
NOTE

ISS AND OTHER PROXY ADVISORY FIRMS' CONFLICTS OF INTEREST: ANALYZING THE INSUFFICIENCY OF NEW SECURITIES AND EXCHANGE COMMISSION RULES AND GUIDANCE

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This Note discusses the impact of conflicts of interest on the proxy advisory firm industry, with a particular focus on conflicts plaguing Institutional Shareholder Services, the dominant proxy advisory firm. The increased proportion of shares held by institutional investors, strong reliance on voting recommendations by certain investment advisors and continuing dominance of Institutional Shareholder Services have culminated in Institutional Shareholder Services' substantial influence in proxy voting. The lack of sufficient regulatory oversight has precipitated considerable risk of proxy voting that serves the best interest of proxy advisory firms rather than that of shareholders. Recent rules and guidance issued by the Securities and Exchange Commission have not adequately addressed these concerns. Several possible reforms may help this situation, including eliminating robo-voting, separating voting advice and corporate governance consulting services and mandating engagement in voting research beyond that provided by proxy advisory firms. Pursuing these avenues of reform could help restore the integrity of voting recommendations and ensure that proxy advisory firms are used in the way they were initially intended: to reduce

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information costs and help investment advisors vote shares in their clients' best interests.

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I. INTRODUCTION

Throughout the history of the United States, voters have sought to use their influence to ensure that their representatives pursue policies that align with their interests. Whether the vote is for a small town's city council, the President of the United States or a corporation's board of directors, the collective action problem disincentivizes stakeholders from exerting the time and resources necessary

for casting an informed vote.¹ A common solution, naturally, has been to decrease voters' information costs.² For political matters, voters often circumvent the need to independently research every candidate and ballot proposition by using heuristics such as endorsements by their preferred political parties.³ While voters can thus more easily engage in their civic duty, this ease comes at the cost of accuracy because endorsements will not be tailored to a voter's particular preferences and idiosyncrasies and may also stem from conflicts of interest and biases that the endorsers have not disclosed to the voter.⁴ Fortunately, voters can also use endorsements as a baseline and conduct additional independent research to determine the proper votes to cast.

In a similar vein, institutional investors face the challenge of gathering sufficient information to vote on an array of proxies for their voluminous holdings. While institutional investors seeking to fulfill their fiduciary duties, unlike the majority of voters in the political context, have only one overarching policy of interest—achieving high rates of returns for investors—the proper strategies for achieving this end are often unclear and vary by sector and company. Like political party endorsements, proxy advisory firms have filled the need for more inexpensive information. These firms' growing influence has led the Securities and Exchange Commission (SEC, or "Commission") to promulgate additional regulations aimed at ensuring that investment advisors use these firms'

¹ Even in the context of shareholder voting, there are different iterations of the collective action problem. See Bernard S. Sharfman, *The Risks and Rewards of Shareholder Voting*, 73 SMU L. REV. 849, 854 (2020) (describing different views of the collective action problem within the context of shareholder voting). Frank Easterbrook and Daniel Fischel presented an apt description: "When many are entitled to vote, none of the voters expects his votes to decide the contest. Consequently none of the voters has the appropriate incentive at the margin to study the firm's affairs and vote intelligently." Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 402 (1983) (footnote omitted).

² See Sharfman, *supra* note 1, at 855–56.

³ See, e.g., Rachel Bernhard & Sean Freeder, *The More You Know: Voter Heuristics and Information Search*, 42 POL. BEHAVIOR 603, 604 (2020).

⁴ See, e.g. *id.*

recommendations in a manner consistent with their fiduciary duties.⁵

This Note argues that the rules and guidance issued by the Securities and Exchange Commission in Exemptions from the Proxy Rules for Proxy Voting Advice,⁶ Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers⁷ and the Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers⁸ are insufficient to ensure that investment advisors' use of proxy advisory firms allows them to consistently vote proxies in a manner reasonably designed to maximize shareholder value. Part II discusses the proxy advisory firm market, its history, and its prior regulatory framework. Part III discusses two prominent conflicts of interest in the proxy advisory firm market, along with the increased risks posed by automated voting. It then scrutinizes the Commission's July 2020 regulations and guidance, demonstrating that while they serve as a step in the right direction, substantial shortcomings remain. Part IV discusses potential solutions, emphasizing the importance of employing a cost-benefit analysis in developing reforms.

II. BACKGROUND ON PROXY ADVISORY FIRMS

A. The Rise of the Proxy Advisory Firm Market

Institutional investors contract with proxy advisory firms to procure proxy research, analyses and recommendations, and to manage the logistics of exercising their voting rights.

⁵ See Exemptions from the Proxy Rules for Proxy Voting Advice, Exchange Act Release No. 89,372, 85 Fed. Reg. 55,082, 55,082, 55,085–86, 55,0124–25 (Sept. 3, 2020) (to be codified at 17 C.F.R. pt. 240).

⁶ *Id.*

⁷ Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Investment Company Act Release No. 33,605, 84 Fed. Reg. 47,420 (Sept. 10, 2019).

⁸ Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, 85 Fed. Reg. 55,155 (Sept. 3, 2020).

Founded in 1985⁹ and now controlled by Deutsche Börse Group, “an international exchange organization and market infrastructure provider,”¹⁰ Institutional Shareholder Services (ISS) successfully filled the expanding need for proxy advisory services and became a dominant force in the industry. After several decades of growth, ISS now has “2,200 employees operat[ing] worldwide across 29 global locations in 15 countries.”¹¹

With the rise in shareholder activism and increased scrutiny of public companies’ corporate governance practices throughout the 1990s and early 2000s, the proxy advisory market continued to expand.¹² In 2003, the Commission adopted new rules pursuant to the Investment Advisers Act of 1940,¹³ requiring investment advisors to create policies reasonably designed to ensure that they vote proxies of their shares in the best interests of their clients.¹⁴ These rules further increased both demand for these firms and their influence with institutional investors.¹⁵ Responding to the increased demand, Glass, Lewis & Co. (“Glass Lewis”),

⁹ See *About ISS*, ISS, <https://www.issgovernance.com/about/about-iss/#1570776311994-db534a1e-7bb2> [<https://perma.cc/GWC8-JHM3>] (last visited Nov. 16, 2021).

¹⁰ See *Genstar Capital Sells ISS for \$2.275 Billion to Deutsche Börse*, WILLKIE, FARR & GALLAHER, LLP (Nov. 17, 2020), <https://www.willkie.com/news/2020/11/genstar-capital-sells-iss-to-deutsche-borse> [<https://perma.cc/GWC8-JHM3>].

¹¹ See *About ISS*, *supra* note 9.

¹² U.S. GOV’T ACCOUNTABILITY OFF., GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 7 (2007) (“According to industry experts, ISS’s reputation and dominance in the proxy advisory industry continued to grow in the 1990s and early 2000s, fueled by the growing fiduciary requirements of institutional investors and increased shareholder activism.”).

¹³ 15 U.S.C. §§ 80b-1 to 80b-21 (2018).

¹⁴ Proxy Voting, 17 C.F.R. § 275.206(4)–6 (2021) (stating that registered investment advisers’ execution of voting authority with respect clients’ securities will be considered fraudulent, unless they “[a]dopt and implement written policies and procedures that are reasonably designed to ensure that [they] vote client securities in the best interest of clients[.]”).

¹⁵ *Id.*

recently acquired by Peloton Capital Management and previously owned by the Ontario Teachers' Pension Plan Board and the Alberta Investment Management Corp.,¹⁶ joined the market in 2003.¹⁷ The company has grown rapidly over the past two decades to become ISS's largest competitor.¹⁸

B. Proxy Advisory Firm Services, Market Concentration and Influence

At annual and special shareholder meetings, shareholders vote on various matters that can impact the value of their shares, including voting for or against directors, certain shareholder proposals and takeover offers. Proxy advisory firms, such as ISS and Glass Lewis, primarily service institutional public equity investors, who own shares in an array of corporations. Both companies provide corporate governance research and recommendations, proxy voting advice and proxy voting and distribution services.¹⁹ ISS also provides environmental, social and governance (ESG) ratings and rankings through its ISS Governance QualityScore

¹⁶ See Press Release, Glass Lewis, Peloton Cap. Mgmt. & Stephen Smith Acquire Class Lewis (Mar. 16, 2021), <https://www.glasslewis.com/press-release-peloton-capital-management-and-stephen-smith-acquire-glass-lewis/> [<https://perma.cc/8A27-PXJJ>].

¹⁷ *Company Overview*, GLASS LEWIS, <https://www.glasslewis.com/company-overview/> [<https://perma.cc/8W4E-XZBE>] (last visited Nov. 16, 2021).

¹⁸ See U.S. GOV'T ACCOUNTABILITY OFF., GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 7, 13 (2007).

¹⁹ See *About ISS*, *supra* note 9 ("Governance offerings include objective governance research and recommendations, and end-to-end proxy voting solutions . . . ISS covers approximately 45,000 meetings in 115 markets yearly, delivering proxy research and vote recommendations while working closely with clients to execute more than 12.2 million ballots representing 3.9 trillion shares."); Press Release, Glass Lewis, *supra* note 16 ("We are a trusted ally of more than 1,200 investors globally who use our high-quality, unbiased Proxy Paper research, and industry-leading Viewpoint proxy vote management solution to help drive value across all their governance activities.").

(GQS).²⁰ GQS “uses a numeric, decile-based score that indicates a company’s governance risk across four categories:” board structure, compensation/remuneration, shareholder rights and takeover defenses and audit and risk oversight.²¹ Through ISS Corporate Solutions (ICS), a separate business unit of ISS, the company also “helps corporate clients develop proposals to be voted on and offers corporate governance consulting services to help clients understand and improve their corporate governance ratings.”²² ISS maintains that it has established a firewall “between the core institutional business and the ICS business”²³ and that “[n]ot only does the firewall create a separation between ISS’s analysts and ICS, but the day-to-day operations of the two groups are separately managed by dedicated staff and the compensation of ISS’s analysts is not directly tied to any activities of ICS.”²⁴ The overall effectiveness of the firewall between ISS and ICS remains unclear.²⁵

The proxy advisory market has remained extremely concentrated, with a 2007 Government Accountability Office (GAO) study indicating that ISS (61% market share) and Glass Lewis (36% market share) collectively control

²⁰ *Governance QualityScore*, ISS, <https://www.issgovernance.com/esg/ratings/governance-qualityscore/> (last visited Nov. 16, 2021) [<https://perma.cc/CC96-HLDX>].

²¹ *Id.*

²² U.S. GOV’T ACCOUNTABILITY OFF., GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 10 (2007); *see also The ICS Story*, ISS CORP. SOLS., <https://www.isscorporatesolutions.com/our-story/> (last visited Nov. 17, 2021) [<https://perma.cc/44WV-6ASK>].

²³ Institutional S’holder Servs., Comment Letter on SEC Staff Roundtable on the Proxy Process, 13 (Nov. 7, 2018), <https://www.sec.gov/comments/4-725/4725-4629940-176410.pdf> [<https://perma.cc/V9VD-ETP4>].

²⁴ INSTITUTIONAL SHAREHOLDER SERVICES, INC., INSTITUTIONAL SHAREHOLDER SERVICES INC. DUE DILIGENCE COMPLIANCE PACKAGE (2017), <https://www.issgovernance.com/file/duediligence/Due-Diligence-Package-November-2017.pdf> [<https://perma.cc/CCN9-6VEX>].

²⁵ *See infra* Part III.B (providing additional discussion regarding the ISS firewall).

approximately 97% of the U.S. market.²⁶ Marco Consulting Group, Proxy Governance, Inc., and Egan-Jones Proxy Services round out the rest of the U.S. market.²⁷ A working paper by Professor Chong Shu analyzes proxy advisory firms' market share for mutual funds, finding that the ISS and Glass Lewis' collective market share declined from 96.5% to 91% between 2007 and 2017.²⁸ According to Professor Shu, "as of 2017, ISS controls 63 percent of the proxy market for mutual funds in the U.S. (\$13.4 trillion in assets from 135 fund families), and Glass Lewis controls 28 percent (\$6.0 trillion in assets from 27 fund families)."²⁹ These results appear similar to those of the 2007 GAO survey, indicating that ISS has successfully maintained its stronghold over the past decade.

