Regulations on Proxy Advisory Firms

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Abstract: Institutional investors often hold the shares of hundreds or thousands of companies in their portfolio and may not be able to afford the time and resources to cast each vote, choosing to outsource to proxy advisory firms. These firms have grown to become significant players in the investment landscape, influencing the voting of large passive funds. Moreover, proxy advisory forms have problematic business models with conflicting interests. Consequently, certain SEC reforms in 2019 are encouraged, particularly increasing greater transparency around policy guidelines behind proxy advice recommendation and increasing disclosure of conflicts of interests. Nonetheless, certain SEC proposals are too restrictive. The mandatory review periods for companies in an already time-stretched proxy season serves to undermine rather than enhance the independence and quality of advice to investors.

Introduction to the Factual Background

Exercising shareholder votes is a critical component of corporate governance to ensure executives act in shareholders' best interest. However, institutional owners such as mutual funds have changed the equity markets landscape by holding small stakes in thousands of companies. The shift towards passive funds holding a diversified basket of securities is also accompanied by increasing complexity and number of corporate ballot issues. Consequently, investment advisers have contracted with proxy advisory firms. These proxy advisory firms have attracted criticisms due to robo-voting concerns and potential conflicts of interest. Consequently, the U.S. Securities and Exchange Commission ("SEC") has made statements and rules regulating the provision of proxy advice in 2019, starting with their August guidance expanding the applicability of proxy rules. Institutional Shareholder Services ("ISS") followed up with filing a lawsuit to stop the SEC. Days later in November, the SEC proposed amendments to federal proxy rules, with comments due in February 2020.

1.1. What is Proxy Voting

Proxy voting is the means by which shareholders can register their decisions on important corporate issues. Funds engage in the proxy voting process on behalf on their clients, and often discharge their proxy voting responsibilities through retaining proxy advisory firms. Proxy advisory firms conduct analyses on various issues including providing advice on how to vote on proposals at upcoming meetings. These firms also provide research and analysis on proxy matters to be considered for shareholder elections at upcoming meetings. Two firms dominate proxy advisory services: ISS and Glass, Lewis & Co ("Glass Lewis"). Together the firms comprise 97% of market share.[1] Proxy advisory services can be contracted for two main services: voting platform and research, covering administration, information compilation, execution of proxies, and preparing research reports.

2. Rise of Institutional Ownership and Proxy Advisory Firms

The US markets have undergone significant change. Institutional investors have surpassed retail investors as the largest owners of equity markets, representing as much of 80% market value of public companies. Large asset managers, including mutual funds, such as Blackrock, Vanguard and State Street constitute the single largest shareholder of at least 40% of all US public companies, and nearly 90% of S&P 500.[2] Index funds are the largest shareholder of nearly 40% of S&P 500 companies,[3] and have proliferated due to diversification benefits at low cost. These asset managers have significant clout in influencing corporate elections and other important shareholder meetings. However, their stewardship is questioned. Blackrock, Vanguard and State Street have zero engagement with about 90% of portfolio companies, not engaging in a single meeting.[4] Yet in 2017, the average mutual fund voted on 1,504 separate proxy proposals.[5]

Several SEC regulations have also inadvertently aided the rise of proxy advisory firms. In 2003, the SEC stated that the vote was not a conflict of interest if it was voted in accordance with a predetermined policy based upon the recommendations of an independent third party. This was construed as a mandatory duty with passive institutional investors voting in nearly every shareholder election due to their mistaken understanding of their obligations. Investment advisers saw proxy advisory firms as almost an insurance policy against breaching its fiduciary duty to its clients. These firms are overseen by the Investment Advisers Act of 1940

1 Glassman, James K. and J. W. Verret. "How To Fix Our Broken Proxy Advisory System." (2013). *Mercatus Center.* https://www.mercatus.org/system/files/Glassman_ProxyAdvisorySystem_04152013.pdf.

