</sup> Overly costly regulations could possibly harm the ability of institutional investors to “vote with their feet.”<sup>271</sup>

Due to the nature of the proxy advisory industry and how institutional investors use proxy advisory firms, the costs of most of the suggested regulations seem to be ill equipped to ameliorate the concerns voiced by those who want regulation of the industry. Overregulation would likely harm the most at-risk clients of proxy advisory firms, entrench ISS’s position as the market leader, and harm competition. When combined with the findings of Part III (that the fears motivating regulation of proxy advisory firms are overstated), Part IV (that proxy advisory firms are critical to the shareholder franchise), and the SEC’s recent trend toward overregulation, it follows that the regulation of proxy advisory firms should be constructed with much care and designed to ensure the overall health of the industry, “instead of imposing mandatory one-size-fits-all requirements as it almost always does.”<sup>272</sup>

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<sup>265</sup> CTR. ON EXEC. COMP., *supra* note 24, at 74.

<sup>266</sup> *Id.*; Rose, *supra* note 107, at 66.

<sup>267</sup> CTR. ON EXEC. COMP., *supra* note 24, at 63. Writing about the potential issues that would arise from mutual funds registering as investment advisers, then-Professor Paredes stated that a consequence of compliance could be the erecting of barriers that would keep new funds from entering the market. Paredes, *supra* note 242, at 989.

<sup>268</sup> GAO REPORT, *supra* note 29, at 15.

<sup>269</sup> Belinfanti, *supra* note 35, at 411.

<sup>270</sup> BlackRock Letter, *supra* note 225, at 9.

<sup>271</sup> Rose, *supra* note 107, at 65.

<sup>272</sup> Paredes, *supra* note 242, at 1026.

### *C. Proposals and Goals for Regulation*

Regulations for proxy advisory firms should be tailored to complement the role proxy advisory firms play in the shareholder franchise, keeping in mind that costly and overly stringent requirements may ultimately harm those most affected by proxy advisory firms. Reform of the proxy system should therefore address the real problems inherent in the status quo and disregard the phantom issues and uncorroborated rhetoric of critics. Thus, to address the concerns relating to financial conflicts of interest, Congress can amend Rule 14a-2(b)(3) to remove the exclusion for proxy advisory firms, which would require that proxy advisory firms disclose significant relationships with issuers. At the same time, the SEC should provide explicit guidance concerning the fiduciary duties owed by institutional investors to their clients when voting their proxies, particularly addressing the use of proxy advisory recommendations in relation to institutional investors' due diligence and independent judgment obligations. Lastly, and less preferably, Congress may amend the Advisers Act to allow registration by all proxy advisory firms regardless of size, without making registration mandatory. Rather than recommend a stock solution to the concerns at hand—mandatory registration and onerous disclosure requirements—the SEC can use a piecemeal approach to evenhandedly address the rational concerns discussed in this Comment.

#### *1. Amending Rule 14a-2(b)(3)*

Amending Rule 14a-2(b)(3) to mandate that all proxy advisory firms disclose any “significant” relationships with an issuer would yield increased disclosure of potential conflicts of interests without causing significant corresponding costs. Glass Lewis is in favor of this measure, and notes that it is not likely to be so onerous a requirement as to prevent new entrants into the market.<sup>273</sup> This form of regulation would be less costly than registration under the Advisers Act, which would necessarily require more onerous compliance measures without redeemable assurance of results.<sup>274</sup> Also, bearing in mind that ISS continues to receive heavy criticism notwithstanding that it is the only major proxy advisory firm currently registered under the Advisers Act, it stands to argue that forcing all proxy advisory firms to register as investment advisers under the Advisers Act is simply too costly to be reasonably justified. Amending Rule 14a-2(b)(3) to govern proxy advisory firms and address

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<sup>273</sup> Glass Lewis Letter, *supra* note 168.

<sup>274</sup> See *supra* notes 92–95.

hidden or undisclosed conflicts of interest bridges the gap between the status quo and a regime of costly regulation under the Advisers Act.