ISS and Glass Lewis's rise has coincided with a dramatic increase in public equity ownership by institutional investors.³⁰ As of 2017, institutional investors "own[ed] about 78% of the market value of the U.S. broad-market Russell 3000 index, and 80% of the large-cap S&P 500 index. In dollars, that is about \$21.7 trillion and \$18 trillion, respectively. . . . Of the 10 largest U.S. companies, institutions

²⁶ U.S. GOV'T ACCOUNTABILITY OFF., GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 13 (2007); see JAMES K. GLASSMAN & J. W. VERRET, HOW TO FIX OUR BROKEN PROXY ADVISORY SYSTEM 8 (2013), https://www.mercatus.org/system/files/Glassman_ProxyAdvisorySystem_04152013.pdf [<https://perma.cc/5MNT-B9QC>].

²⁷ *Id.* at 7. Data for Egan-Jones Proxy Service's estimated clients' equity assets were not available, which adds a margin of error to market share estimates. *Id.* at 13.

²⁸ Chong Shu, *The Proxy Advisory Industry: Influencing and Being Influenced 2* (Mar. 19, 2021) (USC Marshall Sch. of Bus. Rsch. Paper) (unpublished manuscript), <https://ssrn.com/abstract=3614314> (on file with the Columbia Business Law Review).

²⁹ *Id.* (manuscript at 1–2).

³⁰ See Jacob Greenspon, *How Big a Problem Is It That a Few Shareholders Own Stock in So Many Competing Companies?*, HARV. BUS. REV. (Feb. 22, 2019), <https://hbr.org/2019/02/how-big-a-problem-is-it-that-a-few-shareholders-own-stock-in-so-many-competing-companies> [<https://perma.cc/U4N2-NPZ9>] ("Overall, institutional investors (which may offer both active and passive funds) own 80% of all stock in the S&P 500.").

own[ed] between 70% and 85.8%.”³¹ This heavily concentrated ownership structure heightens ISS and Glass Lewis’s influence on corporate governance regimes, as their clients collectively command the market for equity holdings in both large and middle-market public corporations.

The dominance of these two firms raises important questions about the ability of their recommendations to impact voting outcomes. Researchers have derived inconsistent estimates regarding the impact of such recommendations on shareholder voting, yet even lower estimates have found a substantial impact.³² By taking into account “the company- and firm-specific factors that are important to investors[,]”³³ Professors Stephen Choi, Jill Fisch and Marcel Kahan find that “an ISS recommendation shifts 6% to 10% of shareholder votes—a material percentage but far less than commonly attributed to ISS.”³⁴ Professors Jie Cai, Jacqueline Garner and Ralph Walking, meanwhile, find that “a negative ISS recommendation is associated with 19% fewer votes.”³⁵ Even accepting the lower 6% to 10% estimate, ISS appears to exert substantial influence over proxy voting, illustrating the importance of its voting recommendations.

³¹ Charles McGrath, *80% of Equity Market Cap Held by Institutions, PENSIONS & INV.* (Apr. 25, 2017, 1:00 AM), <https://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions> [<https://perma.cc/9VJG-MXND>].

³² See, e.g., Stephen Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 906 (2010); Jie Cai, Jacqueline L. Garner & Ralph A. Walking, *Electing Directors*, 64 J. FIN. 2389, 2404 (2009).

³³ Choi et al., *supra* note 32.

³⁴ *Id.*

³⁵ Cai et al., *supra* note 32. Director and firm performance typically have only a small effect on shareholder voting. For example, “votes exceeding 90% are the norm even for poorly performing firms and directors.” However, “[t]here are two exceptions: directors attending less than 75% of board meetings or receiving a negative ISS recommendation receive 14% and 19% fewer votes, respectively.” *Id.* at 2391.

C. Automated Voting by Investment Advisors

The simultaneous increase in prevalence of a practice known as “robo-voting” by proxy advisory firms’ clients has resulted in further concern regarding the influence of advisory recommendations. Both ISS and Glass Lewis offer their clients a service in which they pre-populate the voting guidelines for proxy cards, requiring an affirmative act by the client to override the proxy advisory firm’s voting guidelines.³⁶ As Professor Shu notes, “[w]hile there is no uniform definition for robo-voting, it generally denotes the practice of investors automatically relying on proxy advisors’ recommendations without evaluating the analysis underpinning them.”³⁷ As part of the effort to ensure investment advisors vote shares in the best interests of their clients,³⁸ the Commission issued Rule 206(4)-6, stating that all investment advisors registered with the Commission under section 203 of the Investment Advisors Act engage in fraudulent behavior by exercising voting authority with respect to client securities, unless they:

- (a) Adopt and implement written policies and procedures that are reasonably designed to ensure that [they] vote client securities in the best interest of clients, which procedures must include how [they] address material conflicts that may arise between [their] interests and those of [their] clients; (b) Disclose to clients how they may obtain information from [them] about how [the advisor] voted with respect to their [clients’] securities; and (c) Describe to clients [their] proxy voting policies and procedures

³⁶ See Letter from Gary A. La Branche, President & CEO, Nat’l Inv. Rel. Inst., to Jay Clayton, Chair, U.S. Sec. & Exch. Comm’n (Aug. 3, 2017), <https://www.niri.org/NIRI/media/NIRI-Resources/NIRI-SEC-Letter-PA-Firms-August-2017.pdf> [<https://perma.cc/NM65-6CWT>].

³⁷ See Shu, *supra* note 28 (manuscript at 11).

³⁸ See Disclosure of Proxy Voting Policies Voting Records by Registered Management Investment Companies, Securities Act Release No. 8188, Exchange Act Release No. 47,304, Investment Company Act Release No. 25,922, 68 Fed. Reg. 6564 (Feb. 7, 2003) (to be codified at 17 C.F.R. pts. 239, 249, 270, 274).

and, upon request, furnish a copy of the policies and procedures to the requesting client.³⁹

While this rule served to bolster the nascent proxy advisory market, it also imposes continued responsibilities—stemming from their fiduciary duties⁴⁰—on investment advisors who rely on proxy voting recommendations from proxy advisory firms. Nonetheless, investment advisors seeking to reduce the significant cost of proxy research can, and often do, defer to proxy advisory firms' recommendations rather than engaging in their own diligence and research.⁴¹ This reliance raises concerns over whether these firms are actually voting “client securities in the best interest of clients.”⁴²

D. Regulation of the Proxy Advisory Industry Prior to the July 2020 Rules

Commentators have described the regulatory regime for the proxy advisory industry as a “patchwork quilt.”⁴³ The first regulatory patch comes from the Investment Advisors Act of

³⁹ Proxy Voting, 17 C.F.R. § 275.206(4)–6 (2021).

⁴⁰ *See, e.g.*, SEC v. Cap. Gains Rsch. Bureau, Inc., 375 U.S. 180, 201 (1963) (“The high standards of business morality enacted by our laws regulating the securities industry do not permit an investment advisor to trade on the market effect of his own recommendations without fully and fairly revealing his personal interests in these recommendations to his clients.”); *Fin. Planning Ass’n v. SEC*, 482 F.3d 481, 490 (D.C. Cir. 2007) (“The overall statutory scheme of the IAA addresses the problems identified to Congress . . . by establishing a federal fiduciary standard to govern the conduct of investment advisers, broadly defined[.]”).

⁴¹ *See infra* Part III.E (providing further discussion of robo-voting).

⁴² 17 C.F.R. § 275.206(4)–6.

⁴³ Matthew Fagan, *Third-Party Institutional Proxy Advisors: Conflicts of Interest and Roads to Reform*, 51 U. MICH. J.L. REFORM 621, 627 (2018) (quoting *Legislative Proposals to Enhance Capital Formation, Transparency, and Regulatory Accountability: Before the Subcomm. on Capital Mkts. & Gov’t Sponsored Enters. of the H. Comm. on Financial Servs.*, 114th Cong. 124 (2016) (statement of Soc’y of Corp. Sec’y and Governance Professionals & the Nat’l Inv. Rels. Inst.) (referring to the minimal regulations to which proxy advisory firms are subject)).

1940.⁴⁴ While enforcement of the Investment Advisors Act has served to dramatically enlarge the proxy advisory firm market, it also restricts the actions of proxy advisory firms registered under the Act.⁴⁵ Nonetheless, not every proxy advisory firm has registered under the Act. In fact, while ISS, along with two other proxy advisory firms, has registered under the Act and urged the Commission to use it as the primary mechanism for regulating proxy advisory firms, Glass Lewis has not registered as an investment advisor.⁴⁶ Instead, as stated by former CEO Katherine Rabin, “Glass Lewis believes that requiring proxy advisory firms to register as investment advisers under the Investment Advisers Act of 1940, as the framework stands today, would provide little or no protection to investors and issuers with respect to the areas of concern that have been raised.”⁴⁷

In its 1963 holding in *SEC v. Capital Gains Research Bureau, Inc.*, the Supreme Court interpreted the Investment Advisors Act as imposing a fiduciary duty of “utmost good faith” on registered investment advisers, requiring them 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.”⁴⁸ Thus, under the Act, ISS has a fiduciary duty to its clients, but not directly to its clients’ shareholders,⁴⁹

⁴⁴ 15 U.S.C. §§ 80b-1 to 80b-21 (2018).

⁴⁵ See *supra* Part II.A (discussing the origin and growth of proxy advisory firms).

⁴⁶ See U.S. GOV’T ACCOUNTABILITY OFF., GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 78(2007); see also George W. Dent, Jr., *A Defense of Proxy Advisors*, MICH. ST. L. REV. 1287, 1321–22 n.184 (2014) (explaining that some proxy advisory firms do not believe that their actions meet the definition of investment advisers).

⁴⁷ Glass Lewis, Comment Letter on SEC Staff Roundtable on the Proxy Process (Nov. 14, 2018), [glasslewis.com/wp-content/uploads/2018/11/GL-SEC-Roundtable-Statement-111418.pdf](https://www.glasslewis.com/wp-content/uploads/2018/11/GL-SEC-Roundtable-Statement-111418.pdf) [<https://perma.cc/3S6E-QCAW>].

⁴⁸ *SEC v. Cap. Gains Rsch. Bureau, Inc.*, 375 U.S. 180, 191–94 (1963).

⁴⁹ Cynthia E. Clark & Harry J. Van Buren III, *Compound Conflicts of Interest in the US Proxy System*, 116 J. BUS. ETHICS 355, 363 (2013).

while Glass Lewis, having remained unregistered, is not subject to any fiduciary duties at all.

Prior to the issuance of the July 2020 rules,⁵⁰ proxy advisory firms faced limited regulation under the Securities Exchange Act of 1934.⁵¹ Under 17 CFR 240.14a-2(b)(3), the Commission exempted proxy advisory firms from its regulation of proxy solicitations so long as they disclosed any significant relationships and material interests related to the matter, did not receive any commission or remuneration from individuals other than the client receiving the advice and did not “furnish proxy voting advice on behalf of any person soliciting proxies.”⁵² Proxy advisory firms also typically rely on 17 CFR 240.14a-2(b)(1),⁵³ which “does not have a specified disclosure requirement for conflicts of interests.”⁵⁴ Nonetheless, “the furnishing of proxy voting advice remained subject to the prohibition on false and misleading statements in Rule 14a-9.”⁵⁵ The 2020 rules amend the regulation of proxy advisory firms under Rule 14a.⁵⁶

⁵⁰ See Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Investment Company Act Release No. 33,605, 84 Fed. Reg. 47,420 (Sept. 10, 2019).

⁵¹ Securities Exchange Act of 1934, 15 U.S.C. § 78a–78qq (2018).

⁵² 17 C.F.R. 240.14a-2(b)(3) (2021).

⁵³ *Id.* 240.14(a)-2(b)(1); see David Bell, Ryan Mitteness & Soo Hwang, *SEC Tightens Regulations on Proxy Advisory Firms*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Aug. 18, 2020), <https://corpgov.law.harvard.edu/2020/08/18/sec-tightens-regulations-on-proxy-advisory-firms/> [https://perma.cc/B9VK-VQF7] (“Proxy advisory firms have typically relied upon the exemptions in Rule 14a-2(b)(1) . . . to avoid the filing and information requirements generally required for solicitations under the federal proxy rules.”).

⁵⁴ Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice, Exchange Act Release No. 87,457, 84 Fed. Reg. 66,518, 66,526 (proposed Dec. 4, 2019) (to be codified at 17 C.F.R. pt. 240).

⁵⁵ *Id.* at 66,537.