2 Strine, Leo E. Jr., "Fiduciary Blind Spot: The Failure of Institutional Investors to Prevent the Illegitimate Use of Working Americans' Savings for Corporate Political Spending" (2018). *Faculty Scholarship at Penn Law*. 2036. https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=3038&context=faculty_scholarship.

3 John Morley, "Too Big to Be Activist" (2019). *Southern California Law Review* . 1407. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3225555.

4 *Supra* note 2, 48.

5 Paul Schott Stevens, Investment Company Institute, letter to Mr. Brent J. Fields re Roundtable on the Proxy Process (November 14, 2018). Available: https://www.ici.org/pdf/18_proxy_rountable_ltr.pdf.

("Advisers Act") and owe fiduciary duties of care and loyalty in providing proxy services.

3. Rise in Criticisms of Proxy Voting

The SEC has become increasingly concerned about the proliferation of proxy voting. The issue is particularly important as retail investors own around two-thirds of Russell 10000 companies through mutual funds or pensions.[6] With the growing influence of asset managers and proxy advisory firms on voting outcomes, including "proposals pursuing an environmental, social or political agenda" with "little or nothing to do with a company's financial performance or shareholder value", the SEC renewed its scrutiny.[7] In 2019, the SEC issued new statements regarding the proxy voting process. Notable is its August guidance and its November statements.

4. SEC August Guidance and Interpretation (August 21, 2019)

On 21 August 2019, the SEC provided interpretation and guidance regarding certain rules governing proxy voting advice (the "federal proxy rules") under Section 14 of the Securities Exchange Act of 1934 (the "Exchange Act"). The interpretation and related guidance relate to the applicability of already existing Rules 14a-1 and 14a-9 under the Exchange Act and is part of the SEC's broader review of the proxy process. First, the SEC confirmed recommendations by proxy advisors as generally solicitations falling under the SEC's proxy rules.[8] Second, the SEC affirmed investment advisors have fiduciary obligations when voting proxies for clients, including when relying on proxy advisory services.

4.1. Solicitation: Rule 14a-1

The SEC plans to oversee all proxy voting advice provided to investors through its powers to regulate "proxy *solicitation*" under Section 14(a) of the Exchange Act. Proxy solicitation may be engaged by proponents or opponents of a ballot measure to garner support or opposition to that measure. State law governs rights of shareholders to vote whilst the SEC regulates voting by *proxy*. The August guidance confirms the SEC's perspective of generally categorising the furnishing of proxy

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[6] Senator Mike Crapo Crapo Statement at Hearing on Proxy Process and Rules (December 6, 2018) (referring to United States Senate Committee on Banking, Housing, and Urban Affairs, Hearings, Full Committee Hearing, Proxy Process and Rules: Examining Current Practices and Potential Changes. Available: https://www.banking.senate.gov/imo/media/doc/Crapo%20Statement%2012-6-18.pdf.)

[7] *Supra* note 5.

[8] Commissioner Elad Roisman, Statement at the Open Meeting: Modernizing SEC Rules Governing Proxy Voting Advice (November 5, 2019). Available: https://www.sec.gov/news/public-statement/statement-roisman-2019-11-05-14a-2b.

voting advice by a proxy advisory firm as a "solicitation" falling under the federal proxy rules. The Exchange Act 14a-1(1) regards "solicitation" as a broad term and includes "communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy". The SEC's broad construction of "solicitation" combined with its authority to establish rules surrounding solicitation is said to be combined for the protection of investors and public interest.

A communication is a solicitation if the purpose of the communication is to influence the shareholders' decisions through the substance of the communication and circumstances of its publication. The SEC believes the communication is invited, that is "solicited" by proxy advisory firms since they have marketed their expertise in assisting clients with making proxy voting determinations.

4.2. Solicitation: Rule 14a-9

The SEC confirmed that Exchange Act Rule 14a-9 applies to proxy voting advice. Under Exchange Act Rule 14a-9, any solicitation is prohibited "from containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact". Moreover, the solicitation must not omit any material fact necessary to make the statements not false or misleading. To comply with this rule, proxy advisory firms must disclose: (i) the methodology underlying its voting advice; (ii) information sources other than public disclosures by the registrant; and (iii) material conflicts of interest arising from providing the proxy service in reasonably enough detail for the client to evaluate.

