Corporate Governance Oversight and Proxy Advisory Firms

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Executive Summary

The Securities and Exchange Commission requires that investment management funds submit proxy votes for all companies in which they own shares. Due to the vast number of stocks held by the typical institutional investor, hedge fund, or mutual fund, most of these investors draw on the research of a proxy advisory firm, which provides them a modicum of guidance in their task and allows them to focus on managing their portfolio.

But while their clients want to maximize returns for their investors, the objectives of proxy advisory firms may not be completely aligned. The opacity with which they operate makes it difficult for investment management companies – and indeed individual shareholders – to discern the truth.

Proxies have become increasingly contentious in recent years as political activists have leveraged shareholder proposals, determined to pursue their political goals in a variety of ways that circumvent legislation or regulatory activities. Proxy advisors, in turn, have themselves become more political in their support of these shareholder proposals. Accordingly, these

activities have been receiving closer scrutiny – especially from Congress, which is currently debating legislation to increase transparency at proxy advisory firms. The SEC has also declared its concern with political activism in proxy voting and may pursue further action in this area as well.

We place the efforts to regulate proxy advisory firms in the context of other 21st century financial regulatory legislation, explore the moral hazard that exists between investment firms and proxy advisory firms – particularly in regard to robo-voting – and consider each within the context of potential legislative activity.

These days some investors perceive that the growing importance of proxy advisors to investment managers may be problematic, as the number of proxy votes multiply. The worry many have is that political or social agendas that are peripheral – or harmful – to long-run returns may be capturing undue priority, with potentially harmful ramifications for the interests of retail investors and other shareholders focused on value maximization. On such a basis, significant reform of the industry may be necessary

Conflicts of Interest in Proxy Voting

Few individual investors are aware of the role that proxy advisors play in guiding the activities of institutional investors – or that they even exist, for that matter – but as the use of proposals for political advocacy accelerates their role is growing in importance.

Proxy advisors make seemingly neutral recommendations, which are drawn on by investment management companies, so they can decide how to vote on the thousands of annual proxy votes held by the firms in their portfolio. Ordinary-course management proxy items typically include the retention of existing board members, approval of new members, or the ratification of the CEO's pay package. However, companies are

increasingly seeing proposals from shareholders that call on the company to take action on some broader public policy proposal, both major and minor.

Proxy voting is important because institutional investors – pensions, college endowments, and investment management companies – dominate shareholder voting; a recent analysis estimated that institutional investors control as much as 80% of the stock market.[1] The SEC requires that institutional investors vote on corporate proxy matters but permits them to use third-party proxy advisory firms.[2]

These frequently call on the company to take additional actions on environmental and social causes. *The Economist* magazine reported that there were 459 shareholder proposals submitted by early April this year, a high proportion of which concerned climate change, racial and gender diversity, pay, and political spending.[3]

The necessary due diligence required to research all these proposals – either from management or shareholders – is simply not feasible or affordable for any but the largest investment management firms, so investors typically pay for the research of proxy advisory firms to guide how they should vote their shares.

Given the increasing frequency of shareholder proposals that are tangential to the core activities of the company, the recommendations of proxy advisors are becoming more important every year.

There is nothing inherently wrong with companies seeking guidance from a third-party source – the sheer number of proxy items makes it difficult

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[1] Charles McGrath, "80% of Equity Market Owned by Institutional Investors," *Pensions and Investments*, April 2017.
[2] James Copland, David Lacker and Bryan Tayan, "Proxy Advisory Firms: Empirical Evidence and the Case for Reform," *Manhattan Institute Report*, May 2018.

[3] "Proxy Season Kicks off on Wall Street," *The Economist*, April 14, 2018.

for institutional investors to perform this activity themselves. However, three potential problems bedevil the proxy advisory industry.

The first is a lack of transparency on proxy firms' methods and accountability for their recommendations. Proxy advisory firms have become, in some respects, akin to a self-appointed regulatory body, capable of making demands on public companies but without any actual statutory authority.[4]

The second problem is that many in the investment community view proxy advisory firms as neutral arbiters – akin to referees in a sporting event – but they are for-profit enterprises with the potential for conflicts of interest no different than any other professional service or consultant. Without robust oversight or copious disclosure, regular investors may not understand the costs they impose on their investments.

A third problem is a practice called "robo-voting." It is common for investment managers to simply and automatically heed the advice of a proxy advisory firm without giving the recommendations even a cursory review.