⁵⁶ See *infra* Part III.D (providing further discussion of the rule changes); Exemptions from the Proxy Rules for Proxy Voting Advice, Exchange Act Release No. 89,372, 85 Fed. Reg. 55,082, 55,124–25 (Sept. 3, 2020) (to be codified at 17 C.F.R. pt. 240).

III. PROXY ADVISORY FIRMS' CONFLICTS OF INTEREST

This Part discusses the need for further regulation of proxy advisory firms' conflicts of interest, dissecting their potential and observed impacts. It addresses two prominent conflicts: (i) the provision of both voting advice and consulting services and (ii) the provision of both governance ratings and consulting services. It begins with a discussion of the risks posed by the conflicts, continuing with the lead up to the 2020 promulgation of final regulations on proxy advisory firms. The Commission publicly recognized the need for reform with its 2010 "Concept Release on the U.S. Proxy System" ("Concept Release"),⁵⁷ leading to its issuance of a preliminary version of regulatory changes in 2019 followed by the final version in 2020.⁵⁸

Concerns regarding the impacts of conflicts of interest within the proxy advisory firm market should be unsurprising, as "the outsourcing of proxy voting and monitoring functions by mutual funds to ISS presents the classic agency problem of 'separation of decision and risk.'"⁵⁹ ISS—along with other proxy advisory firms—makes decisions regarding voting investors' shares while investment advisers and investors themselves bear the risk of these decisions. Proxy advisory firms, meanwhile, dispute the notion that they possess control over shareholder voting. As stated by ISS:

[O]ur clients are sophisticated institutional investors who are free to follow our recommendations or not. Often, the information that we provide to our clients

⁵⁷ Concept Release on the U.S. Proxy System, Exchange Act Release No. 62,495, Investment Company Act Release No. 29,340, 75 Fed. Reg. 42,982, 43,011 (July 22, 2010) ("The use of proxy advisory firms by institutional investors raises a number of potential issues.").

⁵⁸ See Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice, 84 Fed. Reg. at 66,526; Exemptions from the Proxy Rules for Proxy Voting Advice, 85 Fed. Reg. at 55,082.

⁵⁹ Tamara C. Belinfanti, *The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control*, 14 STAN. J. L. BUS. & FIN. 384, 406 (2009) (quoting Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 301 (1983)).

is one of many different inputs they use to make their voting decisions.⁶⁰

While this is certainly accurate for many of ISS's clients and, ideally would be accurate for all of them, certain institutional investors appear to have largely outsourced the voting of their shares to ISS and follow its recommendations with little to no oversight.⁶¹

The Commission, responding to the longstanding concerns over conflicts of interest impacting the dependability of proxy advisory firms' recommendations,⁶² initiated its review of the regulatory scheme for proxy advisory firms in 2010 with the Concept Release.⁶³ The Concept Release recognized that "to the extent that conflicts of interest on the part of proxy advisory firms are insufficiently disclosed and managed, shareholders could be misled and informed shareholder voting could be impaired."⁶⁴ The SEC's final regulations, nonetheless, homed in on the disclosure of conflicts and largely eschewed their management.⁶⁵ Generally, a proxy advisory firm may face several types of conflicts of interest, including "providing voting advice on a matter in which its affiliates or one or more of its clients has a material interest" and "providing voting advice with respect to a registrant's

⁶⁰ Institutional S'holder Serv., *supra* note 22, at 2.

⁶¹ *See infra* Part III.E (providing further discussion of robo-voting and the insufficient review of proxy advisory firms' voting recommendations by certain institutional investors).

⁶² *See, e.g.*, Gretchen Morgenson, *How To Succeed on Wall Street, Conflict-Free*, N.Y. TIMES (Dec. 19, 2004), <https://www.nytimes.com/2004/12/19/business/yourmoney/how-to-succeed-on-wall-street-conflictfree.html> [<https://perma.cc/EFA7-J5D2>] ("By advising both companies and their shareholders on corporate governance issues, I.S.S. has created a potential for bias, some former clients say.").

⁶³ Concept Release on the U.S. Proxy System, Exchange Act Release No. 62,495, Investment Company Act Release No. 29,340, 75 Fed. Reg. 42,982, 43,009 (proposed July 22, 2010) (to be codified at 17 C.F.R. pts. 240, 270, 274, 275).

⁶⁴ *Id.* at 43,011.

⁶⁵ Exemptions from the Proxy Rules for Proxy Voting Advice, Exchange Act Release No. 89,372, 85 Fed. Reg. 55,082 (Sept. 3, 2020) (to be codified at 17 C.F.R. pt. 240).

shareholder meeting while affiliates of the proxy voting advice business hold a significant ownership interest in the registrant.”⁶⁶ This discussion will focus on some of the most frequently critiqued conflicts and those that plague ISS in particular: the provision of both voting advice and consulting services and the provision of both governance ratings and consulting services.⁶⁷

A. Provision of Both Voting Advice and Consulting Services

The first conflict of interest identified as a cause for alarm in the Concept Release is certain proxy advisory firms’ simultaneous provision of both “proxy voting recommendations to investment advisers and other institutional investors” and “consulting services to corporations seeking assistance with proposals to be presented to shareholders or with improving their corporate governance ratings.”⁶⁸ The concern is that such proxy advisory firms, most notably ISS, may reward issuers who utilize its consulting services with more favorable recommendations for management-sponsored proposals while punishing those who elect to forego these services. Issuers will therefore face immense pressure, whether perceived or actual, to purchase consulting services, while institutional investors relying on ISS for voting recommendations receive advice tainted by such conflict.⁶⁹ Glass Lewis, meanwhile, has sought

⁶⁶ *Id.* at 55,096.

⁶⁷ *See, e.g.*, U.S. GOV’T ACCOUNTABILITY OFF., GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 9 (2007) (“The most commonly cited potential for conflict involves ISS, which provides services to both institutional investor clients and corporate clients.”).

⁶⁸ Concept Release on the U.S. Proxy System, 75 Fed. Reg. at 43,011; *see also* U.S. GOV’T ACCOUNTABILITY GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 9 (2007) (discussing proxy advisory firms’ conflicts of interest).

⁶⁹ Concept Release on the U.S. Proxy System, 75 Fed. Reg. at 43,011–12.

to wield its lack of consulting services as a competitive advantage:

Glass Lewis strongly believes that the provision of consulting services to corporate issuers, directors, dissident shareholders and/or shareholder proposal proponents, creates a problematic conflict of interest that goes against the very governance principles for which we advocate. As a result, Glass Lewis does not have a consulting business. This helps ensure that our voting recommendations and analysis are disinterested.⁷⁰

While Glass Lewis has been subject to its own potential conflicts,⁷¹ various indicators suggest that the provision of consulting services by ISS presents a substantial concern.

In their most recent annual proxy season survey, “intended to inform policymakers and the general public about current practices within the proxy advisory industry,”⁷² Nasdaq and the U.S Chamber of Commerce’s Center for Capital Markets Competitiveness discovered a consistent, disconcerting trend regarding ISS’s business practices:

Troublingly, and consistent with the 2019 survey, over half of the companies report that they have been approached by the corporate consulting arm of ISS during the same year in which they received a negative vote recommendation from ISS’[s] proxy

⁷⁰ Glass Lewis, *supra* note 47.

⁷¹ Press Release, U.S. Chamber of Com., U.S. Chamber Calls for SEC To Examine Proxy Advisory Firm (May 30, 2012) <https://www.uschamber.com/press-release/us-chamber-calls-sec-examine-proxy-advisory-firm> [https://perma.cc/J4L8-ZJB6] (“CCMC cites an occurrence where the Ontario Teachers Pension Board’s opposition to the Board of Directors of New York Stock Exchange listed Canadian Pacific Railway Ltd was followed by the Ontario Teacher Pension Fund subsidiary Glass Lewis proxy advisory firm issuing a vote recommendation in the parents [sic] favor[.]”).

⁷² NASDAQ & U.S. CHAMBER OF COM. CTR. FOR CAP. MKTS. COMPETITIVENESS, 2020 PROXY SEASON SURVEY 3 (2020), https://www.centerforcapitalmarkets.com/wp-content/uploads/2020/10/CCMC_Nasdaq_ProxySeasonSurvey2020.pdf [https://perma.cc/JX2C-RLXX].

advice business. The ISS business model—in which it provides corporate governance consulting to the very issuers for which it issues vote recommendations—is inherently conflicted and creates potential biased voting advice.⁷³

This practice highlights the disquieting incentive structure for ISS's recommendations. ICS markets its consulting services based on ISS voting recommendations, allowing the firm to increase profits by issuing negative recommendations for certain issuers.⁷⁴ One commentator compared this to the rules “banning accounting firms from selling consulting services to companies they are auditing” and called on the Commission to “[p]rohibit proxy advisory firms from consulting with companies when they also make recommendations on voting issues for that company.”⁷⁵

B. Provision of Both Consulting Services and Governance Ratings

Another substantial conflict identified in the Concept Release is “when a proxy advisory firm provides corporate governance ratings on issuers to institutional clients, while also offering consulting services to corporate clients so that those issuers can improve their corporate governance ranking.”⁷⁶ Through its ESG GQS, ISS rates “approximately

⁷³ *Id.* at 6.

⁷⁴ *See id.*; *see also* Cynthia E. Clark & Harry J. Van Buren III, *Compound Conflicts of Interest in the US Proxy System*, 116 J. BUS. ETHICS 355, 366 (2013) (“ISS continues to place the governance score on the proxy research report its clients pay for, presumably in an attempt to either remind proxy clients of its governance business or to underscore the connection between a standardized governance score and an individual proxy recommendation.”).

⁷⁵ Jonathan A. Chanis, Comment Letter on Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice (Jan. 30, 2020), <https://www.sec.gov/comments/s7-22-19/s72219-6728459-207302.pdf> [<https://perma.cc/Q583-YX8K>].

⁷⁶ Concept Release on the U.S. Proxy System, Exchange Act Release No. 62,495, Investment Company Act Release No. 29,340, 75 Fed. Reg. 42,982, 43,012 (proposed July 22, 2010). (to be codified at 17 C.F.R. pts. 240, 270, 274, 275).

5,800 publicly-traded companies in 30 markets.”⁷⁷ Other companies, such as the Dow Jones Sustainability Indices, EcoVadis, Sustainalytics, and MSCI, provide similar services.⁷⁸

Due to ISS’s provision of both ESG ratings and corporate governance consulting services, commentators fear that the advisory firm uses its rankings to punish companies that have not purchased its consulting services while simultaneously rewarding those that have. This fear is compounded by the often undisclosed and inconsistent methodologies used for calculating the ESG ratings. Chris Netram, Vice President, Tax & Domestic Economic Policy at the National Association of Manufacturers, describes the methodology as a “black box.”⁷⁹ As explained by Greg Medcraft, OECD director for financial and enterprise affairs, “[w]hile there is a wealth of ESG data out there, it is not consistently comparable or easily verifiable,” because there are different methodologies, metrics, weightings and subjective judgement in ESG ratings.⁸⁰ The lack of transparency in ISS’s ESG ratings,

⁷⁷ *At a Glance: ISS ESG Governance QualityScore Datafeed*, FACTSET, <https://insight.factset.com/resources/iss-gqs-datafeed-at-a-glance> [<https://perma.cc/K5YX-PHUG>] (last visited Nov. 20, 2021) (describing widespread use of GQS and providing a high-level explanation of its general methodology).

⁷⁸ Jasmin Malik Chua, *The Rise in ESG Ratings: What’s the Score?*, VOGUE BUS. (Oct. 28, 2020), <https://www.voguebusiness.com/sustainability/the-rise-in-esg-ratings-whats-the-score> [<https://perma.cc/AKX5-HKMG>] (“[H]undreds of rating and ranking platforms, including the Dow Jones Sustainability Indices (DJSI), EcoVadis, Sustainalytics and MSCI, have sprung up to help asset managers, institutional investors, would-be employees, consumers and other stakeholders assess, measure and benchmark a company’s ESG performance.”).

⁷⁹ Chris Netram, Comment Letter on Amendments to Exceptions from the Proxy Rules for Proxy Voting Advice, at 7 (Feb. 3, 2020), <https://www.sec.gov/comments/s7-22-19/s72219-6735396-207626.pdf> [<https://perma.cc/5X4W-C64M>].