5. ISS files lawsuit (October 31, 2019)

ISS filed a lawsuit on 31 October 2019 in response to the release of the August guidance. Founded in 1985, ISS helps institutional investors making voting decisions, manages the process for voting, and report votes to stakeholders. ISS claims around 60% of the market share and is responsible for over 44,000 shareholder meetings world-wide in over 110 markets, covering over 20,000 companies globally. The following are some criticisms voiced about ISS:

(1) Conflict of Interest: ISS's solutions have ventured beyond its proxy services to include investing data and analytics, ratings,[9] and consulting[10] services. Its most criticised business is its consulting services called Governance Advisory Services which rates companies whilst offering

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[9] Timothy M. Doyle, American Council for Capital Formation, The Conflicted Role of Proxy Advisors at 11 (May 2018). Available: https://accfcorpgov.org/wp-content/uploads/2018/05/ACCF_The-Conflicted-Role-of-Proxy-Advisors.pdf.

[10] *Supra* note 9, 12.

consulting services to change the rating or voting recommendation.[11] As a for-profit enterprise, its incentives may be misaligned depending on the fees paid by customers, and their policies could be subject to alteration for the sake of increasing profits for its consulting businesses.

(2) **Error-prone and robo-voting:** Reports indicate ISS outsources in order to fulfil the proxy season workload. Consequently, it is prone to errors. SEC Commissioner Daniel M. Gallagher cited a survey in which almost all 20 surveyed companies recorded factual errors made in reports by proxy advisory firms.[12] This is concerning should robo-voting be practiced by the investment managers. Small and mid-cap companies are particularly vulnerable as the corporate governance teams of investment funds would prioritise evaluating the shareholder ballots of larger companies. The American Council for Capital Formation ("ACCF") found that 175 asset managers with more than $5 trillion in assets under management voted with ISS on management and shareholder proposals 95% of the time.[13]

(3) **Lack of transparency in policy guidelines**: Both ISS and Glass Lewis develop benchmark policy guidelines for their recommendations. This could depend on the country or region, as well as covering niche regulations. ISS states its policies are based on roundtable feedback from market participants, including institutional investors. However, ISS does not disclose the parties or the feedback itself. Glass Lewis also has the same approach. Whilst both parties recognise the problematic nature by highlighting their internal disclosure and conflict of interest policies, minimal action has been taken to meaningfully address these issues.

6. Implications for ISS

As per its civil complaint, the ISS identifies the August guidance would "incur concrete and particularized harm" from the release in two ways: (i) the new interpretations will subject ISS to all proxy *solicitation* regulations unless it can demonstrate an applicable exemption, increasing compliance costs; and (ii) proxy voting would be subject to Rule 14a-9 which can be enforced by either the SEC or private parties including the issuers disagreeing with ISS's opinions or recommendations, opening the window for lawsuits.

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11 Governance Advisory Services, ISS. https://www.issgovernance.com/solutions/governance-advisory-services/

12 Daniel M. Gallagher, Testimony Before the United States Senate Committee on Banking, Housing and Urban Affairs (December 2018). Available: https://www.banking.senate.gov/imo/media/doc/Gallagher%20Testimony%2012-6-18.pdf.

13 *Supra* note 9.

ISS argues that unlike a person or firm engaged in proxy solicitation, a firm providing proxy advice is disinterested with respect to the ultimate outcome of a shareholder vote, emphasising the difference between proxy *solicitation* and proxy *advice*. ISS contends that proxy solicitations are specialists hired to gather and secure votes,[14] and are distinguished from proxy advisers hired to provide advice and recommendations.