The Importance of Proxy Advisor Recommendations

No one could have predicted how powerful proxy advisor firms would become. For instance, financial journalist Michelle Celarier wrote that

> *"that ISS has become the kingmaker in proxy contests between billionaire hedge fund activists and their multi-billion-dollar corporate prey is even more astonishing given that ISS itself is worth less than $1 billion and started out as a back-office support system, helping shareholders cast their ballots on what are typically mundane matters of corporate governance.*

[4] Timothy Doyle, "The Conflicted Role of Proxy Advisors," American Council for Capital Formation Report, 2018.

Says one former ISS executive who now works at a hedge fund: 'ISS sort of stumbled into this powerful role.'"[5]

Its role now is so powerful the company and industry have drawn the attention of Congress. In May 2018, representatives from both Glass Lewis[6] and ISS[7] sent letters to the Senate Banking Committee, which is considering taking up legislation which has already passed the House of Representatives, to address these long-standing concerns about their industry.[8]

Both companies downplay their influence and the weight their recommendations hold, and argue that it is incorrect to paint them as anything but neutral arbiters or "data aggregators" – rather than for-profit influencers with numerous potential conflicts of interest.

Instead, they emphasize that their task is to identify the priorities of their clients – with the client's assistance – in order to help them vote as they would if they had the time and resources to study the issue themselves. The crux of their argument is that if there's any deviation from investment companies maximizing shareholder returns, it's the fault of their clients. The Council of Institutional Investors explained it thusly:

"ISS and Glass Lewis tend to follow investors on governance policy, not lead them... Their franchises are built on credibility with investors. As a result, advisors' views reflect those of many funds. Indeed, if there were a sharp divergence, we would expect to see advisors punished in the marketplace."[9]

Though ISS claims that it plays only a marginal role in impacting the outcome of proxy votes, and that its recommendations only shift the vote

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[5] Michelle Celarier, "The Mysterious Private Company Controlling Corporate America," *Institutional Investor*. Jan. 29, 2018.
[6] Letter from Katherine Rabin, CEO of Glass Lewis, to Senate Banking Committee, June 1, 2018.
[7] Letter from Gary Retelny, CEO of ISS to Senate Banking Committee, May 30, 2018.
[8] Letter from Sens. Dean Heller, Tom Cotton, David Purdue, Mike Rounds, Tim Scott, and Thom Tillis to Gary Retelny, CEO of ISS, May 11, 2018.
[9] Letter from Kenneth Bertsch to House Committee on Financial Services. Council of Institutional Investors. June 13, 2016.

by 6-10%, academic research suggests that the figure is more significant and may be as high as 25%.[10] ISS also has its own consulting arm, ICS Corporate Solutions, which is (somewhat opaquely) described on its website.

ISS also leans heavily on its Registered Investment Advisor status to deflect criticism of its conflicts of interest, the Center on Executive Compensation notes, arguing that proxy advisory work constitutes "investment advice" under the Advisers Act, which would make the company a fiduciary, and subsequently a "a disinterested fiduciary". The description conflicts with Glass Lewis's view in its own response letter, which declares that it neither dispenses "investment advice" nor serves as a fiduciary.

The fact that ISS is registered as a fiduciary, but Glass Lewis is not, suggests a fundamentally different interpretation of their obligations, and breeds confusion and uncertainty as to what the industry is and is not required to do. Given the SEC's ongoing efforts to ensure transparency in the markets and to protect the interests of retail investors through Regulation Best Interest and others, it is possible that this difference of opinion may prove problematic for the Commission.

Glass Lewis tries to distance itself from ISS, in part because (unlike ISS) it does not have a consulting arm, but the firm also fails to offer any substantive, transparent insight into its guidelines and methodologies.

While proxy advisory firms provide advice on standard proxies for well-managed companies, they have in the past regularly failed to identify major problems on the horizon. For instance, immediately prior to the Wells-Fargo scandal involving the creation of fake customer accounts, which revealed a startling lack of management oversight, ISS recommended against removing any of the sitting board members, even

[10] Nadya Malengo & Yao Shen, "The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design," Review of Financial Studies. Dec. 12, 2016.

though most had been in place well beyond a time period normally thought of as prudent.

Similarly, the company recommended a vote against a shareholder proposal to split the president and chairman of the board at Wells Fargo. Its subsequent recommendation to jettison incumbent board members only came well after the scandal came to light.[11]

Efforts to push environmental, socially responsible, and good governance priorities via proxy battles are getting more traction these days: while the total number of votes in 2018 pertinent to such issues fell slightly from 2017 the percentage scoring 50% approval doubled this year to six percent, and the percentage scoring 40% approval went from 12% last year to 19%.