⁸⁰ Jennifer Laidlaw, *Lack of Standardized ESG Data May Hide Material Risks, OECD Says*, S&P GLOB. MKT. INTELL. (Oct. 2, 2020), <https://www.spglobal.com/marketintelligence/en/news-insights/latest->

coupled with the inconsistent methodologies used by its competitors, may allow ISS to insert biases into its ratings with relatively little risk of discovery. While a divergent voting recommendation from a competitor may raise red flags, market participants are aware of the widespread inconsistencies in ESG ratings, and such discrepancies are thus unlikely to result in substantial scrutiny.⁸¹

In a comment letter to the SEC's 2019 Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice, Clifton A. Pemble, President and CEO of GPS navigation and wireless device and applications company Garmin Ltd., discussed Garmin's concerns with conflicts of interest in the proxy advisory firm market.⁸² Pemble's comment letter homed in on the provision of both consulting services and ratings/rankings:

We have noticed that in some instances the consulting side of a firm's business rated us poorly on governance and compensation practices (much to our surprise and contrary to all available evidence, and for reasons they wouldn't divulge unless we agreed to pay them a large fee), while at the same time the proxy advisory side of the business recommended that shareholders vote *for* all of our governance and compensation related proposals. If there is no correlation at all between a firm's ratings and their voting recommendations, as seems to be the case for Garmin, then what does that say about the reliability or sincerity of the ratings and/or the voting recommendations?⁸³

news-headlines/lack-of-standardized-esg-data-may-hide-material-risks-oecd-says-60541261 [<https://perma.cc/6PV3-7LCU>].

⁸¹ See R. BOFFO AND R. PATALANO, ESG INVESTING: PRACTICES, PROGRESS, AND CHALLENGES, OECD 7 (2020).

⁸² Garmin Ltd., Comment Letter on Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice (Jan. 27, 2020), <https://www.sec.gov/comments/s7-22-19/s72219-6703085-206073.pdf> [<https://perma.cc/W552-Z84S>].

⁸³ *Id.*

A proxy advisory firm supporting an issuer's governance proposals while simultaneously issuing them a poor ESG rating lends credence to the claim that proxy advisory firms use ESG ratings in order to lure issuers into paying for consulting services. This also raises additional concerns regarding the efficacy of the firewall erected between ISS and ICS. ISS, nonetheless, would likely point to the inconsistency between its voting advice and ESG ratings as evidence of the two business' independence.

C. The Firewall Between ISS and ICS

ISS had previously responded to these lines of criticism by touting measures that allegedly manage “the potential of this conflict extremely well.”⁸⁴ According to ISS,

[t]he primary control for this risk is the firewall ISS maintains between the core institutional business and the ICS business. This firewall includes the physical and functional separation between ICS and ISS, with a particular focus on the separation of ICS from the ISS Global Research team.⁸⁵

With this proclamation, ISS paradoxically acknowledges the importance of separating the consulting and voting advice businesses while arguing that its “functional separation” of the two should be deemed equivalent to an actual separation.⁸⁶ ISS also points to its disclosures of conflicts of interest, claiming that they ensure its clients are “fully informed” and “are also provided with details about the amount that each ICS client has paid ICS and the particular products/services they purchased.”⁸⁷ Nevertheless, ISS refuses to explicitly identify ICS relationships on the face of a proxy analysis, which would greatly increase institutional investor and investment advisors' capacity to view and digest these conflicts.⁸⁸

⁸⁴ Institutional S'holder Serv., *supra* note 23, at 13.

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.* at 14.

⁸⁸ *Id.*

Despite its assurances to the contrary, ISS's exposure to conflicts of interest remains worrying. According to ISS itself, "[w]ere the ICS relationship explicitly identified on the face of, or within, a proxy analysis or report, this critical information barrier would be destroyed."⁸⁹ This remains a valid concern—one that would be moot if regulators required the separation of the voting advice and consulting businesses. Moreover, in a 2019 proposed rule, the Commission disputed the adequacy of ISS's disclosures, stating that "concerns remain about the adequacy of these firms' conflicts of interest disclosures" and that the lack of uniform standards for conflicts of interest disclosures "can lead to inconsistent and inadequate disclosures and mitigation measures."⁹⁰

D. Conflicts Have Consequences

Outcomes of shareholder voting dramatically impact shareholder value, permitting shareholders to, *inter alia*, select members of the board, vote on management's proposals and bring shareholder proposals pursuant to Rule 14a-8.⁹¹ As stated by the Delaware Chancery Court in its seminal 1988 holding to *Blasius Indus., Inc. v. Atlas Corp.*, "Delaware courts have long exercised a most sensitive and protective regard for the free and effective exercise of voting rights."⁹² While *Blasius* pertained to an attempt by a corporation's board of directors to curtail shareholder voting,⁹³ the court's pronouncement illustrates the immense importance of shareholder voting to the proper functioning of a corporation.

In a 2018 study,⁹⁴ Professor Tao Li analyzes ISS's voting recommendations to show the concrete impact of its conflicts

⁸⁹ *Id.*

⁹⁰ Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice, Exchange Act Release No. 87,457, 84 Fed. Reg. 66,518, 66,526 n.76 (proposed Dec. 4, 2019) (to be codified at 17 C.F.R. pt. 240).

⁹¹ See Shareholder Proposals, 17 C.F.R. § 240.14a-8 (2021).

⁹² *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 659 n.2 (Del. Ch. 1988).

⁹³ *Id.*

⁹⁴ Tao Li, *Outsourcing Corporate Governance: Conflicts of Interest Within the Proxy Advisory Industry*, 64 MGMT. SCI. 2951 (2018).

of interest. Professor Li analyzes the changes in ISS's voting recommendations subsequent to Glass Lewis's 2003 entry into the proxy advisory firm market, the first time ISS faced a credible rival,⁹⁵ "to show empirically that increased competition brought by Glass Lewis's entry into the proxy advisory market has reduced ISS's favoritism to corporate managers."⁹⁶ Since ISS does not disclose its client list, Professor Li uses the thousand largest firms in the United States as a proxy for ISS's corporate clients and determines "whether ISS adjusts its recommendations for a corporate client after Glass Lewis begins to cover that firm for the first time."⁹⁷ Using data for shareholder meetings between 2004 and 2011, Professor Li finds that "after Glass Lewis's initial coverage, ISS's average 'for' recommendation for shareholder proposals at large firms, a proxy for its clients, increases by 11.9 percentage points compared with control companies."⁹⁸ Similarly, ISS's negative recommendations for governance proposals supported by management increased by an average of 2.7% after Glass Lewis's initial coverage.⁹⁹

To appease lucrative corporate consulting clients, ISS may prefer to vote in line with boards that employ its services as often as possible. Nonetheless, too blatant a bias would harm its voting recommendation business. These data suggest that divergent recommendations by Glass Lewis resulted in increased scrutiny of ISS's guidance, forcing it to reduce the bias in its recommendations. ISS implemented the firewall between ISS and ICS, its "primary control"¹⁰⁰ mechanism for managing this conflict of interest, in the early 1990s.¹⁰¹ It has had decades since then to implement the proper governance procedures to fully separate these two businesses, yet Professor Li's empirical analysis suggests that the firm has

⁹⁵ *Id.* at 2951–52; *see supra* notes 16–18 and accompanying text (discussing the history of the proxy advisory firm market).

⁹⁶ Li, *supra* note 94, at 2952.

⁹⁷ *Id.* at 2960.

⁹⁸ *Id.* at 2961–62.

⁹⁹ *Id.* at 2962.

¹⁰⁰ Institutional S'holder Serv., *supra* note 23, at 13.

¹⁰¹ Li, *supra* note 94, at 2955.

failed to do so. Whether this failure stems from a lack of effort or feasibility remains irrelevant—Professor Li’s analysis suggests that ISS’s ability to provide both voting recommendation and issuer consulting services has resulted in consistently biased recommendations that do not maximize shareholder value. Considering the fact that proxy advisory firms emerged from regulations designed to ensure shareholder value maximization through proxy voting, these revelations should raise significant concerns for regulators and indicate the need for reform.

Professor George W. Dent acknowledges Professor Li’s findings, agreeing that “ISS’s consulting services may enable issuers to bribe ISS to get better recommendations than they deserve.”¹⁰² Nonetheless, Professor Dent argues that “[c]oncerns about conflicts of interest are overblown and somewhat anomalous.”¹⁰³

Professor Dent’s article, which has been critiqued on additional grounds,¹⁰⁴ dismisses concerns over proxy advisory firms’ ability to both issue proxy voting advice to institutional investors and provide corporate governance consulting services to issuers, stating that “ISS’s ratings are worth only what respect they command among investors. If issuers believe that some ratings are punishment for rejecting ISS’s corporate governance services, they can say so individually and collectively[.]”¹⁰⁵ While it is true that “[i]nvestors can decide whom to believe,”¹⁰⁶ the decreased costs and brand recognition that come with doing so may hinder potential competitive advantages available to Glass Lewis and other ISS competitors. As a result of this collective action problem, many institutional investors, particularly passive index funds competing on fees, do not prioritize diligent proxy voting and

¹⁰² Dent, *supra* note 46, at 1324.

¹⁰³ *Id.*

¹⁰⁴ See Fagan, *supra* note 43, at 633–35.

¹⁰⁵ Dent, *supra* note 46, at 1324–25.

¹⁰⁶ *Id.* at 1325.

tend to prefer any option that permits them to minimize costs while fulfilling their fiduciary duties.¹⁰⁷

Professor Dent emphasizes the potential competitive advantage ISS's conflicts create for firms such as Glass Lewis, which can differentiate themselves by emphasizing that they do not provide consulting services,¹⁰⁸ and brushes off concerns that "ISS's consulting services may subsidize its advisory business."¹⁰⁹ Yet, the consequences of permitting ISS to maintain this conflict largely eliminate Glass Lewis's potential for further cutting into its market share or unseating it as the dominant proxy advisory firm. Regardless of whether the conflict truly exists, issuers will continue flocking to ISS's consulting services as a result of their perception of the conflict. Some issuers who received a negative voting recommendation will be amenable to ISS's approaches and will pay for the consulting services. Issuers who receive poor ESG ratings may also be lured into paying the consulting fees. The revenue from the consulting services, as Professor Dent acknowledges, permits ISS to maintain lower prices.¹¹⁰ These resulting lower prices are crucial for cost-conscious customers such as the growing market of passive funds and smaller institutional investors.

Even putting cost concerns aside, many institutional investors may continue using ISS when they believe Glass Lewis or another competitor will provide them with superior recommendations. As Professor Li explained, "[b]ecause investment advisers are required to vote in the best interests of clients (a fiduciary duty), some institutions may find it safer to buy ISS's services even if they prefer the competitor's."¹¹¹ Professor Tamara C. Belinfanti expands on this notion, explaining that ISS possesses a "first mover" advantage in the

¹⁰⁷ See *infra* Part III.E for concerns regarding automated voting and cost-conscious passive funds.

¹⁰⁸ Dent, *supra* note 46, at 1325 n.206.

¹⁰⁹ *Id.* at 1325 (citing CTR. ON EXEC. COMP., A CALL FOR CHANGE IN THE PROXY ADVISORY INDUSTRY STATUS QUO: THE CASE FOR GREATER ACCOUNTABILITY AND OVERSIGHT 32 (2011)).

¹¹⁰ *Id.*

¹¹¹ Li, *supra* note 94, at 2953.

proxy advisory firm market.¹¹² Several advantages stemming from its first-mover status aid it in entrenching its position as the dominant firm. First, ISS benefits from “network effects,”¹¹³ as the more clients it accrues, the more credibility it gains with other investment advisors, and the more likely other institutional investors will be to select it over its less established competitors. “Since it is the more powerful player, ISS’s ‘certification effect’ could be valuable in case a lawsuit occurs.”¹¹⁴ Second, the other considerable advantage arising from ISS’s first mover advantage is consumer switching costs.¹¹⁵ The time, cost and difficulty of negotiating with a new advisor and implementing a new proxy voting system discourages switching to a competitor, regardless of any dissatisfaction.¹¹⁶

Furthermore, any potential competitive advantage for Glass Lewis in emphasizing a lack of conflicts of interest will be tempered by other weaknesses. First, Glass Lewis has faced its own allegations of conflicts of interest.¹¹⁷ In addition,

¹¹² Belinfanti, *supra* note 59, at 412 (“First mover advantage theory states that first movers into a new industry will gain an advantage, creating very high or insurmountable barriers for new entrants.”).