7. SEC November Proposals (November 5, 2019)

On 5 November 2019, SEC voted 3-2 to put forward two proposals impacting proxy advisory firms. The proposals impose stronger conditions on the exemptions which the firms relied on to defer their disclosure and filing requirements as per SEC's proxy rules. The SEC's objective is to ensure that investors and others who vote on investors' behalf have information that is accurate, transparent, and materially complete. The proposals demand stronger disclosure of material conflicts of interests, standardise review of proxy process, and improve mechanisms for investors to be aware of proxy advice. It codifies the August guidance that proxy voting advice would be "proxy solicitations". The proposed rules would have three implications:[15]

- Proxy advisory firms provide an opportunity for the companies to comment on recommendations before they are distributed for shareholder votes;
- Proxy advisory firms must include a hyperlink to a company statement responding to the firm's recommendations; and
- Proxy advisory firms must disclose conflicts of interest on their advice and are strongly urged to disclose its methodology and information sources.

7.1. Mandatory Interaction between Proxy Advisory Firms and Companies

Under the Exchange Act, proxy advisory firms engaging in proxy "solicitation" must follow disclosure and filing requirements pursuant to SEC's proxy rules. However, proxy advisory firms can rely on two exemptions from the proxy rules as under paragraphs (b)(1) and (b)(3) of Rule 14a-2. The SEC seeks to add new conditions to these exemptions, requiring more interactions between the proxy

14 United States Government Accountability Office, Corporate Shareholder Meetings, Proxy Advisory Firms' Role in Voting and Corporate Governance Practices, Report to the Chairman, Subcommittee on Economic Policy, Committee on Banking, Housing, and Urban Affairs, U.S. Senate (November 2016) ("2016 GAO Report") at 6.

15 Grabar, et al. *Proxy Advisory Firms - The SEC Drops the Other Shoe* (2019). Cleary Gottlieb Steen & Hamilton LLP. Available: https://corpgov.law.harvard.edu/2019/11/25/proxy-advisory-firms-the-sec-drops-the-other-shoe/#6b].

advisory firms and the companies before handing over its voting recommendations. This would cover:

- Review and feedback: proxy advisory firm must provide a copy of its advice to companies;
- Final notice of voting advice: proxy advisory firm must provide a copy of its final advice (after revisions from review and feedback period) two business days before client distribution;
- Company statement: proxy advisory firm must include the company's statement about the proxy voting advice (if any) through a hyperlink in the proxy voting advice, and file the company's statement as solicitation material; and
- Confidentiality agreement: proxy advisory firm can have a confidentiality agreement with the company about its voting advice prior to client distribution.

This proposal represents a deviation from current practices. ISS provides S&P 500 companies with a brief period (usually 48 hours or less) to review its proxy voting advice whilst Glass Lewis charges for the preview.[16] Mechanisms for reviewing advice and then incorporating the feedback is not adequate. Hence the proposal seeks to provide companies with the opportunity to correct errors and is backed up by the antifraud provisions of Rule 14a-9.

7.2. Disclosures in Proxy Voting Advice

The SEC's proposal imposes obligations on the content of the voting advice. First, firms must disclose conflicts of interests or material transactions or relationships between the firm (and its affiliate) and the company. Second, the SEC proposes providing examples of omissions which may be considered as "misleading" and would be added to a note to Rule 14a-9. Consequently, ISS would be required to explicitly state whether the company has engaged its Corporate Solutions business should ISS be also providing proxy voting advice.

8. Issues with the Assumptions Underpinning the SEC's New Policy

8.1. Mandatory Interaction

First, there is insufficient data to support the error rate in proxy advice.[17] SEC Commissioner Allisson Herren Lee argues that management voting

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[16] *Supra* note 15.