Robo-voting and its Implications

Institutional investors and large financial management companies have come to rely on the services of proxy advisors to help them decide how to vote on various shareholder resolutions. However, there is a moral hazard endemic in that decision-making process.

Certain investors – generally the largest ones – have sufficient personnel and resources to review the analysis and recommendations of their proxy advisors. But for most investment companies it is easier to simply concur without further review if both major proxy advisors make the same recommendation, a process referred to as "robo-voting." The result is an overreliance on the recommendations of potentially understaffed and underqualified proxy advisor analysts.

Robo-voting is most common amongst smaller investors that lack the capacity or appetite to review individual reports and recommendations. Some of these investors have an arrangement with Glass Lewis and ISS that effectively dictates that they will automatically follow the recommendations provided, and that any deviation requires that a case be

[11] Kevin Wack, "Wells Fargo Exec, Board Members Got the Boot," *American Banker,* April 2015.

made to the internal investment committee. The extent to which these firms are effectively signing over their proxy recommendations has led some to question whether this might constitute a breach of fiduciary duty. Some evidence suggests this may very well be the case.

Given the number of clients they have (ISS claims over 1,900 institutional clients, with Glass Lewis approximately 1,300) and the fact that many appear to have such arrangements in place, the two firms have significant influence on final voting outcomes. For example, institutions vote as directed by ISS and Glass Lewis more than 80% of the time, according to a study by The American Council for Capital Formation.[12]

The Transparency Solution

The moral hazard that exists in the relationship between proxy advisers and investment management firms is the result of a government regulation mandating that they vote their proxies, which effectively coerces them into an over-reliance on firms whose influence exceeds their size, resources and statutory authority.

Finding the appropriate action by the government in these matters is not straightforward. Demanding more transparency from firms has long been touted as the solution, but in this situation it be sufficient.

While some have called for the regulatory agencies to examine the issue and consider action, Rep. Sean Duffy (R-WI) and Rep. Gregory Meeks (D-NY) introduced bipartisan legislation[13] that would address many of these issues. The intent of HR 4015 is to enhance transparency in these shareholder proxy systems, requiring proxy advisory firms to register with the SEC. Firms will also have to disclose potential conflicts of interest, codes of ethics, and methodologies for formulating recommendations and

[12] Timothy Doyle. "The Conflicted Role of Proxy Advisors," The American Council for Capital Formation, May 2018.
[13] H.R. 4015, The Corporate Governance Reform and Transparency Act. Introduced by Rep. Sean Duffy (R-WI).

analyses. The House passed the bill in December 2017, but the Senate Banking Committee has not yet considered it, although it held a hearing on the issue in June 2018.

Thomas Quaadman, the Executive Vice President for the Chamber of Commerce Center for Capital Markets Competitiveness, described ISS and Glass-Lewis as "the de facto standard setters for corporate governance in the United States." Given that position, he suggested that both operated with conflicts of interest and a lack of transparency, and alleged that each has made significant errors when developing vote recommendations.[14]

He also suggested that because somewhat politically active institutions – the Ontario Teachers' Pension Plan and the Alberta Investment Management Corporation – own Glass Lewis, it creates an inherent conflict of interest, and pointed out that the company may be able to exploit its influence to advance a broader agenda at the expense of investors.[15]

Darla Stuckey, President and CEO of the Society for Corporate Governance, also refuted the notion that ISS and Glass Lewis have no influence on how clients vote, and described how these firms "own and control the software platforms that send investor votes to the tabulator for a shareholder meeting."[16]

The issue is entirely created by the requirement that financial managers vote their proxies. Given that in the past most have been manifestly uninterested in doing so, and have found the most expedient answer to this requirement to be outsourcing it as much as possible, it is worth asking whether the requirement makes sense in this day and age.

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[14] Statement by Thomas Quaadman, before the Committee on Banking, Housing, and Urban Affairs. Hearing titled "Legislative Proposals to Examine Corporate Governance," June 28, 2018.

[15] "Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms," U.S. Securities and Exchange Commission, June 30, 2014.

[16] Statement by Darla C. Stuckey before the Committee on Banking, Housing, and Urban Affairs. Hearing titled "Legislative Proposals to Examine Corporate Governance," June 28, 2018.

Removing the requirement would likely give individual investors more weight in any proxy vote, which we suggest would be superior to the status quo. Allowing investment managers to vote proxies when and where they choose might make them more engaged in these issues than they currently are, we would suggest.

The Costs of Activism is Borne by Investors

There is a recent precedent for government intervention when a perception develops that investors are being given short shrift.