¹¹³ *Id.*

¹¹⁴ Li, *supra* note 94, at 2953.

¹¹⁵ See Belinfanti, *supra* note 59, at 413.

¹¹⁶ *Id.*

¹¹⁷ See, e.g., Press Release, U.S. Chamber of Commerce, *supra* note 71; see also Meaghan Kilroy, *Procter & Gamble Says Trian Loses Vote for Board Spot; Nelson Peltz Disputes Results*, PENSIONS & INVS. (Oct. 10, 2017), <https://www.pionline.com/article/20171010/ONLINE/171019996/procter-gamble-says-trian-loses-vote-for-board-spot-nelson-peltz-disputes-results> [<https://perma.cc/DSM5-LHV6>] (“Canada Pension Plan Investment Board and the C\$180.5 billion Ontario Teachers’ Pension Plan, Toronto, all supported Trian’s proxy fight with the consumer goods manufacturer, according to their proxy-voting disclosures.”); Martin Lipton, *Dealing with Activist Hedge Funds*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 6, 2014), <https://corpgov.law.harvard.edu/2014/11/06/dealing-with-activist-hedge-funds-3/> [<https://perma.cc/XP52-B3G2>] (“Prominent institutional investors and strategic acquirors have been working with activists both behind the scenes and by partnering in sponsoring an activist attack such as CalSTRS with Relational in attacking Timken[] [and] Ontario Teachers’ Pension Fund with Pershing Square in attacking Canadian Pacific[.]”).

Glass Lewis, unlike ISS, has not registered under the Investment Advisers Act.¹¹⁸ While ISS's conflicts, resulting from its provision of corporate governance consulting services, appear more expansive and concerning, ISS can easily point to Glass Lewis and other competitors' conflicts to make the argument that the presence of certain conflicts must simply be accepted by institutional investors. Since institutional investors value multiple factors aside from perceived quality of information, ISS appears to have had little trouble maintaining its command of the proxy advisory firm market. However, a lack of complaints by institutional investors does not *ipso facto* eliminate the numerous causes for concern stemming from ISS and other proxy advisers' inherent conflicts of interest.

Moreover, even if one were to accept Professor Dent's implicit assumption that investment advisers' primary consideration in selecting a proxy advisory firm is quality of information, investment advisers' preferences cannot serve as an effective signal of quality if they are not aware of the conflicts of interest tainting the recommendations on which they rely. Commentators have lamented that "the conflicts disclosures provided by proxy voting advice businesses are vague or boilerplate disclosures that do not provide sufficient information about the nature of potential conflicts."¹¹⁹ As described by Gary Retelny, CEO of ISS, ISS's clients must actively request a non-boilerplate conflicts disclosure:

[E]ach proxy analysis and research report that ISS issues contains a legend indicating that the subject of the analysis or report may be a client of or affiliated with a client of ISS, ICS or another ISS subsidiary.

¹¹⁸ See *supra* note 46 and accompanying text.

¹¹⁹ Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice, Exchange Act Release No. 87,457, 84 Fed. Reg. 66,518, 66,526 (proposed Dec. 4, 2019) (to be codified at 17 C.F.R. pt. 240); see also Fagan, *supra* note 43, at 635 ("The disclosures used by some advisers . . . are merely blanket statements saying that they 'may have done business with the corporation that is the subject of the report' and then providing an email that people can use to ask for more information. . . . These steps are simply not enough." (footnote omitted)).

Each analysis and report also notes that one or more proponents of a shareholder proposal may be a client of ISS or one of its affiliates, or may be affiliated with such a party. . . . Any institutional client that wishes to learn more about the relationship, if any, between ICS and the subject of a particular analysis or report may contact ISS'[s] Legal and Compliance Department for relevant details.¹²⁰

While Retelny states that “many clients”¹²¹ meet with ISS on a regular basis to discuss conflicts, indicating interest by certain institutional investors in understanding them, many others may fail to request them or may fail to receive timely updates. Under this policy, institutional investors have to incur the time and cost associated with obtaining this information. Prominently displaying these conflicts on each report would be a simple solution, as proxy advisory firms possess information regarding the conflicts and are therefore the cheapest cost providers. Standardizing such disclosures would therefore substantially increase the available mix of information at a relatively low cost.

E. Securities and Exchange Commission Rules Addressing Conflicts of Interest Concerns

Fortunately, the SEC recognized the issue of insufficient conflicts disclosures in its issuance of final rules regulating proxy advisory firms in 2020.¹²² The Commission amended Rule 14a-1(l)(iii) to codify its past guidance that proxy voting advice constitutes a proxy solicitation.¹²³ While proxy

¹²⁰ Int'l S'holder Serv., *supra* note 23, at 14.

¹²¹ *Id.*

¹²² See generally Exemptions from the Proxy Rules for Proxy Voting Advice, Exchange Act Release No. 89,372, 85 Fed. Reg. 55,082 (Sept. 3, 2020) (to be codified at 17 C.F.R. pt. 240).

¹²³ See 17 C.F.R. § 240.14a-1(l) (2021) (“The terms ‘solicit’ and ‘solicitation’ include . . . [a]ny proxy voting advice that makes a recommendation to a security holder as to its vote, consent, or authorization on a specific matter for which security holder approval is solicited, and that is furnished by a person that markets its expertise as a provider of such

advisory firms typically rely on Rules 14a-2(b)(1) and (b)(3) to exempt them from proxy filing and information requirements, the Commission's new rules require heightened disclosure requirements in order for proxy advisory firms to be able to utilize these exceptions. On its own, Rule 14a-2(b)(1) does not possess a conflicts disclosure requirement, while Rule 14a-2(b)(3) requires the disclosure of "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."¹²⁴ Under the proposed rule amending 14a-2(b)(9)(i), exemptions under Rules 14a-2(b)(1) and (b)(3) would only be available if proxy advisory firms include the following disclosures:

Any material interests, direct or indirect, of the proxy voting advice business (or its affiliates) in the matter or parties concerning which it is providing the advice; [a]ny material transaction or relationship between the proxy voting advice business (or its affiliates) and (i) the registrant (or any of the registrant's affiliates), (ii) another soliciting person (or its affiliates), or (iii) a shareholder proponent (or its affiliates), in connection with the matter covered by the proxy voting advice; [a]ny other information regarding the interest, transaction, or relationship of the proxy voting advice business (or its affiliate) that is material to assessing the objectivity of the proxy voting advice in light of the circumstances of the particular interest, transaction, or relationship; and [a]ny policies and procedures used to identify, as well as the steps taken to address, any such material conflicts of interest arising from such interest, transaction, or relationship.¹²⁵

With this proposed rule, the SEC aimed to standardize disclosures, thereby increasing the information available to

proxy voting advice, separately from other forms of investment advice, and sells such proxy voting advice for a fee.").

¹²⁴ Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice, Exchange Act Release No. 87,457, 84 Fed. Reg. 66,518, 66,526 (proposed Dec. 4, 2019) (to be codified at 17 C.F.R. pt. 240).

¹²⁵ *Id.*

proxy advisory firms' clients and signaling what they should expect to receive in each report. The increased detail and consistency from previous requirements under Rule 14a-2(b)(3) would theoretically lead institutional investors to carefully examine the disclosed conflicts' impact and could potentially incentivize proxy advisory firms to eliminate some of them altogether.

Responding to comments favoring a more principles-based approach, the SEC streamlined the final rule to grant "the proxy voting advice business flexibility to determine the precise level of detail needed about any identified conflicts of interest."¹²⁶ The relevant portion of Rule 14a-2(b)(9)(i) states that Rules 14a-2(b)(1) and (b)(3) will not be available unless:

The proxy voting advice business includes in its proxy voting advice or in an electronic medium used to deliver the proxy voting advice prominent disclosure of: (A) Any information regarding an interest, transaction, or relationship of the proxy voting advice business (or its affiliates) that is material to assessing the objectivity of the proxy voting advice in light of the circumstances of the particular interest, transaction, or relationship; and (B) Any policies and procedures used to identify, as well as the steps taken to address, any such material conflicts of interest arising from such interest, transaction, or relationship.¹²⁷

While this modification results in a certain degree of self-policing by proxy advisory firms, this risk seems relatively minor, as the Commission may take action in the occurrence of routinely insufficient disclosures. Just as with the proposed rule, including these conflicts disclosure requirements constitutes a clear benefit and should be lauded as a necessary step.

Yet, merely requiring the disclosure does not go far enough—to fully ensure the accuracy of this information the SEC must fashion rules that mitigate their presence. As

¹²⁶ Exemptions from the Proxy Rules for Proxy Voting Advice, 85 Fed. Reg. at 55,099.

¹²⁷ 17 C.F.R. § 240.14a-2(b)(9)(i) (2021).

discussed above, institutional investors' awareness of the conflicts of interest will be insufficient for preventing the impacts of those conflicts, as they aim to minimize costs and potential legal liability. In fact, the use of proxy advisory firms originated from institutional investors' efforts to comply with regulations regarding proxy voting in a cost-effective manner.¹²⁸ The troubling trend of automated or "robo-voting" by proxy advisory firms' clients¹²⁹ further diminishes the impact of the enhanced conflicts disclosures required by rule 14a-2(b)(9)(i).¹³⁰

F. Automated Voting and Robo-Voting

Judge Leo Strine, former Chief Justice of the Delaware Supreme Court, has described robo-voting by investment advisors in particularly blunt terms:

[P]owerful CEOs 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.¹³¹

Judge Strine highlights the immense pitfalls of permitting investment advisors to simply defer to proxy advisory firms' recommendations, compounding the risk of conflicts of interest as well as their impact on shareholder voting. Unfortunately, robo-voting presents a particularly attractive

¹²⁸ See *supra* notes 12–15 and accompanying text (discussing the history of the proxy advisory firm industry).

¹²⁹ Shu, *supra* note 28, (manuscript at 12) (finding that the percentage of ISS customers voting in line with its recommendations more than 99.9% of the time increased from 5% in 2007 to 23% in 2017).

¹³⁰ 17 C.F.R. § 240.14a-2(b)(9)(i) (2021).

¹³¹ 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).

option for various cost-conscious investment advisers. Investment advisers must uphold their fiduciary duties by ensuring their proxy votes on behalf of clients maximize shareholder value. As a result, investment advisers are incentivized to outsource as much of this process as possible to proxy advisory firms, as they have lower information costs and can develop proxy voting policies in a cost-effective manner. If the fees charged by proxy advisory firms were not lower than the cost of producing the information in-house, investment advisers would never employ their services.

The incentive to cut costs by deferring to proxy advisory firm recommendations is much stronger for smaller mutual funds who tend to lack the resources and economies of scale found in their larger counterparts. Research supports the existence of this phenomenon, showing that smaller funds frequently vote in line with proxy advisory firms' recommendations.¹³² Although less widespread among larger funds the practice has still been used by a substantial proportion of mutual funds and other institutional investors.¹³³ In a survey of companies conducted during the 2017 proxy season, "the participating companies reported an average of 19.3% of the total vote is voted consistent with the adverse recommendations within three business days of an adverse ISS recommendation."¹³⁴

Professors Stephen Choi, Jill Fisch, and Marcel Kahan analyze mutual fund voting decisions in uncontested director elections to determine the voting shortcuts used on a low-

¹³² See Stephen J. Choi, Jill E. Fisch & Marcel Kahan, *Who Calls the Shots?: How Mutual Funds Vote on Director Elections*, 3 HARV. BUS. L. REV. 35, 67 (2013) ("We find that, although a substantial number of funds employ short cuts, appearing to presumptively follow the voting recommendations of either management or ISS, these strategies are more common in smaller fund families.").

¹³³ *Id.*; Shu, *supra* note 28, (manuscript at 13) (finding that the percentage of ISS customers voting in line with its recommendations more than 99.9% of the time increased from 5% in 2007 to 23% in 2017).