## 2. *Clarifying Institutional Investors' Fiduciary Duty to Vote in the Best Interests of Their Clients*

By clarifying the fiduciary duty institutional investors have to vote in the best interests of their clients, the SEC can employ a flexible approach that addresses relevant concerns without subjecting proxy advisory firms to costly registration. The guidelines could provide that the mere hiring of a proxy advisory firm is insufficient to satisfy fiduciary obligations, and further that institutional investors must exercise some level of due diligence when subscribing to a proxy advisory firm's voting recommendations. Providing explicit guidelines concerning fiduciary obligations and liability would likely open a dialogue between institutional investors and proxy advisory firms, and it would induce institutional investors to investigate and confirm that the services they are paying for ultimately satisfy their fiduciary obligations and that the recommendations they follow are in the best interest of their clients. While this practice will impose some additional costs on institutional investors, it could be accomplished without forcing proxy advisory firms to provide expensive disclosures mandated under the Advisers Act that may have questionable utility.<sup>275</sup> Pursuant to this, the SEC could then require institutional investors to file an annual statement explaining which firms they have hired, why they hired those firms, and any additional steps that they have taken to ensure that they are voting in their client's best interest.

## 3. *Nonmandatory Advisers Act Registration*

Rather than forcing all proxy advisory firms to register as investment advisers under the Advisers Act, the SEC could amend the Act to allow proxy advisory firms to register without making it mandatory. This would allow institutional investors to pressure unregistered proxy advisory firms to register only if they valued it.<sup>276</sup> This kind of "default rule" allows for flexibility: It lets "parties . . . contract around the law to order their affairs to fit their particular

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<sup>275</sup> Glass Lewis Letter, *supra* note 168 ("[M]any of the requirements for registered investment advisers are not pertinent to proxy advisors and therefore neither the exercise of complying with the registration nor the registration itself would have great utility to institutional investor clients.").

<sup>276</sup> Paredes, *supra* note 242, at 993-94 (noting that because complying with the Advisers Act is costly, registration could show that those who register are more honest).

needs and preferences.”<sup>277</sup> This solution was conceived by Commissioner Paredes in 2006, when hedge funds became the targets of regulatory reform talk, as an alternative to mandatory registration as investment advisers.<sup>278</sup> This is an imperfect solution given the gap between the number of hedge funds, around 8,000 in 2006 when Commissioner Paredes proposed this idea, and the number of proxy advisory firms—there are essentially three broad-based proxy advisory firms in ISS, Glass Lewis, and Egan Jones, and then a few additional niche firms.<sup>279</sup> Coupled with the vast resources of large institutional investors, it is possible that the large institutional investors could push for proxy advisory firms to register under the Advisers Act, as they are in a better position to bear the cost of compliance. The gulf in resources between large institutional investors and small institutional investors could expose small institutional investors who would be more sensitive to a shift in costs. This solution is still preferable to mandatory registration because it allows market factors to influence the decision to register. If institutional investors attach value to the disclosures mandated under the Act—in other words, the disclosures are useful—then proxy advisory firms and new market entrants would register to fulfill their needs. However, given the paucity of firms and the scarcity of competition, this is not particularly desirable because proxy advisory firms would just cater to large institutional investors, leaving small investors—the most at-risk clients—to bear the costs of market influences.

#### *D. Final Thoughts on Regulation*

A combination of amending Rule 14a-2(b)(3) and expounding upon the fiduciary duty of institutional investors is a potential regulatory framework that adequately addresses the conflicts-of-interest issue and clarifies the duties of institutional investors without imposing the significant costs of formal registration under the Advisers Act or the disclosure of the data, reasoning, and methodologies used in formulating voting recommendations. However, this framework should not be read as an exhaustive list of the possible ways by which proxy advisory firms can and should be regulated. An approach that is flexible and mindful of the important role proxy advisory firms play in the shareholder franchise, and one that accounts for the likelihood that overregulation may damage the most sensitive clients of proxy advisory firms,

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<sup>277</sup> *Id.* at 1026.

<sup>278</sup> *See generally id.* at 975 (arguing that the SEC should use default rules instead of mandatory rules to reduce the risk of overregulation).

<sup>279</sup> CTR. ON EXEC. COMP., *supra* note 24, at 28–41.

would likely be satisfactory. The first steps of regulation need not be the final steps; it is always possible to add more regulations in light of new developments or a lack of efficacy of the initial efforts.

#### CONCLUSION

Proxy advisory firms will be overregulated if they are regulated based solely on the views and recommendations of their critics. The concerns of the critics of proxy advisory firms are overstated and distort how proxy advisory firms function and are used by their clients. Proxy advisory firms serve a very important function in facilitating the rational, efficient exercise of the shareholder franchise. In light of this, and considering the SEC's recent tendency to overregulate (and the likely consequences of overregulation), it is crucial for the SEC to fully inform itself of the issues this Comment discusses. The regulatory framework proposed in this Comment has several advantages over the most prominent approaches that have been suggested because it addresses the true issues inherent in the proxy advisory industry and accounts for the utility of proxy advisory firms. In this manner, this framework should successfully provide for federal oversight without imposing burdensome costs.

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