For instance, in 2015 the Obama Administration called on more stringent rules overseeing investment managers, pointing out that even a small reduction in the long-run return on an investor's portfolio resulting from higher management fees can result in a large reduction in the value of a portfolio over a sustained period of time, and that this reality necessitated closer government scrutiny of the actions of these advisors.[17]

This is particularly relevant giving the conflicts of interest apparent in the situation. Regarding proxy firms' professed neutrality; for instance, the Manhattan Institute's James Copland noted that:

> *"ISS receives a substantial amount of income from labor-union pension funds and socially responsible investing funds, which gives the company an incentive to favor proposals that are backed by these clients. As a result, the behaviors of proxy advisors deviate from concern over share value, [suggesting] that this process may be oriented toward influencing corporate behavior in a manner that generates private returns to a subset of investors while harming the average diversified investor."*[18]

[17] "Middle Class Economics: Strengthening Retirement Security by Cracking Down on Backdoor Payments and Hidden Fees." Fact Sheet released by the Council of Economic Advisers, Feb. 23, 2015.
[18] James Copland, "Politicized Proxy Advisers vs. Individual Investors," *The Wall Street Journal*, Oct. 7, 2012.

The actions of proxy advisors may be imposing a similar cost on investors, we submit. Given their conflicts of interest, shoddy guidance, and lack of certainty, they deserve the same scrutiny as fiduciaries, if not more.

Financial Regulation: Getting It Right

The federal government has painfully learned over the last two decades that effectively regulating corporate governance in financial markets is easier said than done. The pattern of legislative and regulatory action in this realm is best described as a punctuated equilibrium, with most activity taking place in direct response to a perceived change in the market environment.

The 2001 financial collapse of Enron brought the problem of shoddy corporate governance to the attention of Congress. By using accounting loopholes, special purpose entities, and myriad other tricks obscured by deficient financial reporting, the company's executives hid billions in debt and failed deals. It became the largest corporate bankruptcy in U.S. history.

Reacting to this debacle, Congress passed the Sarbanes-Oxley Act in an attempt to prevent similar calamities in the future. While the legislation compelled companies to provide substantially more information to investors, it also increased compliance costs, which in turn reduced the number of Initial Public Offerings (IPOs) on American stock exchanges. That reduction still exists today.[19]

In the aftermath of the 2008-2009 financial market crisis Congress passed Dodd-Frank, a measure intended to prevent a similar disaster from occurring again. Dodd-Frank certainly has some merits: the increase in capital requirements and stricter regulatory oversight likely diminished the odds of another major financial crash – or at least blunt the damage such a crash could inflict.

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[19] Joseph Piotroski and Suraj Srinivasan, "Regulation and Bonding: The Sarbanes-Oxley Act and the Flow of International Listings," *The Journal of Accounting Research*, March 2008.

But the legislation has major downsides as well: by increasing compliance costs for banks, Dodd-Frank has contributed to a marked reduction in banks across the country, with over 1,000 having been acquired or otherwise disappeared since the act's passage.[20] That outcome, many believe, effectively made access to capital more difficult for smaller firms operating in smaller cities and rural communities where community banks tend to dominate the financial market landscape. Because of this, the law may have contributed to the growing economic gap between rural America and the prosperous cities along the coasts.[21]

Again, retail investors were the victim of legislation aimed to help them.

Addressing deficiencies in domestic financial markets in a way that mitigates the long-term economic impact on retail investors requires a measured, focused approach. Too little regulation can leave people out in the cold, while too much could exacerbate inequality, reduce economic growth, and make U.S. capital markets less competitive. The lessons that Congress and regulators have taken from 21st century financial incidents – act sooner rather than later, and do so judiciously but decisively – may apply to the current status of proxy advisers as well.[22]

The potential conflicts of interest, factually inaccurate guidance, and lack of transparency that can arise from a reliance on proxy advisory firms tends to dilute the focus on stock price performance and maximizing returns in favor of other special interests, ultimately hurting investors. Ending the requirement that investment funds vote their proxies would reduce the potential cost of this moral hazard problem.

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[20] Michal Kowalik, Troy Davig, Charles S. Morris, and Kristen Regehr, "Bank Consolidation and Merger Activity Following the Crisis," *Economic Review*, The Federal Reserve Bank of Kansas City, Summer 2015.
[21] Ike Brannon, "Congress Should Help Small Communities by Amending Dodd-Frank," *The American*, Jan. 2015.
[22] Though of course we do not suggest that the actions of proxy advisors represent a risk to financial markets anywhere as dire as the dot-com bubble or the financial crisis.