¹³⁴ FRANK M. PLACENTI, ARE PROXY ADVISERS REALLY A PROBLEM 8 (2018), https://accfcorgov.org/wp-content/uploads/2018/10/ACCF_ProxyProblemReport_FINAL.pdf [<https://perma.cc/TB7K-3Y8G>].

stake, high information cost issue. They find that smaller funds are more likely to vote in line with ISS and that 3.04% of sample assets vote in line with ISS recommendations more than 99% of the time, while 10.16% follow ISS recommendations more than 97.5% of the time.¹³⁵ Nonetheless, “[b]ecause of the large percentage of ISS ‘for’ recommendations and fund ‘for’ votes, it is perhaps more valuable to examine the relationship between ‘withhold’ recommendations and votes.”¹³⁶ Furthermore, 3.2% of sample assets vote “withhold” in accordance with ISS at least 90% of the time, while 8.07% vote in “withhold” in accordance with ISS at least 80% of the time.¹³⁷ This suggests substantial reliance on ISS’s recommendations by these investors. Professor Shu’s research goes further, utilizing the formatting of mutual funds’ N-PX form filings to determine their proxy adviser.¹³⁸ “In 2017, 29 investors managing over \$200 billion of combined assets almost entirely followed ISS recommendations. From 2007 to 2017, the fraction of robo-voting ISS customers grew from 5 percent to 23 percent.”¹³⁹ In addition, “ISS customers that provide any index product are 8 percent more likely to blindly follow ISS’s advice.”¹⁴⁰ The apparent willingness of certain institutional investors to

¹³⁵ Choi et. al, *supra* note 132, at 53.

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *Id.* (manuscript at 6). In a 2018 comment letter, BlackRock suggested the Securities and Exchange Commission conduct the analysis Shu has completed using his innovation of identifying proxy advisory firms used through the formatting of the N-PX form. BlackRock, Comment Letter on SEC Staff Roundtable on the Proxy Process, at 6 (Nov. 16, 2018) <https://www.blackrock.com/corporate/literature/publication/sec-roundtable-proxy-process-111618.pdf> [<https://perma.cc/Q6KR-7EW8>]. BlackRock called on the Commission to “compare the actual voting data in the N-PX files against the proxy advisor recommendations on shareholder proposals.” *Id.* (footnote omitted). Blackrock commented that the analysis may also highlight which firms appear to rely more heavily on proxy advisor recommendations as well as demonstrate the different voting policies of various firms and the lack of correlation in the voting data.” *Id.*

¹³⁹ Shu, *supra* note 28 (manuscript at 12).

¹⁴⁰ *Id.* (manuscript at 13).

follow ISS's recommendations, coupled with the increasing share of equities these institutional investors hold and ISS's long-held status as the dominant proxy advisory firm, demonstrates its immense influence.

ISS responds to these critiques by stating that its clients "often vote in accordance with our recommendations because those recommendations are tailored to their own views on corporate governance, not because they follow our advice without thought or intention."¹⁴¹ However, Professor Shu's analysis accounts for this, finding that after funds switch from Glass Lewis to ISS, their vote agreement with ISS increases "by 24 percent, and vote agreement with Glass Lewis decline immediately by 21 percent. Similarly, after a fund switches from ISS to Glass Lewis, its vote agreement with Glass Lewis rises immediately by 38 percent, and vote agreement with ISS decreases immediately by 23 percent."¹⁴² In addition, this pattern remains even after restricting "the sample of switching funds to those that do not change their proxy voting guidelines to further control for funds' voting preferences."¹⁴³ While most institutional investors do not appear to engage in robo-voting and likely oversee proxy advisory firms' actions, the substantial proportion that appear to conduct insufficient pose great cause for concern.

These findings cast additional doubt on the SEC's strategy of mandating heightened conflicts of interest disclosures in order to address the conflicts of interest within the proxy advisory firm market. If a single study identified institutional investors in control of "over \$200 billion of assets"¹⁴⁴ that appear comfortable with effectively ceding proxy voting control to the whims of ISS, there is little indication that they will closely scrutinize additional conflicts of interest disclosures. The convenience and decreased costs of fully outsourcing proxy voting presents a tantalizing prospect.

¹⁴¹ Institutional S'holder Serv., *supra* note 23, at 2.

¹⁴² Shu, *supra* note 28 (manuscript at 3).

¹⁴³ *Id.*

¹⁴⁴ *Id.* (manuscript at 12).

As alluded to by Professor Shu's analysis, robo-voting appears particularly pervasive in passive index funds, which are designed to match the performance of a certain financial index, such as the S&P 500 or the Russell 3000.¹⁴⁵ The collective action problem decreases the profitability of conducting increased diligence on shareholder voting.¹⁴⁶ Due to the diffuse ownership structure of many companies, even large institutional investors will not be able to singlehandedly influence the outcome of shareholder voting and therefore be unable to profit from increased diligence unless they can garner sufficient support for their positions.¹⁴⁷ Nonetheless, active funds can expand resources into governance quality analysis as part of their pre-investment diligence, allowing them to profit by investing in companies with superior corporate governance.¹⁴⁸ They can also continuously reevaluate their portfolios based on such concerns. On the other hand, "[b]ecause a passive fund seeks only to match the performance of a market index—not outperform it—the fund lacks a financial incentive to ensure that the companies in their portfolio are well run."¹⁴⁹ Since these funds do not possess any competitive advantage in providing higher returns for their clients, they are left to compete on cost.¹⁵⁰ Consequently, expenditures on proxy research and analysis merely drives up costs, necessitating higher fees, and decreasing demand for the fund.¹⁵¹ Professor Dorothy Shapiro Lund proposes resolving this issue by prohibiting index and other passive funds from voting their shares.¹⁵²

¹⁴⁵ Giovanni Strampelli, *Are Passive Index Funds Active Owners? Corporate Governance Consequences of Passive Investing*, 55 SAN DIEGO L. REV. 803, 809 (2018) (defining "passive index fund").

¹⁴⁶ Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 511 (2018).

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *See id.* at 512.

¹⁵¹ *Id.*

¹⁵² *See id.* at 528–29.

Professors Edward Rock and Marcell Kahan, on the other hand, argue that investment advisers who manage the “bulk of assets held in index funds . . . have among the *best* incentives to acquire information.”¹⁵³ Although “index funds do not gain a competitive advantage over other index funds by casting informed votes,” index fund advisors still “have incentives to cast informed votes because these votes may raise their fees from assets under management.”¹⁵⁴ While the fees amount to a far lower percentage of returns than those of active fund advisers, they still align the interests of index fund advisers and their clients by allowing the advisers to profit from improvements in corporate governance that increase shareholder value.¹⁵⁵ Moreover, although index funds suffer from the collective action problem and cannot single-handedly influence votes, their voluminous holdings still grant them far more influence than most investors.¹⁵⁶ Nonetheless, the prevalence of robo-voting in index funds as compared to active funds suggests that these incentives may still be insufficient.

Much of the correlation between proxy advisory firm recommendations and investment advisers’ voting may be explained by the prevalence of trivial votes that are unlikely to impact shareholder value, meaning that the crux of the issue lies with investment advisers’ actions in high-stakes votes. A proxy fight, which places control of a company on the ballot, is paradigmatic of a high-stakes vote. As analyzed by Professors Edwin Hu, Joshua Mitts and Haley Sylvester, the 2020 proxy fight at GameStop illustrates index funds’ low prioritization of voting their shares.¹⁵⁷ New guidance issued

¹⁵³ Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B.U. L. REV. 1771, 1776 (2020).

¹⁵⁴ *Id.* at 1792.

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* at 1793.

¹⁵⁷ Edwin Hu, Joshua Mitts & Haley Sylvester, *The Index-Fund Dilemma: An Empirical Study of the Lending-Voting Tradeoff* 16–17 (Columbia L. & Economics Working Paper No. 647, 2020), <https://ssrn.com/abstract=3673531> [<https://perma.cc/2YDS-J8C8>].

by the Commission in 2019¹⁵⁸ has given funds “more legal flexibility” in making the tradeoff between voting and lending their shares.¹⁵⁹ This has heightened the incentive for index funds to profit from lending their shares rather than voting them. In line with these incentives, index funds significantly increased the shares made available for lending in 2020¹⁶⁰ despite the upcoming proxy fight, resulting in a likely suboptimal outcome:

The GameStop case is a good example of where individually rational behavior can lead to suboptimal outcomes. The two activists on the ballot in June had been on the ballot previously. In prior years, the institutional investors holding GameStop’s stock had opposed these candidates. And seeing as the candidates are seeking to cut costs and repurchase shares, the institutions likely determined that these candidates would not create value for the firm in the long term. But this year, the institutions did not show up to vote—and the activist’s candidates won.¹⁶¹

While one can argue that this practice demonstrates investment advisers acting in the best interests of their clients, it also illustrates the insufficient incentives for them to diligently research and vote shares in a manner that will increase long-term shareholder value. This lack of priority given to voting shares likely carries over to overreliance on proxy advisory firms’ voting recommendations.

Fortunately, the mere utilization of proxy advisory firms does not preclude independent analysis and research by investment advisors, as the majority of funds do not consistently vote in line with their proxy advisory firms’ recommendations.¹⁶² For example, Blackrock, one of the

¹⁵⁸ Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Investment Company Act Release No. 33,605, 84 Fed. Reg. 47,420 (Sept. 10, 2019).

¹⁵⁹ Edwin Hu, Joshua Mitts & Haley Sylvester, *supra* note 157, at 3.

¹⁶⁰ *Id.* at 17.

¹⁶¹ *Id.* at 17 n.45.

¹⁶² See Shu, *supra* note 28, at 23.

largest investment management companies in the world,¹⁶³ has evinced its emphasis on independent research and has denounced blind reliance on proxy advisory firms:¹⁶⁴

BlackRock analysts don't comb through every shareholder proposal. Rather . . . the firm uses the advisory services I.S.S. and Glass, Lewis & Company to help summarize proxy statements. Once those services have identified an issue, BlackRock assigns an analyst to it.¹⁶⁵

Thus, through the services of the proxy advisory firms, BlackRock saves the time and expense of individually researching noncontentious issues, applying its own reasoning for controversial matters, thereby ensuring its votes are targeted to maximize shareholder value.

While automated voting need not necessarily result in robo-voting¹⁶⁶ with no oversight by investment advisers over proxy advisory firms' recommendations, the need for an affirmative

¹⁶³ *Introduction to BlackRock*, BLACKROCK, <https://www.blackrock.com/sg/en/introduction-to-blackrock> [<https://perma.cc/8TJH-4BTZ>] (last visited Nov. 21, 2021).

¹⁶⁴ See Susanne Craig, *The Giant of Shareholders Quietly Stirring*, N.Y. TIMES (May 18, 2013), <http://www.nytimes.com/2013/05/19/business/blackrock-a-shareholding-giant-is-quietly-stirring.html> [<https://perma.cc/6HJ4-JL7E>] ("We reach our voting decisions independently of proxy advisory firms[.]").

The team does not follow the recommendations of any single proxy advisor. While we subscribe to research from several proxy advisory firms, their research is one among many inputs into our vote analysis process. We do not blindly follow proxy advisors' recommendations on how to vote. We use proxy research firms primarily to synthesize corporate governance information and analysis into a concise, easily reviewable format so that our analysts can readily identify and prioritize those companies where our own additional research and engagement would be beneficial.

BLACKROCK, PROXY VOTING AND SHAREHOLDER ENGAGEMENT FAQ 3 (2021), <https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-faq-global.pdf> [<https://perma.cc/6GJH-2KA8>].

¹⁶⁵ Craig, *supra* note 164.

¹⁶⁶ See *supra* Part III.C for a definition of robo-voting.

act by the investment adviser to override proxy advisory firms' recommendations appears to have proven tempting for many institutional investors. Nevertheless, as articulated by the Supreme Court, an investment advisor is a fiduciary, and "[c]ourts have imposed on a fiduciary an affirmative duty of utmost good faith, and full and fair disclosure of all material facts[.]"¹⁶⁷ Investment Advisers' fiduciary duties, coupled with Rule 206(4)-6,¹⁶⁸ likely prohibit them from completely outsourcing proxy voting responsibilities to their proxy advisory firm of choice. Under Rule 206(4)-(7), investment advisers must also "[a]dopt and implement written policies and procedures reasonably designed to prevent violation . . . of the Act and the rules that the Commission has adopted under the Act[.]"¹⁶⁹

In fact, even prior to the SEC's issuance of guidance regarding automated voting in 2019 and 2020, the Commission had already evinced its view that full delegation of proxy voting without oversight would be a violation of investment advisors' fiduciary duties under Rule 206(4)-7.¹⁷⁰ In Staff Legal Bulletin No. 20, the Commission stated that investment advisers must "adopt and implement policies and procedures that are reasonably designed to provide sufficient ongoing oversight of the third party in order to ensure that the investment adviser, acting through the third party, continues to vote proxies in the best interests of its clients."¹⁷¹ In addition, "investment advisers should establish and implement measures reasonably designed to identify and address the proxy advisory firm's conflicts that can arise on an ongoing basis[.]"¹⁷²

¹⁶⁷ *Sec. & Exch. Comm'n v. Cap. Gains Rsch Bureau, Inc.*, 375 U.S. 180, 194 (1963) (internal quotation marks omitted).

