SECURITIES & EXCHANGE

Corporate Governance Oversight and Proxy Advisory Firms

Do proxy advisors have too much power?

BY IKE BRANNON AND JARED WHITLEY

The Securities and Exchange Commission requires that investment management funds submit proxy votes for all companies in which they own shares. Because of 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 some guidance in their task and allows them to focus on managing their portfolio.

But while their clients want to maximize returns, the objectives of proxy advisory firms may not be completely aligned with that goal. The opacity with which these advisory firms operate makes it difficult for investment management companies—and individual shareholders—to discern that alignment.

Proxies have become increasingly contentious in recent years as political activists have taken to leveraging shareholder proposals to pursue fashionable political goals in a variety of ways. Proxy advisors have themselves become more political in their support of some of these goals. Accordingly, these activities have been receiving closer scrutiny—especially from Congress, which is currently debating legislation to increase transparency at these proxy advisory firms. The SEC has also declared its concern with political activism in proxy voting and may pursue further action in this area.

These days, some investors perceive that the growing importance of proxy advisors to investment managers may be problematic as the number of proxy votes multiplies. The worry many have is that political or social agendas that may be 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

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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.

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 broader public policy proposals, both major and minor.

Proxy advisors are 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. The SEC requires that institutional investors vote on corporate proxy matters but permits them to use recommendations from third-party proxy advisory firms. 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 of this year, a high proportion of which concerned climate change, racial and gender diversity, pay, and political spending. 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 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.

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 in fact, these firms 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 have become. For instance, earlier this year financial journalist Michelle Celarier wrote in *Institutional Investor* about the proxy advisor Institutional Shareholder Services (ISS):

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

ISS's role now is so powerful the company and industry have drawn the attention of Congress. In May 2018, representatives from ISS and another advisory firm, Glass Lewis, sent letters to the Senate Banking Committee, which is considering legislation that has already passed the House of Representatives to address these longstanding concerns about their industry. Both companies downplayed their influence and the weight their recommendations hold, arguing 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.

They emphasized 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. An industry trade group, the Council of Institutional Investors, explained it in a 2016 letter to the House Committee on Financial Services:

> 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.

ISS claims that it plays only a marginal role in affecting the outcome of proxy votes, and that its recommendations only shift the vote by 6–10%. However, academic research suggests that the figure is more significant and may be as high as 25%. ISS also has its own corporate consulting arm, ICS Corporate Solutions, which is (somewhat opaquely) described on its website.

ISS leans heavily on its Registered Investment Advisor status to deflect criticism of its conflicts of interest, notes the Center on Executive Compensation. ISS argues that proxy advisory work constitutes "investment advice" under the Advisors Act, which would make the company a fiduciary and subsequently a "a disinterested fiduciary." This description diverges from Glass Lewis's view of itself in its letter to the Senate Banking Committee, 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 other requirements, it is possible that this difference of opinion may prove problematic.

Glass Lewis tries to distance itself from ISS, in part because (unlike ISS) it does not have a consulting arm. But Glass Lewis 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 the firms they analyze. For instance, immediately prior to the recent 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 though most had been in place well beyond a time period normally considered prudent. Similarly, the company recommended a vote against a shareholder proposal to split the president and chairman of the board. ISS did subsequently recommend jettisoning incumbent board members, but not until well after the scandal came to light.

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 pertinent to such issues have fallen slightly this year from 2017, the percentage scoring 50% approval doubled this year to 6% 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 among 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 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.

Given the number of clients they have (ISS claims over 1,900 institutional clients and 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.

THE TRANSPARENCY SOLUTION

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

Rep. Sean Duffy (R–WI) and Rep. Gregory Meeks (D–NY) introduced bipartisan legislation that would address many of these issues. The intent of HR 4015 is to enhance transparency in shareholder proxy systems, requiring proxy advisory firms to register with the SEC. Firms would also have to disclose potential conflicts of interest, codes of ethics, and methodologies for formulating recommendations and 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.

In testimony at that hearing, Thomas Quaadman, 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 suggests that both operate with conflicts of interest and a lack of transparency. He further alleges that each has made significant errors when developing vote recommendations. He also suggests that because Glass Lewis is owned by two somewhat politically active institutions—the Ontario Teachers' Pension Plan and the Alberta Investment Management Corporation—it creates an inherent conflict of interest. Quaadman pointed out that the company may be able to exploit its influence to advance a broader agenda at the expense of investors.

At the same hearing, 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. She described how these firms "own and control the software platforms that send investor votes to the tabulator for a shareholder meeting."

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. 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.

THE COSTS OF ACTIVISM ARE BORNE BY INVESTORS

There is recent precedent for government intervention when a perception develops that investors are being given short shrift. In 2015 the Obama administration called for more stringent rules overseeing investment managers. The administration pointed 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. This reality, according to the administration, necessitated closer government scrutiny of the actions of these advisors.

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

> 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.

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 on American stock exchanges. That reduction still exists today.

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 diminish the odds of another major financial crash or at least blunt the damage such a crash could inflict. 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. (See "Banking," p. 77.) 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.

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

Addressing deficiencies in domestic financial markets in a way that mitigates the long-term economic effect 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 advisors as well.

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

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