[17] Commissioner Allison Herren Lee, Statement on Shareholder Rights (November 5, 2019). Available: https://www.sec.gov/news/public-statement/statement-lee-2019-11-05-shareholder-rights#_ftnref4

recommendations prevail 90% of the time,[18] and that the first proposal mandating two review periods of proxy adviser recommendations would undermine the reliability and independence of proxy adviser recommendations. The Council of Institutional Investors ("CII") contend that the systemic factual errors in proxy advice is not evidentially grounded and cannot be verified or was due to methodological differences.[19] Whilst funds often vote with management on management proposals, funds are more likely to differ with respect to shareholder proposals. Funds voted in support on shareholder proposals nearly 35% of the time compared with ISS's support of nearly 65% of shareholder proposals.[20] This highlights that funds are largely independent of recommendations. Accordingly, ISS claims to provide "different recommendations to different clients about the same vote".[21]

Second, greater involvement by companies would not necessarily improve proxy voting advice. Instead, Lee argues that issuers' involvement in proxy advisory firms should be limited to verification of facts. Otherwise this would influence the independence of their recommendations and is contrary to the position taken by existing regulations governing stock analysts.[22] Proxy advisory firms' influence on shareholder voting is heavily overstated, with most pension funds and institutional investors voting according to their own guidelines and policies. The mandatory review periods would increase costs, undercut independence and hinder the ability of proxy advisers to deliver timely advice. The proposals would leave a total of four workdays for proxy advisory firms to conduct research and complete the recommendation.[23] Shorter timeframes and harsher regulations would not be conducive to improved proxy advisory recommendations.

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18 Letter from Institutional Shareholder Services, Inc. (Aug 16, 2019). Available: https://www.issgovernance.com/file/duediligence/20190816-iss-roundtable-comment-letter.pdf

19 CII Fact Sheet on Proxy Advisory Firms and Shareholder Proposals (November 5, 2019). Available: https://www.cii.org/files/about_us/press_releases/2019/11-05-19%20CII%20Fact%20Sheet%20on%20Proxy%20Advisory%20Firms%20and%20Shareholder%20Proposals.pdf.

20 *Supra* note 4, 10.

21 *Supra* note 21.

22 FINRA Rule 2241. Available: https://www.cii.org/files/about_us/press_releases/2019/11-05-19%20CII%20Fact%20Sheet%20on%20Proxy%20Advisory%20Firms%20and%20Shareholder%20Proposals.pdf.

23 *Supra* note 17.

8.2. Disclosure in Proxy Voting Advice

Nonetheless, the disclosure of conflict of interests is in in accordance with the objective of enhanced transparency. Considering ISS's service offerings, the new proposal would serve to mitigate and address concerns of conflicts of interests.

9. Changes to Proxy Advice Landscape and Moving Forward

There are concerns that the new proposals would shift power from shareholders to management, shielding executives from accountability.[24] Proxy advisory firms voting against executives must provide their report first. Issuers can review and include their thoughts about the advisory's firm conclusions in the final reports. Imposing these obligations on anti-management advice would tilt the power of corporate voting towards management.

Studies into the existing competition in the proxy advisory landscape propose reforms that would enhance the quality and competitive forces in the proxy advisory businesses. It is suggested that competition would alleviate conflicts of interests in proxy advisory industry.[25] Feedback following the 60 days public comment period will shed more perspectives from impacted players on this issue.

10. Conclusion

Proxy advisory firms hold great influence over voting on corporate issues. It follows that they must be scrutinised for any lack of transparency and conflicts of interest. Nonetheless whilst stronger disclosure is necessary for better protection of investors, the stringent mandatory review periods may serve to undercut the quality and independence of the proxy voting advice. SEC reforms are a step in the right direction but need to be receptive to the feedback of investment funds and proxy advisory firms to generate any meaningful improvement for shareholders' corporate governance.

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[24] Commissioner Robert J. Jackson Jr., Statement on Proposals to Restrict Shareholder Voting (November 5, 2019). Available: https://www.sec.gov/news/public-statement/statement-jackson-2019-11-05-open-meeting.

[25] Li, Tao. "Outsourcing Corporate Governance: Conflicts of Interest Within the Proxy Advisory Industry" (2016). 64 *Management Science*. 2951. Available: http://ssrn.com/abstract=2828690.