¹⁶⁸ Proxy Voting, 17 C.F.R. § 275.206(4)-6 (2021).

¹⁶⁹ Compliance Procedures and Practices, 17 C.F.R. § 275.206(4)-7 (2021).

¹⁷⁰ See SEC Staff Legal Bulletin No. 20 (June 30, 2014) <https://www.sec.gov/investment/slb20-proxy-voting-responsibilities-investment-advisers> [<https://perma.cc/6P39-ABBB>].

¹⁷¹ *Id.*

¹⁷² *Id.*

In 2019, the SEC provided additional guidance in the Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers.¹⁷³ The SEC delineated its view that

[a]n investment adviser that retains a proxy advisory firm to provide voting recommendations or voting execution services also should consider additional steps to evaluate whether the investment adviser's voting determinations are consistent with its voting policies and procedures and in the client's best interest before the votes are cast.¹⁷⁴

Some of these suggested additional steps include assessing “pre-populated” votes shown on the proxy advisory firm's electronic voting platform before such votes are cast, such as through periodic sampling of the proxy advisory firm's pre-populated votes,” and considering “whether a higher degree of analysis may be necessary or appropriate . . .” in certain situations, such as when “the matter is highly contested or controversial.”¹⁷⁵ The SEC also provided additional guidance regarding disclosure requirements for investment advisers in its 2020 Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers:

[A]n investment adviser that uses automated voting should consider disclosing: (1) [t]he extent of that use and under what circumstances it uses automated voting; and (2) how its policies and procedures address the use of automated voting in cases where it becomes aware before the submission deadline for proxies to be voted at the shareholder meeting that an issuer intends to file or has filed additional soliciting

¹⁷³ See Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Investment Company Act Release No. 33,605, 84 Fed. Reg. 47, 420 (Sept. 10, 2019).

¹⁷⁴ *Id.* at 47,424.

¹⁷⁵ *Id.*

materials with the Commission regarding a matter to be voted upon.¹⁷⁶

Implementing both the increased scrutiny of votes by proxy advisory firms and heightened disclosure requirements would amount to a substantial improvement in oversight by investment advisors.

Sampling the pre-populated votes allows investment advisors to uphold their fiduciary duties in a fairly cost-effective manner. Taking this step will not dramatically increase costs and may identify certain long-term biases in proxy advisory firms' recommendations. For example, if a proxy advisory firm with both voting advice and governance consulting arms consistently votes against an issuer's proposals as punishment for not purchasing consulting services, regular sampling is likely to determine that the proxy adviser may not be voting in shareholders' best interests on this matter. A "higher degree of analysis"¹⁷⁷ will thus be required prior to voting shares in that company. Engaging in a higher degree of analysis for highly controversial or contested matters also serves as a cost-effective oversight enhancement. The most contested matters are likely to be the most important to shareholders, and increased diligence in these matters will create outsized benefits. Nonetheless, this certainly will not catch all recommendations stemming from biases or errors. In addition, enhancing disclosures by investment advisers regarding their use of automated voting would bolster the disclosures required for proxy advisory firms under Final Rule 14a-2(b)(9)(i). Shareholders who have concerns regarding proxy advisory firms' conflicts of interest and general voting recommendations are free to select investment advisors who engage in greater diligence when voting their shares. Shareholders can also use these disclosures to decide whether

¹⁷⁶ Supplement to Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, 85 Fed. Reg. 55,155, 55,156 (Sept. 3, 2020).

¹⁷⁷ Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Investment Company Act Release No. 33,605, 84 Fed. Reg. 47,420, 47,424 (Sept. 10, 2019).

they would prefer not to grant an investment advisor authority to vote their shares at all.

Unfortunately, the guidance issued by the SEC remains extremely vague. Stating that investment advisers should “consider” additional diligence and disclosures when engaging in automated voting is a far cry from specific guidance that will prompt many investment advisers to significantly bolster their current practices.¹⁷⁸ While more specific guidance risks eschewing the nuances of investment advisers’ specific situations and practices, the guidance would greatly benefit from increased strictness. If the Commission desires to maintain a more general framework, as it has with its Final Rule conflicts of interest disclosures for proxy advisory firms,¹⁷⁹ this can still be accomplished without sacrificing more stringent guidelines. For example, the Commission could require any investment advisers engaging in automated voting to engage in their choice of certain reviews, such as sampling or analyzing contentious proposals, rather than merely suggesting a consideration of these potential steps. The same holds true for the guidance regarding disclosures on automated voting policies. Moreover, additional reforms appear necessary for ensuring shareholder value maximization through voting while continuing to minimize information costs.

IV. POTENTIAL REFORMS

A. Considerations for Developing Reforms

On June 1, 2021, SEC Chair Gary Gensler issued a statement regarding the 2019 Interpretation and Guidance and the 2020 Rule Amendments:

I am now directing the staff to consider whether to recommend further regulatory action regarding proxy

¹⁷⁸ *Id.* (Investment advisers “could consider whether a higher degree of analysis may be necessary or appropriate to assess whether any votes it casts on behalf of its client are cast in the client’s best interest.”).

¹⁷⁹ 17 C.F.R. § 240.14a-2(b)(3) (2021).

voting advice. In particular, the staff should consider whether to recommend that the Commission revisit its 2020 codification of the definition of solicitation as encompassing proxy voting advice, the 2019 Interpretation and Guidance regarding that definition, and the conditions on exemptions from the information and filing requirements in the 2020 Rule Amendments, among other matters.¹⁸⁰

The SEC Division of Corporation Finance, in turn, stated that it is “now considering whether to recommend that the Commission revisit the 2019 Interpretation and Guidance and the 2020 Rule Amendments.”¹⁸¹ The Division of Corporation Finance also announced a delay in its recommendation of relevant enforcement actions to the Commission:

[T]he Division of Corporation Finance has determined that it will not recommend enforcement action to the Commission based on the 2019 Interpretation and Guidance or the 2020 Rule Amendments during the period in which the Commission is considering further regulatory action in this area. . . . [I]n the event that new regulatory action leaves the 2020 exemption conditions in place with the current December 1, 2021 compliance date, the staff will not recommend any enforcement action based on those conditions for a reasonable period of time after any resumption by Institutional Shareholder Services Inc. of its litigation challenging the 2020 amendments and the 2019 Interpretation and Guidance.¹⁸²

¹⁸⁰ Gary Gensler, *Statement on the Application of the Proxy Rules to Proxy Voting Advice*, U.S. SEC. & EXCH. COMM'N (June 1, 2021) <https://www.sec.gov/news/public-statement/gensler-proxy-2021-06-01> [<https://perma.cc/6NLM-DRES>].

¹⁸¹ SEC Div. of Corp. Fin., *Statement on Compliance with the Commission's 2019 Interpretation and Guidance Regarding the Applicability of the Proxy Rules to Proxy Voting Advice and Amended Rules 14a-1(1), 14a-2(b), 14a-9*, U.S. SEC. & EXCH. COMM'N (June 1, 2021) https://www.sec.gov/news/public-statement/corp-fin-proxy-rules-2021-06-01?utm_medium=email&utm_source=govdelivery [<https://perma.cc/7NAC-8PQX>]

¹⁸² *Id.*

This Part discusses potential reforms for minimizing proxy advisory firms' conflicts of interest and their potential negative impact on shareholder value. It recommends changes to the SEC's rules and guidance for investment advisers and the proxy advisory firms they employ, with a focus on the costs and benefits of two specific recommendations: (i) the established proposal of prohibiting proxy advisory firms from providing corporate governance consulting services and (ii) a novel reform mandating that investment advisers employ the services of more than one proxy advisory firm. Rules requiring investment advisers to vote their shares in the best interests of their clients¹⁸³ stem from the recognition that effective corporate governance can dramatically impact shareholder value. In the same vein, the emergence of proxy advisory firms resulted from the recognition that outsourcing voting recommendations to firms specializing in their development was necessary for maintaining serviceable research costs. As such, for shareholders to truly benefit from reforms to proxy voting rules and/or guidance, the benefits of the reforms must exceed any costs associated with their implementation.

Prior to the establishment of proxy advisory firms, institutional investors tended to follow the so-called "Wall Street Rule—vote with management or sell . . ." ¹⁸⁴ This effectively ceded much of shareholders' influence over management and did not promote good governance. Rather than voicing their concerns and influencing board of directors' decisions, institutional investors utilized the sale of their shares as a nuclear option. As such, management would only suffer consequences if institutional investors deemed governance sufficiently poor to justify liquidating their position in the company. While this effectively prevented truly

¹⁸³ See Interpretive Bulletin Relating to Written Statements of Investment Policy, Including Proxy Voting Policy or Guidelines, 29 C.F.R. § 2509.94-2 (2008); Disclosure of Proxy Voting Policies Voting Records by Registered Management Investment Companies, Companies, Securities Act Release No. 8188, Exchange Act Release No. 47,304, Investment Company Act Release No. 25,922, 68 Fed. Reg. 6564, 6565 (Feb. 7, 2003) (to be codified at 17 C.F.R. pts. 239, 249, 270, 274).

¹⁸⁴ Dent, *supra* note 46, at 1288.

egregious, harmful practices, the Wall Street Rule led institutional investors to simply use management's support as a heuristic and clearly did not promote value maximization. Such a policy also exacerbates management's existing substantial degree of influence in a vote. Professor Yair Listokin explains this influence using "data on corporate votes on shareholder proposals sponsored by management or other parties,"¹⁸⁵ the majority of which occurred before the Commission's 2003 rules on proxy voting.¹⁸⁶ Professor Listokin explains that

[t]here are relatively few close votes on management-sponsored resolutions, but management wins a disproportionate number of the extremely close votes that do occur. The best explanation for this distribution of outcomes is that management first receives a noisy signal about the likely outcome of a resolution, bringing likely successes forward and avoiding likely failures.¹⁸⁷

Proxy advisory firms thus clearly benefit shareholders. Even with inherent flaws in these firms' recommendations, they provide shareholders with an alternative to management, which already has considerable influence over voting outcomes. By minimizing proxy advisory firms' conflicts of interest and maximizing investment advisors' cost-effective review of their recommendations, the use of proxy advisory firms can live up to its goal of increasing shareholder value.

Employing a cost-benefit analysis, the efficacy of reforms to the proxy advisory firm market depends on three factors: (i) the decrease in shareholder value resulting from conflicts of interest, (ii) how effectively the reforms eliminate the conflicts or mitigate their effects and (iii) the costs associated with

¹⁸⁵ Yair Listokin, *Management Always Wins the Close Ones*, 159 AM. L. & ECON. REV. 159, 168 (2008) ("The collected votes occurred in over 2,700 different companies, including all companies in the Fortune 500 and S&P 500.").

¹⁸⁶ See Disclosure of Proxy Voting Policies Voting Records by Registered Management Investment Companies, 68 Fed. Reg. at 6564.

¹⁸⁷ Listokin, *supra* note 185, at 180.

implementing the reforms. As described in Part III, the conflicts plaguing proxy advisory firms, coupled with insufficient oversight by their clients, present cause for concern, but the precise decrease in value they create is difficult to measure. Previous studies have shown decreases in shareholder value stemming from proxy advisory firms' recommendations; however, these studies did not isolate conflicts of interest as the explanatory variable. For example, Professors David Larcker, Allan McCall, and Gaizka Ormazabal analyze proxy advisory firms' recommendations on say-on-pay votes, finding that they have a "substantive impact" on say-on-pay voting outcomes.¹⁸⁸ In response to the influence of recommendations, "many boards of directors change their compensation programs before formal shareholder votes in a manner that better aligns the programs with the recommendation policies of proxy advisory firms."¹⁸⁹ However, "[t]he stock market reaction to these changes in compensation program is statistically negative."¹⁹⁰ The increased proportion of shares held by institutional investors, market concentration of proxy advisory firms, institutional investors' increasing reliance on proxy advisory firms' voting recommendations and management's incentive to respond to such recommendations converge to grant proxy advisory firms substantial influence over shareholder voting and corporate governance policies.

B. Separating Proxy Voting Advice and Governance Consulting

A simple solution for eliminating two of the most prominent conflicts of interest plaguing ISS, the country's dominant proxy advisory firm, is requiring it—along with all other proxy advisory firms—to separate its corporate proxy voting advice business from its corporate governance

¹⁸⁸ David F. Larcker, Allan L. McCall & Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58 J. L. & ECON., 173, 203 (2015).

¹⁸⁹ *Id.*

¹⁹⁰ *Id.*

consulting business.¹⁹¹ This would immediately eliminate perceptions of and actual bad faith in voting recommendations made to reward issuers who utilize its consulting services and punish those who do not. ISS would also be able to retain its governance ratings/rankings business, as separating the consulting business also removes any incentive for issuing bad-faith governance ratings.

Implementing this reform would be rather simple and would neither upend the proxy advisory firm industry nor impose additional costs on institutional investors. Many researchers and commentators are rightfully concerned that “proposals to regulate or limit the use of proxy advisors would exacerbate . . . concentration in the industry,”¹⁹² as “the costs of regulation are more easily borne by large firms than by small firms.”¹⁹³ However, this reform would not exacerbate industry concentration because it would primarily affect ISS, rather than its competitors, who “seek to differentiate themselves from ISS by stressing that they have no conflicts of interest because they do not offer corporate governance consulting services.”¹⁹⁴ As a result of the “firewall”¹⁹⁵ already implemented by ISS, separating ISS’s consulting business should be a fairly straightforward process that would allow its voting distribution and advice business to continue unhindered. As explained by ISS CEO Gary Retelny, ICS is a physically and legally distinct entity from ISS, with independent workflow and separately managed day-to-day operations.¹⁹⁶ Consequently, ISS should have no issues

¹⁹¹ See Exemptions from the Proxy Rules for Proxy Voting Advice, 85 Fed. Reg. 55,082, 55,098 n.210 (Sept. 3, 2020) (to be codified at 17 C.F.R. pt. 240) (acknowledging “letters from Garmin (recommending that the Commission require proxy voting advice businesses to separate their proxy advisory businesses from their consulting businesses”); Chanis, *supra* note 75 (recommending that the Commission prohibit proxy voting advice businesses from also providing consulting services to companies that are the subject of their proxy voting advice).

¹⁹² Dent, *supra* note 46, at 1308.

¹⁹³ *Id.* at 1308–09.

¹⁹⁴ *Id.* at 1320.

¹⁹⁵ See Institutional S’holder Serv., *supra* note 23.

¹⁹⁶ *Id.*

spinning off ICS, resulting in a genuine separation of the two businesses, rather than an inferior substitution in the form of a firewall.

While this solution would allow for increased confidence in ISS's voting recommendations, it fails to address several concerns. First, the Commission acknowledged this proposal and promptly disregarded it when issuing final rules on July 22, 2020.¹⁹⁷ The Commission only briefly described the comment letters advocating this reform—it neither discussed the merits and drawbacks of the proposal nor provided a rationale for disregarding it, suggesting that it did not seriously consider implementing such a regime.¹⁹⁸ There are numerous possible reasons for the lack of consideration, such as its great divergence from the Commission's 2019 proposed rules¹⁹⁹ and the Commission's potential preference for more gradual reforms; however, this does cast doubt on the feasibility of convincing the Commission to more seriously review this reform. Nonetheless, advocacy beyond several comment letters may prove more effective, and future commissioners may also prove more amenable.

Furthermore, a spin-off would not address additional conflicts of interest, including “providing voting advice on a matter in which its affiliates or one or more of its clients has a material interest” and “providing voting advice with respect

¹⁹⁷ See Exemptions from the Proxy Rules for Proxy Voting Advice, 85 Fed. Reg. 55,082, 55,098 n.210 (Sept. 3, 2020) (to be codified at 17 C.F.R. pt. 240) (acknowledging “letters from Garmin (recommending that the Commission require proxy voting advice businesses to separate their proxy advisory businesses from their consulting businesses”); Chanis, *supra* note 75 (recommending that the Commission prohibit proxy voting advice businesses from also providing consulting services to companies that are the subject of their proxy voting advice).

¹⁹⁸ See Exemptions from the Proxy Rules for Proxy Voting Advice, 85 Fed. Reg. 55,082, 55,098 n.210 (Sept. 3, 2020) (to be codified at 17 C.F.R. pt. 240)

¹⁹⁹ Compare Exemptions from the Proxy Rules for Proxy Voting Advice, 85 Fed. Reg. 55,082 (Sept. 3, 2020) (to be codified at 17 C.F.R. pt. 240) with Amendments to Exemptions from the Proxy Rules for Proxy Voting Advice, 84 Fed. Reg. 66,518, 66,526 (proposed Dec. 4, 2019) (to be codified at 17 C.F.R. pt. 240).

to a registrant's shareholder meeting while affiliates of the proxy voting advice business hold a significant ownership interest in the registrant."²⁰⁰ These conflicts will persist in all proxy advisory firms and appear extremely difficult to eliminate. As discussed below, however, improved monitoring by investment advisers and the elimination of robo-voting could serve to minimize their impacts. Requiring investment advisers to employ more than one proxy advisory firm presents a more effective strategy for reducing these conflicts than separating the advisory and rating businesses.

This solution also fails to address the rise in robo-voting by investment advisers. While eliminating two of the proxy advisory firm industry's most troubling conflicts of interest serves to decrease the risks of robo-voting, additional concerns such as other conflicts, errors and generic policies remain, and investment advisers should not be permitted to fully outsource their voting responsibilities. As such, this reform would need to be combined with stricter guidance regarding automated voting. Rule 206(4)-6 requires investment advisers to implement "procedures that are reasonably designed to ensure that [they] vote client securities in the best interest of clients."²⁰¹ The Commission's current guidance on adhering to this rule merely states that an investment advisor "should *consider* reasonable measures to determine that it is casting votes on behalf of its clients consistently with its voting policies and procedures,"²⁰² and suggests possible measures such as sampling pre-populated votes, considering additional information beyond voting recommendations, and engaging in additional analysis for highly contested matters.²⁰³ Replacing the word "consider" with "adopt" in this guidance would dramatically increase its effectiveness in discouraging robo-voting and thereby ensuring that investment advisers vote

²⁰⁰ Exemptions from the Proxy Rules for Proxy Voting Advice, 85 Fed. Reg. at 55,096.

²⁰¹ Proxy Voting, 17 C.F.R. § 275.206(4)-6 (2021).

²⁰² Commission Guidance Regarding Proxy Voting Responsibilities of Investment Advisers, Investment Company Act Release No. 33,605, 84 Fed. Reg. 47,420, 47,424 (Sept. 10, 2019) (emphasis added).

²⁰³ *Id.* at 47,424.

their clients' shares in their best interest. Leaving investment advisors the flexibility to determine the procedures they find most effective appears appropriate, so long as they implement procedures similar to those listed in the guidance. The Commission should also consider including the receipt of voting recommendations from more than one proxy advisory firm as a possible procedure and may even consider adopting a rule requiring this.

C. Requiring Investment Advisors to Receive Voting Advice from More than One Proxy Advisory Firm

As discussed above, mitigating conflicts requires a cost-benefit analysis. A novel solution for eliminating conflicts of interest within the proxy advisory firm market, albeit at a higher price, entails requiring investment advisers who choose to use a proxy advisory firm's voting advice services to employ the services of an additional firm. Investment advisers would then be required to internally review any conflicting voting recommendations from the two firms they elect to employ. This strategy would cleanse the voting recommendations of any conflicts of interest unique to a specific proxy advisory firm. Consider, for example, an investment advisor who decides to receive voting recommendations from both ISS and Glass Lewis. Glass Lewis's recommendations will not be tainted by a desire to reward companies that pay for ISS's governance consulting services, while ISS's recommendations will not be influenced by any of Glass Lewis's potential conflicts of interest.

Conflicts stemming from a desire to support proposals benefitting proxy advisory firms' clients would also be mitigated to the extent that the two proxy advisory firms serve different clients. As such, the more variance between the two firms' client bases, the more effective this would be for eliminating remaining conflicts. The selection of proxy advisory firms by investment advisers will depend on their preferences and priorities. A large investment management corporation like Blackrock, which already "subscribe[s] to

research from several proxy advisory firms . . .”²⁰⁴ and uses their analysis to “identify and prioritize those companies where [its] own additional research and engagement would be beneficial[.]”²⁰⁵ would be less cost conscious and would likely prioritize research quality and maximizing variance between client bases. A cost-conscious passive fund, on the other hand, would be incentivized to select proxy advisory firms with the lowest fees and with minimum variance in order minimize its required internal review of divergent recommendations. The added costs of a second proxy advisory firm and additional internal review may present too great a burden for passive funds. For these funds, simply seeking to minimize proxy advisory firms’ conflicts of interest may present a more effective solution.

Requiring investment advisors to receive voting recommendations from more than one proxy advisory firm might pressure these firms to reduce their fees. All else held equal, needing to solicit services from two separate firms would double the cost of receiving voting recommendations. This increased cost would likely encourage certain investment advisors to eschew the voting recommendations, and proxy advisory firms would need to lower their prices if they wish to retain these clients. Proxy advisory firms, meanwhile, would be able to retain full revenues from their lucrative vote management services, as these would still only be provided by one firm.

V. CONCLUSION

Informed shareholder voting serves as a crucial check on the power of boards of directors, allowing shareholders to hold directors accountable and introduce proposals they believe will increase the value of the company. Historically, difficulties in organizing, the collective action problem and management’s immense influence in voting outcomes²⁰⁶ have tilted the balance of power away from shareholders. In

²⁰⁴ BLACKROCK, *supra* note 164, at 3.

²⁰⁵ *Id.*

²⁰⁶ *See generally* Listokin, *supra* note 187.

addition, the “Wall Street Rule,”²⁰⁷ adopted as a heuristic by many institutional investors, according to which shareholders either vote with management or sell, has decreased the impact of shareholder voting and failed to maximize shareholder value.²⁰⁸ The SEC’s 2003 rules requiring investment advisors to implement policies designed to ensure they vote shares in their clients’ best interests²⁰⁹ served as a watershed moment for the proxy advisory firm industry and a prime opportunity for improving corporate governance and increasing shareholder influence. Independent evaluation of every vote for each institutional investor’s many positions is clearly cost-prohibitive, inefficient and unnecessary. The provision of voting recommendations and research by proxy advisory firms therefore amounts to a crucial service, as these firms can compile information at a sufficiently low cost to allow for informed shareholder voting and decreased reliance on management.

Nevertheless, the proxy advisory firm industry remains far from perfect, and safeguarding shareholder voting must be prioritized. Effective regulation of this industry necessitates a cost-benefit analysis, and the current status quo remains wholly inadequate. Blatant, easily addressable conflicts of interest have persisted and demonstrably influenced voting recommendations.²¹⁰ Requiring increased conflicts of interest disclosures, while a step in the right direction, fails to account for the incentives that investment advisors face in addition to obtaining the most accurate information possible—namely, cost and protecting themselves from potential legal liability. As such, mandating that both proxy advisory firms and investment advisers take concrete actions is necessary to meaningfully address persistent conflicts of interest.

²⁰⁷ See Dent, *supra* note 46, at 1288.

²⁰⁸ *Id.* at 1288–89.

²⁰⁹ See Disclosure of Proxy Voting Policies Voting Records by Registered Management Investment Companies, Companies, Securities Act Release No. 8188, Exchange Act Release No. 47,304, Investment Company Act Release No. 25,922, 68 Fed. Reg. 6564 (Feb. 7, 2003) (to be codified at 17 C.F.R. pts. 239, 249, 270, 274).

²¹⁰ See Li, *supra* note 94, at 2961.

Separating the voting advice business from the governance consulting business eliminates two prominent conflicts of interest without raising costs for investment advisors. Combining this with periodic sampling of voting recommendations and enhanced analysis of contentious issues by investment advisors will dramatically enhance the reliability of proxy voting at a reasonable cost. Alternatively, requiring voting recommendations from more than one proxy advisory firm, a practice already adopted by certain investment advisors,²¹¹ would mitigate most conflicts, although at an increased cost. Each solution possesses inherent tradeoffs; however, the benefits of securing shareholder value maximization through proxy voting cannot be understated.

²¹¹ See BLACKROCK, *supra* note 164.